Regulatory Institutions and Policy Choice

Explaining Financial Fragility
in South Korea before the 1997 Crisis

Yong-Ki Kim

Thesis submitted in fulfilment of the requirement of the PhD

In International Relations,

London School of Economics and Political Science,

University of London

2003

Abstract

The question raised in this thesis is "In the context of the developmental state, what is the explanation for Korea's financial regulatory failure, which contributed to the 1997 crisis?" There have been two dominant explanations, i.e. exogenous and endogenous. The first one cites the exogenous breakdown of the developmental state. Wade (1998, 2000) argues that the Korean government was forced by the US government to remove capital controls. He claims that such financial regulatory liberalization was not consistent with the developmental state model. The second one focuses on endogenous forces, especially the growing influence of business over government (Haggard 2000).

The thesis argues that the latter explanation is the more convincing. Three financial liberalization issues, i.e. US pressure on the Korean foreign exchange rate, Financial Policy Talks between the US and Korean governments and multilateral talks surrounding Korea's entry to the OECD, and key prudential regulatory measures before the crisis are investigated. It shows that the exogenous explanation is basically irrelevant in explaining regulatory outcomes. The outcomes are consistent with the preference of the private sector, in particular, *chaebol.*

This thesis differs, however, from the Haggard argument, in arguing that the regulatory capture was facilitated by Korea's regulatory institutional centralization within the Finance Ministry. Due to the historical proximity of the Ministry to the business sector, regulatory centralization left the state more exposed to policy capture. Institutional centralization had been a principal requirement for the developmental state in the literature. However, the thesis argues that such centralization in the financial regulatory area proved to be a weakness rather than a strength in the period when financial liberalization was occurring. The thesis has also investigated in much more detail the different regulatory policies applied to different financial sectors. The difference resulted from different business-government balance of power by sector.

Acknowledgements

This study has accumulated many debts of gratitude to those who have supported my study in the U.K.

My first and foremost appreciation is to my beloved father, who passed away on 14 June 2001, and to my beloved mother. I shall always recall with the deepest gratitude the support they gave me, even during difficult times.

I am grateful beyond words to my own family - my wife, Jeong-Hwa, my son, Dae-Ryong, and my daughter, Ga-Yoon - for their love and understanding during the long days and nights of my belated study. My older brother, Seung-Ki, also supported me with confidence.

I am deeply grateful to Dr. Andrew Walter for his thoughtful and careful supervision of my work. Without him, it would have been almost impossible to bring this study to a conclusion.

I also wish to acknowledge the British Foreign and Commonwealth Office for an award, which supported my initial two years' study at the LSE. The Department of International Relations and the Scholarships Office at the LSE also gave me generous financial support after that time.

I have now resumed my career as a newspaper journalist and am convinced that my studies at the LSE will bring a new perspective to my work, in explaining international political economy issues. I feel privileged to have had an opportunity to study here and warmly thank my supervisor and my family and those who, although not mentioned by name, have also provided great support during the writing of this PhD thesis.

YKK

INDEX TO ABBREVIATIONS

BAI	Board of Audit and Inspection
BIS	Bank for International Settlements
BoK	Bank of Korea
BoP	Balance of Payments
CB	Convertible Bonds
CD	Certificates of Deposit
CP	Commercial Paper
DIC	Deposit Insurance Co.
DMBs	Deposit Money Banks
DR	Depositary Receipts
EPB	Economic Planning Board
EU	European Union
FCG	Fund for Credit Guarantees
FCM	Fund for Credit Management
FDI	Foreign Direct Investment
FKI	Federation of Korean Industries
FRB	Federal Reserve Board
FSC	Financial Supervisory Commission
IFCs	Investment Finance Companies
ISI	Import Substitution Industrialization
IMF	International Monetary Fund
ITCs	Investment Trust Corporations
KAMCO	Korea Asset Management Corporation
KDB	Korea Development Bank
KEB	Korea Exchange Bank
KFB	Korea First Bank
Ko-exim	Export and Import Bank of Korea
L/C	Letter of Credit
Libid	London Interbank Bid Rate
Libor	London Interbank Offered Rate
LLR	Lender of Last Resort
M&A	Merger and Acquisition
MoF	Ministry of Finance
MoFE	Ministry of Finance and Economy
MCI	Ministry of Commerse and Industry
NBFIs	Non-BanK Financial Institutions
NICs	Newly Industrialised Countries
OBS	Office of Bank Supervision
OIS	Office of Insurance Supervision
OSS	Office of Securities Supervision
RP	Repurchase Agreement
SME	Small and Medium Size Enterprise
SOC	Social Overhead Capital
S&P	Standard and Poor's

Table of Contents

Part 2 Case Studies

Tables

Charts

Introduction

Questions

What explains the financial regulatory failure in South Korea (hereafter referred to as "Korea"), which contributed to the 1997 banking and foreign currency crisis? How should we understand the financial regulatory failure in Korea in the context of the developmental state?

Since the 1997 crisis, the question as to why Korea was disastrously affected has been addressed in the literature from a number of different perspectives. Haggard (2000) classified the literature on the causes of the crisis into three distinct schools: fundamentalists, who focused on macroeconomic and particularly exchange rate mismanagement (Noland et al. 1998; Kahler 1998; Corsetti, Pesenti, and Roubine 1998), internationalists, who emphasized the volatility of international capital markets (Obstfeld 1996; Radelet and Sachs 1998; Baig and Goldfajn 1999), and new fundamentalists, who focused on regulatory and structural problems, in particular in the financial sector (Krugman 1998; Caprio 1998; Goldstein, Kaminsky, and Reinhart 2000).

Of the few points on which the literature has almost unanimously converged, one is that the country failed to adopt an adequate regulatory policy, that is, prudential regulation/ supervision was unable to cope with the consequences of financial sector liberalization. Moral hazard, which is inherent in financial institutions, resulted in risky investments by the financial institutions (McKinnon and Pill 1998). Weak prudential regulatory policy allowed an accumulation of short-term external liabilities far exceeding the level of international reserves held at the start of the crisis. It also led to a build-up of problem loans to corporates in the banking and non-banking financial sector, including loans that were vulnerable to macroeconomic slowdown.

Even those who attribute the crisis to financial panic among international creditors (e.g., Radelet and Sachs 1998) recognise that the vulnerability was crucial in having induced the panic in East Asia in 1997. By all accounts, financial regulatory failure is indicated as crucial in causing the vulnerability of the country's financial system and thus in contributing to the outbreak of the crisis, though the literature cites divergent immediate explanatory variables.

The role of the government in Korea's economic development is at the centre of explanations of the regulatory failure. Influential policy-makers, e.g, Alan Greenspan, Chairman of the Federal Reserve Board in the US, claim that the economic model in the region, in particular in relation to the financial system, was problematic. Government-directed investment, using the banking system to finance investment is singled out for blame (Testimony of Chairman Alan Greenspan at the US Senate, March 3 1998). Many economists agree (Frankel 1998; Wolf 1998). Most of Korea's senior policymakers also seem convinced (e.g. Financial Supervisory Commission 1999).

The economic model on which Korea was often said to be based, i.e., the developmental state model, has a premise that a "strong state" has "both the capacity and instruments to discipline business, and the business–government relationship was structured to limit the opportunities for particularistic rent-seeking or for business control over the policy agenda" (Haggard 1998: 81; see also Johnson 1982; Amsden 1989; Evans 1995).

Political economists revisited the developmental state model and give an opinion on the role of the model in relation to the crisis. They have tried to identify explanatory variables for the regulatory failure.[1] There have been mixed responses to critiques of that model. Some (e.g., Wade 1998, 2000; Chang 1998) consider that financial regulatory liberalization, in particular the removal of controls in capital account, was not consistent with the developmental state. They argue that the Korean government was forced by US government pressure to do so and the developmental state lost its capacity to coordinate borrowings and investments, which was essential for the country's economic well-being. The explanatory variable for the regulatory failure in this argument is the external factor surrounding the developmental state, i.e. the US government pressure, which undermined the developmental state model.

[1] Walter (2001) indicates, "political economy should focus on explanation of outcomes rather than optimal welfare considerations." In fact, Asian economic growth has posed questions about sources, rather than consequences (Pempell 1999: 138). Also, Kong (2000) argues, "While economic institutionalists have focused on tracing superior economic outcomes to the government's interventionary instruments (especially the impact of government policy on relative prices), political institutionalists have explained the factors that enabled the state to attain and sustain its dominant social position without

Others do not necessarily deny that financial sector liberalisation had a detrimental effect on the economy and that it was adopted in part because of external factors. They recognise, however, that "the sources of economic vulnerability were not limited to particular policies but were rooted in basic features of the business-government relationship" (Haggard 2000: 38; Also see Woo-Cumings 1999; Kang 2002). They consider that the balance of power in business-government relations in the developmental state has tilted towards business. Financial reform was "captured" in its basic design as well as its implementation and enforcement due to political interference, i.e. the growing influence of private interest on government decisions; accordingly, a significant set of risks were posed by weakly-regulated liberalization (Haggard 2000). In this argument, the explanatory variable for the regulatory failure is endogenous in the model, the close business-government relations; the state was not "strong" enough to be insulated from private interest, unlike what had been previously believed, in the process of regulatory liberalization. This argument appears to follow a classic line of liberal political economy i.e. Olson (1982), which indicates that over time, autonomous states are captured by special interests.

This research argues that the endogenous factor approach is more convincing in explaining the regulatory failure. What is overlooked in the approach is, however, an explanation of how the supposedly competent and autonomous bureaucracy of the state has responded and succumbed to private preference over financial regulatory outcomes. If politicians have relied on particular firms and groups for political support at the macro

succumbing to the negative effects commonly associated with state power" (p. 1).

level, as Haggard argues (2000), thus giving the private sector growing influence, how did the relevant bureaucracy, i.e., the financial regulatory authorities, allow the perverse private sector influence over policy outcomes?[2] Thus, this research focuses on the impact of government-bureaucracy-industry triangle on financial regulatory policy in Korea.

Existing explanations have been incomplete in addressing such a question. Kang (2002) focuses on "larger institutional environment within which actors operate" without looking at "microanalytical explorations of political economy" (p. 202). Haggard (2000) pays attention to explanatory variables for part of particular outcomes, such as entry liberalization to the merchant banking sector, but most of his work is concerned with "business-government relations and their effect on the policy environment" (p. 15). In this regard, both Haggard (2000) and Kang (2002) are similar in terms of considering the effects of change in the "larger institutional environment" on policy outcomes. However, such broader approaches toward financial regulatory failure may be vulnerable to the criticism that "they have not identified the right institutions or those most important to the outcomes at hand."[3] Also, Evans (1997) indicates, "Depending on the internal structure of the state, similar business-government networks have different implications ... for the construction of joint public-private projects in pursuit of economic transformation" (p.

---

[2] This question is drawn from Haggard (2000: 39). While referring to corruption, he indicates, "What such indices do not capture is the broader political relationships between politicians and the private sector. These include the extent to which politicians rely on particular firms and groups for political support, the transparency of business-government relations, and whether institutions encourage healthy or perverse private-sector influence on policy."

[3] Hall (1998) argues that "[I]t is not national-level institutions that most affect economic policy or performance but sectoral or regional-level institutions" (p. 183). Also see Campbell et al. 1991; Hollingsworth et al. 1994

66).

In short, this thesis focuses on the following questions, which are raised but left unanswered in the literature. How should we understand financial regulatory failure in Korea in the context of micro business-government relations, i.e, the *chaebol*-financial sector–financial regulatory authorities relations? How was the then "institutional configurations" of financial regulatory policy affected by private preference? Was the strong state bound to succumb to interest group capture as Olson (1982) argues?

Thesis Structure

This thesis consists of two parts. The first part (Chapters 1 - 4) sets out an overall examination of the financial regulatory institutional framework and its characteristics, and financial regulatory outcomes in Korea, 1960 to 1997, in the context of the developmental state. The first chapter is a detailed literature review of the role of the government in economic growth and financial liberalization (and regulation). It sets out an analytical framework for the explanation of the financial regulatory outcomes. The second chapter is a description of the emergence of a financial regulatory institutional framework in Korea, the structural feature of the regulatory framework, and its unsuccessful adaptation to the new situation, formed by financial liberalization including capital account liberalization.

The third and fourth chapters are an investigation of financial sector liberalization, in particular focusing on capital account liberalization, and weak prudential regulation over the financial sector before the crisis. If Chapter 2 focuses on the bureaucracy (a defining element of the developmental state), i.e., characteristics of the regulatory authorities, Chapters 3 and 4 look closely at the impact of close business-government relations (another defining element of the state) on regulatory outcomes. We investigate how international pressure and domestic private preference affected the regulatory institutions in producing particular regulatory outcomes.

In this regard, these two chapters are a test of dominant explanations for the regulatory failure, i.e., an exogenous explanation with the focus on US government pressure (Wade and Veneroso 1998; Wade 2000; Chang 1998) and an endogenous one with regulatory "capture" (Haggard 2000; Kang 2002). Three issues of capital account opening, i.e. the foreign exchange rate system, Financial Policy Talks, Korea's entry to the OECD (in Chapter 3), and key prudential regulatory outcomes, e.g., BIS capital adequacy requirements, large exposure limits and foreign currency liquidity ratios (in Chapter 4), are examined.

The second part of this thesis (Chapters 5 –7) consists of detailed investigations of different financial sectors, i.e., deposit money banks (DMBs), development banks, and merchant banks, and a conclusion. These chapters examine regulatory policy applied to different financial sectors in the domestic context of regulatory authorities–financial sector–business (*chaebol*) relations. Three questions in particular are addressed in those chapters. First, why were divergent regulatory policies applied to the different segments of the financial sector? Secondly, how did each sector with different forms of ownership and political influence manoeuvre in such different regulatory environments? Thirdly, what was the role of each segment in creating vulnerability in the financial system? Chapter 8 concludes and offers a contribution of this thesis to the literature.

Brief Introduction to Each Chapter

Chapter 1 identifies relevant theoretical approaches regarding the role of the government in East Asian economic development and the previous debate on financial repression and liberalization in the context of business-government relations. It argues that recent analyses of financial regulatory outcomes do not pay sufficient attention to particular regulatory institutional frameworks in the state while they emphasize the growing influence of private business in business-government relations at a wider level. It highlights the particular regulatory outcomes to be explained throughout this thesis, chosen on the basis of their relevance to the increased financial vulnerability of the financial system. This chapter is supplemented by three appendices: indicators of capital flows before the banking and foreign currency crisis showing the vulnerability of the economy to the systemic risks (Appendix 1.1 and 1.2); and major events occurring during the crisis period (Appendix 1.3).

Chapter 2 describes the regulatory framework in Korea. It examines the weakness of its financial regulatory institutions. Contrary to previous descriptions of the institutions (e.g., World Bank 1993), this study argues that centralization of the authority among the regulatory framework turned out to be an impediment to the introduction and implementation of sound prudential regulation. It is also claimed that institutional inertia of the regulatory institutions was serious. The inertia resulted from the bureaucratic interest of related authorities, i.e., the Finance Ministry (the MoF and the MoFE) and the Bank of Korea (BoK), in addition to the growing influence of private interest. This institutional inertia was a major obstacle, which prevented the country from adapting a new regulatory framework in accordance with the impending problem of foreign currency over-borrowing.

Chapter 3 examines and explains financial sector liberalization, in particular focusing capital account liberalization as it was before the crisis. Existing competing approaches to explaining economic policy are tested in the three major capital account opening issues, i.e. the change in the foreign exchange rate system, Financial Policy Talks between US and Korean governments, and Korea's entry to the OECD. The reason why capital account opening, among overall financial sector liberalization issues, is examined in detail is twofold. First, capital account opening was the most crucial policy change among others in terms of rendering the then prudential regulatory framework insufficient, exacerbating moral hazard and foreign currency over-lending (or over-borrowing) problems. Second, it has also been argued that the removal of capital controls caused the dismantling of the developmental state, and that the removal was forced by US government pressure (Wade and Veneroso 1998).

Accordingly, the area of capital account liberalization policy was where international and domestic forces interacted with the government in order to get their preferable outcomes, and the policy was very relevant to the outbreak of the foreign exchange crisis. In this regard, the policy area of capital account opening should be a crucial case for the testing the strong state argument. Moreover, the issue of domestic financial liberalization, which was by and large affected by business-government relations in the domestic context, is dealt with in detail in the second part of this thesis.

Chapter 4 examines and explains prudential regulation/supervision put into practice prior to the crisis in Korea. The influence of business over prudential regulatory policy outcomes was more evident than that over capital account liberalization outcomes. Evidence shows that the regulatory authorities in the then framework were treating financial institutions with regulatory forbearance.

Chapter 4 also investigates how prudential supervision in a narrow sense, such as licensing and on-site examination, was distorted, due to the growing influence of business. Distortion of key prudential rules, such as the Bank for International Settlements (BIS) capital adequacy requirements, loan classification, and large exposure limits, in their design, implementation and enforcement are investigated. What was remarkable is that the influence of big business was even strengthened by the centralization of regulatory authority within the Finance Ministry. The Ministry's policy frequently impeded the policy objective of stabilization including prudential regulation, which was defended by the BoK and the Office of Bank Supervision (OBS).

Chapter 4 reveals crucial evidence showing that government involvement in banking, based on the close business–government relations in the developmental state, was causing a moral hazard problem in financial institutions, rather than restraining it, and distorting the lender of last resort function of the country's central bank. A significant amount of foreign currency deposits (*de facto* international reserves), over US$ 30 billion, with Korean financial institutions were made by the BoK on the orders of the Finance Ministry for reasons of macroeconomic stability and financial and corporate sector international competitiveness.

Chapters 5-7 address issues relating to regulatory divergence over different financial sectors, i.e., deposit money banks, development banks, and merchant banks, in the context of business-government relations.

Chapter 5 deals with the regulatory policy applied to the DMBs. It is argued that though it was frequently disturbed by the Finance Ministry, the policy objective of the BoK, stabilization, led to a relatively strict regulatory policy to the DMBs. It was not deniable however that ultimately *chaebol* was powerful. Chapter 6 examines the regulatory policy applied to the development banks, which was different from that applied to the DMBs. Development banks were a major source of long-term financing of *chaebol* and were wholly-owned by the government. The development banks were not subject to the policy objective of stabilization of the BoK. Rather, the banks, in particular the Korea Development Bank, often impeded the object of the BoK's policy objective, stabilization, in order to increase the source of corporate finance.

Chapter 7 is the last part of the investigation into the regulatory divergence over different financial sectors. It considers closely the dominant argument about the causes of the regulatory failure in Korea, i.e., "capture of liberalization" (Haggard 2000). The argument is based on the experience of regulatory liberalization over the merchant banking sector, in particular the licensing process of new entrants. Chapter 7 argues, however, that such an explanation gives only part of the answer for the regulatory failure applied to merchant banks. It notes that the merchant banking sector has enjoyed *de facto* a regulatory-free situation since its inception in the 1970s, when the state was "strong" - in other words, when the government was so dominant that it was largely autonomous of private business interest in policy decisions. This implies that part of the reason for the regulatory failure can be also traced to the fundamental limitation of financial repression with close business-government relations exerted by the strong state in the 1960s and 1970s.

Chapter 8 is the summary of the thesis and implications for the literature. The thesis is distinguished from present research in terms of focusing on the micro level institutional configurations of financial regulation and examining key regulatory outcomes in detail, in the context of business-government relations. The major finding on the financial regulatory institutions in this thesis is, contrary to the commendation on good "institutional mechanisms" and "effective prudential regulation" in the famous World Bank's *East Asian Miracle* report in 1993, that the developmental state institutions left the state exposed to special interests. Centralization of regulatory institutions with the Finance Ministry turned out to be a critical weakness in implementing prudential regulatory measures. It also notes that different financial regulatory outcomes over financial sectors resulted from different balance of power in business-government relations.

In particular, regulatory centralization enabled private interest to affect easily the regulatory outcomes due to the historical proximity of the Finance Ministry to the business sector. As financial liberalization including capital account liberalization advanced, the financial system without a suitable prudential regulatory framework and policies became volatile to systemic risks. This may imply that the developmental state with such close business-government relations and a developmental characteristic was weak in establishing prudential regulatory system.[4]

It should be noted that it was possible to adopt relatively sound regulatory policy in the aftermath of the crisis by an independent regulatory authority, the Financial Supervisory Commission. This suggests that a major crisis was necessary for this fundamental institutional reform/ breaking of bureaucratic inertia to be successful, as Olson (1982) argues. This implies that delegation of the authority for prudential regulation with independent regulatory authority is crucial. This inference again tells us of the importance of configurations of regulatory institutions at the micro level in having sound prudential regulatory outcomes. A major crisis was eventually a necessary precursor of effective regulatory/bureaucratic reform in Korea and this fits well into

[4] "Developmental characteristic" refers to the assumption that developmental states define their missions primarily in terms of long-term national economic enhancement. They actively and regularly intervene in economic activities with the goal of improving the international competitiveness of their domestic economies (Pempel 1999: 139).

Olson's 1982 thesis, which says that states can be autonomous of interest groups in the wake of major crises.

Justification for a Single Country Case Study

This thesis is a single country case study. Thus, it is likely to encounter the criticism that "the single observation is not a useful technique for testing hypotheses or theories" (King, Keohane, and Verba 1994: 211). This is because measurement error may yield a false negative, omitted variables may yield an unpredicted result, or social-scientific theories are insufficiently precise. Thus, conclusions derived from a single observation "is not the way social science is or should be conducted" (King, Keohane, and Verba 1994: 103).

However, as they themselves recognise elsewhere in the same book, if it is part of a research programme, a single-observation can be useful for evaluating causal explanations. If there are other single observations, perhaps gathered by other researchers, against which it can be compared, it is no longer a single observation (King, Keohane, and Verba 1994: 103). This research explicitly locates itself within the framework of the existing social scientific literature regarding both the literature explaining the regulatory failure in Korea before the 1997 crisis and the developmental state.

Also, this single country case study, which includes a class of events of financial regulation in different areas, can be "heuristic". By looking closely at the complex government-financial sector-business relations, we can use this case study as an opportunity to understand the complexity of the questions examined, to develop further the existing explanatory framework, and to clarify and elaborate the theories used by other researchers (see George 1979: 51-52). Moreover, this single country case study includes three case studies of different financial segments of financial regulation (Part II). With certain aspects of existing explanations for financial regulation (and liberalization) applied to the different segments of the financial sector being selected and examined, this single country study can have the benefit of the "method of structured, focused comparison," thus producing an opportunity for further empirical testing of alternative analytical models (see George 1979: 60; Cohen 1996: 274).

Arguably, investigating the case of South Korea is much more significant than investigating other crisis-afflicted Asian countries. Korea has been central to the debate over the role of the state in the success of the East Asian Newly Industrialized Countries (NICs) (Haggard and Lee 1993: 16). Chalmers Johnson, the forerunner among the developmental state theorists, also suggests that South Korea is the only developmental state other than Japan (Johnson 1998).[5] Others also argue, "Even among the developmental states of East Asia, the Korean one stands out as a particular striking case. When it was in its ascendancy, it was the most dramatic, if not necessarily most effective, specimen of this species, while its subsequent decline was the earliest and the most comprehensive" (Chang and Evans 1999: 20). The crisis in Korea highlighted the Asian crisis in many ways and no one persuasively forecasted the crisis until just before the

[5] Chalmers Johnson argues, "In terms of the countries affected by the meltdown, the Asian Model really only applied to Japan and South Korea. It never existed in Thailand or Indonesia ..." (Johnson 1998: 653).

event. The country had, and has, the biggest economy among the crisis-afflicted countries.

Consequently, with reference to the controversy regarding the role of the developmental state in relation to the Asian crisis, Korea is a key or pivotal case for research, which has been located at the intersection of international relations and comparative politics (Kang 2002: 178). In fact, the case of Korea has been at the centre of the controversy in the literature on the Asian crisis and the developmental state.[6]

[6] See Chang 1998; Chang, Park, and Yoo 1998; Cumings 1998; Demetriades and Fattouh 1999; Weiss 1998; Woo-Cumings 1998, 1999; Haggard and Mo 2000; Wade 2000; Kong 2000; Kang 2002.

Chapter 1 Literature Review and Analytical Framework

This chapter is divided into two sections. The first section starts with an introduction to the critiques of the developmental state model. It then examines conflicting views on the role of the government in East Asia regarding economic growth and, in particular, the developmental state argument. The developmental state is shown to have both bureaucratic competence and close business-government relations as its defining elements. A recent approach among developmental state theorists, focusing on the broader institutional milieu (Haggard 1998), is also explored as are responses of political economists to the critiques of the developmental state model.

The second section of this chapter explores the outcome variables to be explained in this thesis: a combination of financial sector liberalization including capital account liberalization and weak prudential regulation/supervision, which failed to restrain the moral hazard problem in the financial sector. It also reviews recent dominant explanations, on the basis of the context of "institutional arrangements in their broader political milieu", for the financial regulatory failure in Korea, and discusses what those explanations have overlooked; a micro-level institutional approach is suggested to address what was missed in the explanations. This section is supplemented by three appendices: indicators of capital flows showing the vulnerability of the Korean financial system (Appendix 1.1 and 1.2) and major events which occurred during the crisis period (Appendix 1.3).

1.1 Literature Review on the Role of the Governments of East Asia

Since well before the crisis, the role of the governments of East Asia has been a major subject of controversy within at least three different schools: the dependency school, the neoclassical economists, and those with the developmental state perspective. The rapid economic growth in East Asia undermined the dependency school and then challenged the neoclassical perspective. The 1997 crisis in Asia has also undermined the developmental state theorists.

As Katzenstein, Keohane, and Krasner (1998) indicate, "Dissatisfaction with existing orientations and research programs, coupled with changes in the world, has created openings for alternative conceptualisations" (p 647). In fact, the three different schools have been tested by the experience in East Asia in relation to the role of government. In the wake of the crisis, Summers, US deputy Treasury Secretary, stated, "There has been a great deal of discussion about the 'Asian model'"(Summers 1998).

1.1.1 Critiques of the Developmental State Model

As briefly mentioned in the Introduction of this thesis, the developmental state is now seen as one of the main villains responsible for the crisis. In particular, government intervention in the financial markets has been blamed as the major cause of the crisis by many policy-makers and commentators (e.g., Greenspan 1998; Corsetti, Pesenti & Roubini 1998; Krugman 1998).

In his testimony before the Committee on Banking and Financial Services, Alan Greenspan stated that Asian economies had endeavoured to achieve rapid growth by means of a much higher mix of government-directed production than had been seen in the market-driven economies of the West. He claimed that for years domestic savings and rapidly-increasing capital inflows had been directed by governments into investments that banks were required to finance. He argued that, lacking a true market test, much of that investment had been unprofitable (Testimony of Chairman Alan Greenspan at the US Senate, January 30 1998).

In other testimony, he argued that "following the breakdown, an increasing awareness, bordering in some cases on shock that their economic model was incomplete, or worse, has arguably emerged in the region." He declared, "My sense is that one consequence of this Asian crisis is an increasing awareness in the region that market capitalism, as practiced in the West, especially in the United States, is the superior model; that is, it provides greater promise of producing rising standards of living and continuous growth" (Testimony of Chairman Alan Greenspan at the US Senate, March 3 1998).

Corsetti, Pesenti & Roubini (1998) also argue that "Political pressures to maintain high rates of economic growth had led to a long tradition of public guarantees for private projects, some of which were effectively undertaken under government control, directly subsidized, or supported by policies of directed credit to favoured firms and/ or industries." Where government had previously intervened, they claim, non-financial corporations generally underestimated the costs and risks of the underlying investment projects. "With financial and industrial policy enmeshed within a widespread business sector network of personal and political favouritism, and with governments that appeared willing to intervene in favour of troubled firms, markets operated under the impression that the return on investment was somewhat 'insured' against adverse shocks" (p. 21).

A journalist at the *Washington Post* confirms the existence of the view on the Asian developmental states of the US Treasury and the IMF on the eve of the crisis as follows;

> To Rubin, Summers, and their lieutenants, Korea's crisis was the inevitable result of the country's stubborn insularity and its slavish attempts to follow the Japanese economic model, with its system of cosseting banks to pump funds into industry. The treasury's international staff had long urged Seoul to open up its financial sector … (Blustein 2001: 143)

Some blame the developmental state model directly. Charles Wolf at the Rand Institute, for example, maintains that the primary cause of the crisis was the legacy of the so-called Japanese development model with its perverse consequences. He argues that some proximate causes, such as short-term borrowing by Asian banks and companies, their long-term lending or investing, and the unrealistic assumption of foreign investors that pegging Asian currencies to the US dollar would be maintained, are traceable to the primary cause: widespread insulation from market forces. Hence, where the Asian model is not removed and replaced by the market-mediated allocation of resources, recovery from the crisis is more likely to be slow and fitful – and ultimately far more painful (Charles Jr. Wolf, "Too Much Government Control" *Wall Street Journal*, 4 February

1998).[1] Krugman (1998) also argues, "The problem began with financial intermediaries – institutions whose liabilities were perceived as having an implicit government guarantee, but were essentially unregulated and therefore subject to severe moral hazard problems."

In sum, the developmental state, in particular in relation to its financial structure, which had previously been admired by external commentators and policy makers, has been strongly criticized since the outbreak of the crisis. However, what should be noted in these critiques is that only one aspect of the developmental state, i.e., government intervention in the market, has been critically highlighted, whereas another and perhaps far more important aspect of the state, the impact of close business-government relations on the crisis, is not fully examined nor understood.

1.1.2 Three Perspectives on the Role of the Government

In order to understand the developmental state model which emerged in the 1980s, it would be helpful to look at the brief history of ideas on the role of the government in economic growth. For some time during the post-World War II period, 'Import Substitution Industrialisation ("ISI")' had been a dominant view in developmental economics. It originated from Raul Prebisch's doubt about the benefit of integration into

[1] It is interesting to recall that Charles Wolf once found it "a striking fact that the few relatively successful developing economies – Hong Kong, Malaysia, Singapore, the Republic of Korea and Taiwan, China – have greatly benefited from decisions and policies that limit government's role in economic decision-making, and instead allow markets- notwithstanding their imperfections and shortcomings – to exercise a decisive role in determining resource allocation " (World Bank 1993: 32).

the international economy.[2] He conceived that primary producers in developing countries faced price volatility in the short term and deteriorating terms of trade in the long term. Therefore, his suggestion, using infant-industry arguments, was that industrialization should be achieved through ISI. This view subsequently developed into dependency theory (Haggard 1990).

This dependency view, however, was under attack by neoclassical economists during the 1960s. The economists argued that the problems of developing countries were due to erroneous government intervention and not to international structural forces or rigidities. External relations through trade with developed countries had been less disruptive than had previously been thought and inward foreign investment from developed countries had spawned benefits, such as technological adaptation. The East Asian experience was thus conceived as supporting the neoclassical arguments.

As a matter of fact, some governments in East Asia applied a unique economic policy, which could be conceived as being consistent with the neoclassical approach in some areas. Export-oriented trade policy and sound macroeconomic policies, characterized by fiscal discipline, were representative examples, among others. In

---

[2] Raul Prebisch is the founder of the school of 'dependence theory.' Dependency is defined as "a description of the relationship between developed and underdeveloped countries"(Oxford Concise Dictionary of Politics, Edited by Ian Mclean, Oxford University Press, New York, 1996, p. 136). He thought, the world "was divided into centre (the developed, industrialized North) and the periphery (the underdeveloped agricultural South); the relationship between them was determined by the structure of the world economy. In place of classical trade theory's notion of a mutually advantageous relationship between centre and periphery, Presbisch argued that a model of unequal exchange operated, with Latin American economies facing a long-term secular decline in

particular, the strategy of strong relationships between those economies and the international economy, which was embodied in export-oriented policy, was superior to ISI strategy adopted in Latin America. Moreover, the East Asian economies were even more egalitarian than developed countries, in contrast to those in Latin American countries (Haggard 1990). Thus, the experience in East Asia profoundly undermined the position of the dependency school.

There were, however, many other heterodox areas in the East Asian experience. Without doubt, one of those was industrial policy. Since the mid-1980s, a group of scholars challenged the neoclassical perception and the East Asian success story strongly supported that challenge.[3] The major critique of those scholars concerned the role of the state in promoting growth. They argued that patterns of industrial-structural change in the East Asian countries had to be attributed to the industrial policy of developmental states in the region.

The World Bank's famous 1993 report, *The East Asian Miracle*, mirrors a complex of both orthodox and heterodox policies in East Asia. "The report interpreted East Asian success as a challenge to Bank orthodoxy, and acknowledged a significant role for the state. However, it also placed emphasis on the market-consistency of the successful aspects of East Asian industrial policy interventionism ..."(Foot and Walter

---

their terms of trade." (in http://www.policycyber.com/ps101lexicon/messages/231.html)

[3] As Haggard (1990) indicates, they consist of a theoretically eclectic group of economists, political scientists, and area specialists. Their works include Amsden1985, 1989, Johnson 1982, Jones and SaKong 1980, Wade 1990. Haggard (1990) is also a representative work, challenging the neoclassical perspective.

1999: 256). What is remarkable is that both the World Bank's *Miracle* report and the proponents of industrial policy share the assumption that a competent and meritocratic bureaucracy, which was closely connected to, but still independent of business preference, has been an essential institutional prerequisite for successful policy formation and implementation (Evans 1998: 66).

1.1.3 The Developmental State Model

Sound macroeconomic policy in East Asian countries has been a crucial underpinning for the neoclassical perception. From that perception, however, the question as to why the industrial policy of intervention by the government in the market in East Asia had not resulted in rent-seeking behaviour but rapid economic growth with a relatively egalitarian nature could not be answered.

The developmental state model with the focus on the institutional characteristics in the economies of the region, i.e., Japan, Korea, and Taiwan, has thus emerged to address that question. In the seminal work in 1982, *MITI and the Japanese Miracle*, Chalmers Johnson "constructed a Weberian ideal type of an interventionist state that was neither socialist ... nor free-market ... but something different: the plan-rational capitalist developmental state, conjoining private ownership with state guidance" (Woo-Cumings 1999: 1-2).

The institutional features of the developmental state were contradictory because the bureaucracy in the state was independent in policy decisions from the influence of business, but had close ties to the business community. Evans (1995, 1998) called the contradictory combination of close ties and independence "embedded autonomy." Bureaucratic competence and close business-government relations are assumed to be defining elements of the developmental state. Most of explanations on the region's economic growth, based on the developmental state perspective, have tried to articulate such institutional features, as shown in the examples of "discipline (by the state over private enterprise)" (Amsden 1989), and "governed interdependence" (Weiss and Hobson 1995).

However, there was divergence in the literature. Initial explanations of some developmental state theorists, such as Amsden (1989) and Wade (1990), following Johnson's 1982 work, appeared to suggest a state-centric argument because the dominant position of the government over the society/private actors was emphasized in those explanations. Focus on a particular bureaucracy, such as the Economic Planning Board (EPB) in Korea coined as "pilot agency", reinforced such a perception of the states in the region.

It became clear, however, that the developmental state argument is essentially an institutional approach with the focus on close relations between business and government. Though it was important for the state to maintain a competent, coherent and autonomous bureaucracy for economic development, the state was only effective when it was based on "close ties of bureaucrats to business in which the bureaucrats retain the ability to formulate and act on preferences autonomously" (Evans 1995; Schneider 1998: 103). The state was able to "discipline" the private sector in a particular institutional and political setting, where policy decisions were made, and the state was called "strong" or "autonomous" (Haggard, Cooper, and Collins 1993: 3).

The developmental state was assumed to have three characteristics: coercive capacity, comparative independence from particular interest groups and classes, and an interventionism capable of restructuring society, or substituting for other structures, such as the market (Woo 1991: 2). These characteristics had institutional uniqueness at macro and micro levels, in other words political (or constitutional) and institutional (or bureaucratic) levels.

At macro level, the basic constitutional organization of political authority circumscribed the relationship between politicians, bureaucrats and interest groups. This relationship contributed to the decisiveness with which government could act and the reliability of its economic policy. For example, authoritarian rule and the concentration of executive power expedited the introduction of a number of comprehensive reforms, including those relating to previous patterns of private interaction between government and business. At micro level, the organization of the bureaucracy was crucial to ensure the quality of high-level economic decision-making, the reduction and control of rent-seeking and corruption, and the efficiency and coherence of policy implementation. Bureaucrats pursued organizational rather than political or personal goals since they had clear career paths within the bureaucracy (Cheng *et al.* 1996).

1.1.4 Reconceptualization of Business-Government Relations

As the importance of business grew, some of developmental state theorists paid more attention to the broader institutional milieu, such as the type of regime and the party structure, and particularly the "strength" of the state, than to the advantage of competent and meritocratic bureaucracies (e.g., Haggard 1998). It is emphasized that bureaucratic and political institutions can amplify or mute the tendency of politicians to be responsive to interest group pressures and short-term political constraints, which introduce distortions, reduce the credibility of policy, and lead to sub-optimal performance. But this depends "on how they structure decision-making and the representation of interests" (Haggard 1998).

Thus, bureaucratic and political institutions are one important element of the political matrix, where the policy-making process is subject to collective action, coordination and commitment problems. But another important element of the matrix should be the relationship between the government and the private sector. Even if politicians are not "captured" by the private sector, they are dependent on the private sector in several important respects - for resources, information, political support, and ultimately for investment and growth which are a source of legitimacy in any economy (Lindblom 1977; Chang 1994; Haggard 1998).

In this regard, Haggard (1998) suggests "a reconceptualization of the business-government relationship" in the developmental state model. "Rather than thinking in terms of insulation and autonomy, it may be more useful to see business-government relations as an ongoing negotiation." Though the state was indicated to have both the capacity and instruments to discipline business, equally important is the fact that the business-government relationship was set to restrain the opportunities for particularistic rent-seeking or for business control over the opportunities for government decisions. Haggard (1998) proposes that at least three aspects of "business-government relations" will influence the outcome of this bargaining relationship. The first is the nature of political institutions and the extent to which they provide opportunities for business access to, and control over, the policy agenda. The second is that we should know not only about the preference of the private sector but also its political capacity. The third aspect is that the first and the second factors are endogenous to the broader political relationship between government and the private sector: the extent to which politicians depend on business support (Haggard 1998: 83).

Based on the perspective of such reconceptualization of business-government relations, Haggard concludes that the Korean government has been politically vulnerable and reliant on business support. It is also indicated that an increase in the organization and influence of the domestic private sector "raises the question of how a shift in the balance of political power between the public and private sectors will affect government policy in the future" (pp 84-99). This issue is important because it came to be the starting point of present dominant explanations, such as Haggard (2000) and Kang (2002), for the financial regulatory failure in Korea. It should be noted, however, that although the explanations are based on a new institutional perspective, the focus of the approach is largely on the third aspect of "the broader political relationship between the government and the private sector." The first and the second aspects, regarding micro level business-government relations in particular configurations of financial regulatory institutions, are by and large unaddressed. We revisit this point in Section 1.2.3.

1.1.5 Response of Developmental State Theorists to the Critiques

In response to the above critiques in Section 1.1.1, developmental state theorists responded with mixed views which can be classified into two groups. The first group tends to blame the crisis on inappropriate regulatory liberalisation, forced by external factors such as the US government, rather than on the developmental state itself (Chang 1998; Wade 1998; Wade and Veneroso 1998). By contrast, the second group recognizes that close business-government relations in the developmental state had an inherent weakness which contributed to the onset of the crisis (Woo-Cumings 1999; Haggard 2000; Kang 2002). The South Korean case is pivotal in both cases.

The first group argues that it was not the model itself but the eclipse of the model which contributed to the crisis. The regulatory liberalization was caused by external pressure. With reference to Korea, for example, Wade and Veneroso (1998) argue that external forces, such as US government pressure, compelled the Korean government to promote capital account liberalization which is not consistent with the developmental state model. They insist that capital controls are required to make an economy with a high-corporate debt-to-equity ratio less vulnerable to the whims and stampedes of portfolio and hedge fund managers and more generally to re-establish stable growth (Wade and Veneroso 1998: 31).

It is also claimed that too much liberalization undermined the developmental characteristic of the state's ability to coordinate investments in large-scale industries. This allowed excess capacity to emerge in industries like automobiles, shipbuilding, steel, petrochemicals and semi-conductors, and eventually led to the fall in export prices and the accumulation of non-performing loans (Chang 1998).

By contrast, the second group seems to be partly in agreement with the critiques of neo-classical economists insofar as it recognizes that the model itself had inherent and characteristic weaknesses (Woo-Cumings 1999; Haggard 2000). Focusing on close business-government relations of the developmental state, Haggard (2000) argues that the relations, which were believed to be an asset during the high growth period, generated moral hazard, distorted the liberalization process and increased the vulnerability to shocks, particularly in an era of greater capital mobility. Government intervention in and through the financial sector inhibited the ability of banks to monitor their clients and politicised both lending decisions and subsequent losses.

However, Haggard underlines the fact that equal, if not greater, risks arose from poorly conceived and regulated liberalization and privatization. These reforms are often seen as antidotes to rent seeking and corruption. Nonetheless, they can also be captured by business and distorted in ways that shift risk back to the government and increase vulnerability to shocks, typically by weakening the regulatory process. These conflicting weaknesses resulted from some characteristics that the developmental state did not have, including political counterweights to private economic power, independent regulatory agencies and transparency in business-government relations (Haggard 2000).

1.2 Analytical Framework

1.2.1 Outcome Variables: Financial Sector Liberalization, Moral Hazard and Prudential Regulation/Supervision

Most analyses of the crisis agree that large foreign capital inflows, caused by domestic financial and capital account liberalization, were intermediated by domestic financial institutions and that those flows expanded credit, often to risky borrowers, while the government did not impose an appropriate framework of prudential supervision/ regulation.[4]

An IMF working paper indicated, "[T]he banking crises of the 1980s and 1990s have pointed out the link between financial liberalization and financial fragility and the existence of a possible trade-off between the benefits of liberalization and the costs of increasing financial fragility, especially in developing markets" (Rossi 1999: 3). Some prominent economists, Bhagwhati (1998) and Rodrick (1998), have raised questions about the benefits of capital account liberalization and have argued that in some cases capital controls could be appropriate, e.g. in the Asian crisis.

[4] It is argued that "Even if we acknowledge the central role of capital movements in triggering the crisis, any full account of its onset and depth must encompass these domestic conditions as well" (Haggard 2000: 15).

The question of the relevance of financial liberalization to the crisis was originally raised by Diaz-Alejandro (1985), "Good-bye Financial Repression, Hello Financial Crash" in *Journal of Development Economics* (vol. 19, no. 1). According to Velasco (1988), Diaz-Alejandro indicated, "In the Southern Cone countries, ... the acquisition of debt was intimately connected with the liberalization of international capital movements and domestic financial markets" (p. 263). Why did financial reforms in the 1970s aim at ending "financial repression" (McKinnon 1980) and seek to free domestic financial markets yield by 1983 widespread bankruptcies of domestic financial sectors and massive government interventions or nationalization of private financial institutions? (Diaz-Alejandro 1988: 364) Andres Velasco (1988) summarized several crucial points made by Diaz-Alejandro (1988), as follows:

> "Following the advice of Northern experts, the banking system was privatized and interest rate ceilings abolished, but little attention was paid to possible market failures arising from moral hazard and asymmetric information. After a period of very high real interest rates many firms began playing a Ponzi game vis-à-vis domestic banks, which continued to lend under the apparent belief that the government would bail them out in a crunch. As so often in economics, this became a self-fulfilling prophecy: widespread bank failures hit Argentina and Chile between 1980 and 1983 and governments – under pressure from foreign creditors – guaranteed the loans involved" (Velasco 1988: 263). [5]

In line with the argument of Diaz-Alejandro, McKinnon and Pill (1988) developed a simple framework on the progress of the crisis, which they call

---

[5] For further information about the Ponzi game, see http://home.nycap.rr.com/useless/ponzi/ which refers to a kind of pyramid scheme based

"overborrowing syndrome" and which focuses on "the interactions between structural economic reform, expectations regarding its success, and institutional and market failures in the financial system" (p. 1268).

In many cases, according to McKinnon and Pill (1988), the interrelationship between these three factors has spawned catastrophes, such as Mexican-style financial crises, though the scale and depth of such disasters vary by country and by time. Therefore, the ultimate focus is on a requirement for comprehensive public controls and ultimately regulatory authority intervention. Because the problem of overborrowing lies in institutional weakness, failing to deal with the moral hazard problem caused by the government's implicit guarantees to financial institutions, a first-best solution would be to have an appropriate institutional infrastructure of regulation and supervision (McKinnon and Pill 1998). [6]

Barry Eichengreen also agrees with the above views. He indicated at an IMF conference in October 1998 that financial institutions are fragile in the context of liberalization in international financial transactions because their assets are relatively illiquid, but their liabilities are repayable on demand. Thus, those institutions are susceptible to self-fulfilling crises of depositor confidence. Accordingly, the focus is again centred on financial liberalization and appropriate prudential regulation/ supervision. "So it is these recognitions that prompt governments to impose a panoply of

---

on a story of Carlo Charles Ponzi in the 1920s.

[6] There are many works focusing on the role of the domestic financial sector and moral hazard in explaining financial crises (e.g. Krugman 1998).

prudential regulations on the transactions and positions of financial intermediaries where they think those transactions and positions have implications for systemic stability." The less developed the financial market, the greater is the requirement for prudential regulation. "Such regulations are especially strict where the techniques of risk management are thought to be least well developed, where auditing and accounting practices leave the most to be desired, and where financial disclosure is least adequate, weakening market discipline."[7]

As for structural economic reform, there was a significant change in Korea's policy regime: domestic liberalization in trade and finance, and capital account liberalization during the 1980s and1990s, particularly during the mid-1990s when the country was negotiating with OECD member countries for its entry. It is certain that financial sector liberalization, together with trade liberalization, led to an increase in capital inflows.

As for expectations regarding the success of economic reform, it is argued that "With further capital market opening, firms built up expectation of the Korean currency appreciation and the gradual decline of the domestic interest rates to converge on foreign interest rates thus increased their foreign borrowing and investment"(Cho 1999: 18). What should be noted in this process is that the flows were intermediated by domestic banks and thus the risk inherent in foreign capital inflows was magnified. McKinnon and

---

[7] See IMF Transcript: Capital Account Liberalization: What's the Best Stance? ([with Barry Eichengreen, Michael Mussa, Jagdish Bhagwati, Richard Cooper and

Pill (1996) describe how foreign capital inflows affect the supervisory and regulatory framework as well as the solvency of deposit-taking commercial banks, apart from the macroeconomic consequences (McKinnon and Pill 1996: 9). They categorize a number of likely risks when large inflows of foreign financial capital enter a newly liberalized domestic banking system.[8]

As for institutional and market failure in the financial system, the moral hazard of financial institutions and the necessity for prudential regulation should be clearly recognized. Banking is especially important due to its function of asset transformation, from assets with liquidity to those without. Therefore, the government gives an implicit or explicit guarantee to those who deposit funds, and accordingly the banking institutions can easily fall into moral hazard. It is also indicated that moral hazard may arise from the incentive of borrowers to misrepresent their position and to over-borrow, on the

---

Ricardo Hausman)] October 2, 1998, 2:30 p.m. at International Monetary Fund, Washington, D.C. http://www.imf.org/external/np/tr/1998/tr981002a.htm

[8] The risks are as follows; credit risk will increase as bank lending rises. A sudden increase in the available funds may lead to greater investment by companies in risky prospects; foreign exchange exposure rapidly increases when the inflows are in the form of lending to domestic banks by foreign investors; real exchange rate risk on the profitability of traded goods sector decreases due to the increase in capital inflows; settlement risk increases if the payment system cannot deal with the magnitude or direction of cross-border settlements; liquidity risk rises if the size of the capital inflows is large in relation to that of domestic securities markets; and, "risks arise from the supervisory and regulatory framework: regulators face larger and different challenges in assessing the risks borne by the institutions they supervise when capital inflows are considerable and the risks described above multiply." (McKinnon and Pill 1996). In relation to the Asian crisis, the authors emphasise the risks and costs of open foreign exchange positions in banks. As a representative example, they suggest that "Offshore borrowing in foreign currency to fund domestic currency denominated credit expansion is the typical vehicle for this currency speculation." (McKinnon and Pill 1998). Also, refer to Ariyoshi, A., K. Habermeier, et al. 2000. in particular Box 2 (Risks in Banks' Cross-Border Transactions) in Page 34, Part III.

assumption that if they run into difficulties lenders will be forced to agree to better terms. Prudential regulation/supervision should thus be implemented to restrain such moral hazard (Lastra 1996; McKinnon and Pill 1998; Balino, T. J. T., A. J. Ubide, et al. 1999).[9]

In this connection, Goodhart (1998) proposes the traditional rationale for bank regulation and supervision by reference to the following four main considerations:

> (1) the pivotal position of banks in the financial system, especially in clearing and payments systems;
>
> (2) the potential systemic dangers resulting from runs on banks;
>
> (3) the nature of bank contracts;
>
> (4) the adverse selection and moral hazard associated with the lender-of-last-resort role and other safety net arrangements that apply to banks (Goodhart 1998: 10).

In sum, financial sector liberalization, moral hazard, and weak prudential regulation are now seen as key outcome variables contributing to the crisis. Together with the existence of those variables, the Korean financial system became increasingly vulnerable through the 1990s as Appendices 1.1 and 1.2 show.

1.2.2 Explanatory Variables in Competing Approaches

Different theoretical orientations suggest different research 'maps' for explanations (Katzenstein, Keohane, and Krasner 1998). The explanations in the existing

[9] The moral hazard problem does not require government intervention, though it may be exacerbated by assumptions of likely LLR support (Walter 2001).

IPE (International Political Economy) literature for financial liberalization policy (including capital account liberalization) can be divided into four different approaches: structural realist and globalization approaches (international/ systemic level), and interest-based and institution-oriented views (domestic level). These approaches produce different explanatory variables (and actors behind the explanatory variables) and different implications for state autonomy.

Most of the existing approaches, except for the institution-oriented view, suggest that governments would be forced to move toward financial liberalization. The autonomy of the state has a low priority in those approaches (Table 1.1).

Table 1.1 Competing Approaches to Financial Liberalization[10]

Level of analysis	International/ systemic		Domestic	
Competing approaches	Structural realist approach (Gilpin, Helleiner, Loriaux)	Globalization school (Andrews, Cerny, Strange)	Interest – based approach (Rogowski, Frieden)	Institutions – oriented approach (Garrett and Lange)
Explanatory variables	Hegemon	Structural constraints of international capital mobility/ markets	Private interest group preference, corruption	Organizational structures of the political economy
Pattern	Predatory hegemon imposes its will on other states.	International capital mobility structurally constrains states.	Powerful private actors influence government decisions, "Capture of liberalization"	Institutions intermediate external and internal pressure.
Degree of state autonomy	Low (except hegemon)	Low	Low	High
Possible explanatory variables in financial liberalizati -on in Korea	Pressure from the US government and international institutions such as the IMF	International investors, capital mobility, peer group pressure, subsidiaries of foreign financial institutions in Korea	*chaebol*, Domestic financial sectors	Business-politicians relations (macro), Business-Financial regulatory authority relations(micro)

As Table 1.1 sets out, all the competing approaches (except for the institutions-oriented one) suggest constraints that compel governments to move toward financial liberalization policy. Those constraints are hegemon (powerful states), structural forces

[10] Classification of competing approaches in explaining economic policy outcomes is largely drawn from Hall (1998) and Keohane and Milner (1996).

including international capital mobility at the systemic level, and private interest group preference at the domestic level.

Firstly, the structural realist approach suggests that, as a result of uneven growth by countries, hegemony changes its interest in an anarchical international system. It is argued that the US, the 'predatory hegemon,' coercively constrains other countries to liberalize their financial system (Gilpin 1987; Helleiner 1994; Loriaux 1991, 1997). In line with this approach, there are many works which trace the cause of financial liberalization in Korea to US government pressure (Haggard and Maxfield 1993, 1996; Wade, 1998, 2000; Woo-Cumings 1991, 1997).

Secondly, the globalization school claims that technological development is the source of financial liberalization. Globalised capital markets have structural power which constrains governments to converge toward financial liberalization (Andrews 1994; Cerny 1993; Strange 1996). With reference to developing countries in particular, Haggard and Maxfield (1996) trace the reasons behind capital account liberalization in developing countries to the systemic pressure of global capital markets. The growing integration of developing countries into the world economy has constrained government choices with respect to international financial policy. "As the integration of financial market deepens, international constraints will play an increasing role in future, not only with regard to the capital account but with reference to economic policy more generally" (Haggard and Maxfield, 1996: 236).

Thirdly, interest group-oriented views at the domestic level are not necessarily separated from the above systemic approaches. These views suggest that systemic pressures are internalized by changing prices, thus forcing changes in the policy preferences of domestic interest groups. Government should change their policy to reflect this newly-emerged private preference (Frieden 1991; Choi 1993; Frieden and Rogowski 1996; Woo-Cumings 1997).

Although Table 1.1 classifies the corruption and "capture" of liberalization as an explanatory variable and pattern respectively, into the interest group approach, they may also be in line with the institutions-oriented approach. For example, outcomes from business-government relations where a government was autonomous from the influence of business interest will be different from the outcomes when the same government is corrupted or captured by the same business interest. In this context, corruption is a crucial element in business-government relations, and capture of liberalization is an outcome of changed business-government relations.[11]

While the above three approaches all assume that the autonomy of governments is constrained by various explanatory variables, such as hegemon, capital mobility or private preferences, the fourth view i.e., the institutional approach, still considers that state autonomy remains high. In regard to the interest group-oriented view, Garrett and Lange (1996) indicate that policy outcomes are not the direct result of political conflict arising from the preferences of different actors, weighted by their market power and their

[11] This may infer that each perspective is not inconsistent with other perspectives.

propensity for collective action. They argue that, "institutional conditions have a significant bearing on political processes. ... extant institutions mediate in the relationship between internationally induced changes in the policy preferences of domestic actors, on the one hand, and political outcomes (both policy and institutional change), on the other" (Garrett and Lange 1996: 49).

1.2.3 A Framework Adopted in this Research

Although competing approaches to financial liberalization in the IPE literature are helpful in understanding the overall process toward financial liberalization over countries, the institutionalist approach has been dominant in explaining economic outcomes in Korea as we have reviewed. The approach by developmental state theorists has contributed to showing how features of business-government relations influence the efficiency and creditability of economic policy outcomes. As indicated in Section 1.1.4, recent works such as Haggard (1998) raise the question as to how change in the balance of political power between the public and private sectors would affect government policy (Haggard 1998: 99).

Some of the present explanations (Chang 1998; Wade 1998) are in line with the structural realist approach, while others (Haggard 2000; Kang 2002) introduced an interest-based approach into the institutional one. The latter has focused on how macro-political institutions, such as basic features of the political order like the type of regime and the party structure, affect business control over the policy agenda. Capture of liberalization in financial regulatory policy outcomes and corruption are suggested in this institutional approach explanation for regulatory failure. In this regard, such institutional explanations can be said to be in line with an interest group-oriented view.

According to this new approach with the focus on macro-political institutions, politicians are dependent on the private sector for resources, information, political support and ultimately for the investment and growth that are a source of legitimacy in any economy (Haggard 1998: 82). The approach requires a reconsideration of the benefits of close business-government relations in the developmental state; there may be an optimal level of "distance" between the public and the private sector. When governments lack political ties with the private sector, policy outcomes are likely to be inimical to growth. By contrast, if governments have too close links to the business community, governments can be captured by business interest, corrupted, and pursue rent-seeking (Haggard 1998: 99).

1.2.3.1 Effects of Political Institutions on Policy Outcomes at Macro Level

Recent explanations for financial regulatory failure in Korea seem to be dominated by the regulatory capture argument, such as Haggard 2000, which is essentially the institutional approach but includes characteristics of an interest-based view. Haggard (2000) indicates that there was poorly-conceived and - regulated financial regulation and privatisation prior to the crisis. The problem was that these reforms were captured by business and distorted. It is argued that the problem originated from some characteristics that the developmental state did not have, including sufficient political counterweights to private economic power, independent regulatory agencies and transparency in business-government relations (Haggard 2000). It follows that the supposedly strong state in Korea was, in the process of financial liberalization, captured by the dominance of big business, i.e., the change in the power balance in business-government relations towards the former, as government elites had to rely on business for political support.

Kang (2002) also argues that the transition to democracy in the 1980s in Korea transformed the basic business-state (government) relationship, allowing business to exert a greater influence than usual over policy decisions (p. 178). This seems, so far, to be in line with what Haggard (1998) indicates, i.e. a change in macro-political institutions, reflecting regime change and the growing influence of business. However, he goes further. He maintains, "It is unwise to focus on individual policy choices (for example, export-oriented industrialization) or specific institutional arrangements (the bureaucracy) as isolated issues. Both institutions and policies are intervening variables, and the larger institutional environment, in this case the government – business relationship, affect any specific issues" (Kang 2002: 179). In other words, while Haggard (1998) still indicates the importance of institutions at the micro level (such as bureaucracy), though they are influenced by institutions at the macro level, Kang (2002) insists that "larger" (or macro-) institutions determine policy outcomes.[12] In this regard, Kang (2002) underestimates the

[12] In fact, this kind of 'macro-level' institutional approach has been common in institutions-based research. Garrett and Lange (1996) consider the linear effects of institutions on economic policies. Political institutions mediate societal preferences once the latter have been made. Democracy, which is certainly a macro concept, is regarded as important since government is more responsive to societal preferences in democracies than in authoritarian regimes and totalitarian systems (Garrett and Lange 1996). However,

effects of various forms of institutional arrangements and policy choices by bureaucrats on policy outcomes. It is questionable, however, whether the effects over policy outcomes of institutions at the micro level are any less significant than those of institutions at the macro level.

1.2.3.2 Effects of Political Institutions on Policy Outcomes at Micro Level

Not only does change in macro-political institutions have an impact on economic policies, but change in political institutions at the 'micro level,' e.g., organizational change within a government, and organizational characteristics of bureaucracy over time, also has a significant impact on policy outcomes.

A good example can be found in the literature on central bank independence. Delegating monetary authority to an independent central bank, for example, constitutes a credible commitment that will remedy the 'time inconsistency' problem. Hence, the consequence will be lower rates of inflation without raising unemployment rates (Garrett and Lange 1996). There is also a lot of literature on the effects of wage bargaining institutions on macroeconomic outcomes (e.g. Iversen, Pontusson, and Soskice 2000).

As Hall (1998) indicates, it is important to identify the right institutions with the policy outcomes. Evans (1997) argues, "Depending on the internal structure of the state, similar business-government networks have different implications..." (p. 66). In fact, it

---

Garrett and Lange (1996) do not deny the significance of institutions at the micro level on policy outcomes.

has been argued that the developmental state has maintained characteristic institutional arrangements, in particular in its government institutions. Centralization of the state bureaucracy, which was almost anonymously agreed among developmental state theorists, is a good example. The questions of how characteristic institutional arrangements have been related with change in the macro level institutional environment and whether characteristic institutional arrangements were still effective in producing policy outcomes in the context of the growing influence of the private over the public sector are of interest.

We explore these questions in more detail by discussing the findings of a book by Haggard, Maxfield, and Lee et al. (1993) which dealt with micro-level institutional effects on particular policy areas of financial regulation. It focused on "the power and organization of relevant social groups and the extent to which institutional arrangements, including the integrity and cohesion of the state apparatus itself," which "allow them to gain access to and control over the decision-making process" of financial regulatory policy (Haggard, Maxfield, and Lee et al. 1993: 5).

Haggard and Lee (1993) discussed competing views on "financial repression". Advocates of intervention in financial markets perceived that a competent, informed and "strong" government aiming to maximize social welfare would offset and correct market imperfections, while proponents of the rent-seeking and regulatory capture model argued that government intervention should reflect pressures coming from powerful groups, such as manufacturing or the banking sector, or personal ties to government officials, capable of extracting policy favours. In this context, the latter group would argue that the resultant negative allocative effects and political incentives should be removed through liberalization (pp. 7-8). Moreover, the latter group argued that capital account liberalization would impose discipline needed both for the financial sector and macroeconomic policy. However, Haggard and Lee (1993) indicated that such a model for liberalization was flawed for it did not produce sufficient empirical work; there was no clear evidence whether financial market policy was in fact a result of such political pressure or whether it was due to other reasons such as economic constraints or the projects of government officials (p. 8).

Haggard and Lee (1993) extended the review to the issue of "financial liberalization"; why could the role of the state in credit allocation (intervention) be efficient, rather than resource distribution by financial market (liberalization)? In this extended review, they defined "what is commonly called financial repression is, in effect, a hierarchical system of credit allocation" (p. 12). They sought theoretical evidence for the intervention from the argument of Oliver Williamson (1975, 1985). As firms have developed their own internal capital markets for allocating financial resources by themselves in a hierarchical arrangement because financial transactions have been subject to moral hazard and costly contract enforcement, government can perform a similar role of credit allocation (pp. 11-12). In this case, of course, firms receiving credit are like divisional sub-units.

Institutional features mattered in the system of financial repression, Haggard and Lee (1993) indicated. Two aspects, in particular, were noted. One was political power and the interests of the private sector receiving credit. Depending on the relative size, organization and financial needs of the manufacturing sector, support for such interventionist policies varies. The other, it was suggested, was the ability of the state to restrain the power of rent-seeking groups which depended on the interests of the politicians and the structure of the government institutions.

What we should draw from the discussion of the book (Haggard, Maxfield, and Lee et al. 1993) is again that not only the interests of politicians, but also the structure of government institutions mattered in explaining financial regulatory policy. In particular, the centralization of government institutions, which was indicated as a core element of "financial repression," was not fully understood in the context of financial regulatory outcomes in the 1990s, i.e., the selective nature of financial sector liberalization (including capital account liberalization) and weak prudential supervision/regulation.

This research notes that the case study of Korea (Choi 1993) in the book (Haggard, Maxfield, and Lee et al. 1993) only dealt with some limited areas of financial sector liberalization (excluding capital account liberalization) from the perspective of business-government relations. Even in the limited case study, only the increase in the concentrated power of big business (*chaebol*) was focused on, whereas the nature of financial regulatory institutions such as the concentration of authority within the finance ministry was overlooked. In this regard, this research extends the discussion of the 1993 book by Haggard, Maxfield and Lee.

In conclusion, from the perspective of close business-government relations, we pinpoint the relevance of the particular configurations of government financial regulatory institutions and the growing influence of the private sector to the regulatory failure in Korea.

Appendix 1.1 Vulnerable Areas of the Korean Economy

The 1997 crisis in Korea consisted of two different crises: a banking crisis, which started in the first half of 1997, and a foreign exchange liquidity crisis during the second half of 1997. The banking crisis fed the foreign exchange crisis and vice-versa. As is now well-known, the foreign exchange liquidity crisis was different from typical liquidity crises resulting from foreign investors' attacks on a currency with an overvalued exchange rate. The crisis in Korea started with a banking crisis as the *chaebol* plunged into difficulties and financial institutions became nearly insolvent. As the contagious effects of other Asian crises spread, following the international banks' refusal to rollover their short-term lending to Korean financial institutions, the banking crisis developed into a foreign currency liquidity crisis.[13] While there is controversy as to what extent its own problems contributed to the breakout of the crisis, little of the literature doubts that the Korean economy was then vulnerable toward systemic risks. Table 1.2 shows that the economy was characterized as one with a high ratio of short-term external liabilities to international reserves. The short-term liabilities were required to be repaid during the crisis period. The liabilities, along with high debt/equity ratios for the *chaebol*, were thus blamed as the proximate causes of the crisis.

---

[13] The contagious effect started in Hong Kong where international banks started to withdraw their short-term lending from the subsidiaries of Korean financial institutions. As of June 1997, G10 creditor banks' lending to banks in Hong Kong (including those to the subsidiaries of Korean financial institutions) was US$ 222.289 billion, of which 64% were those having a maturity of one year or less. (BIS, 1999; p 44)

Table 1.2 also shows that the bulk of capital inflows was intermediated by domestic financial institutions. Those institutions had to repay over US$ 33 billion of their short-term borrowings in 1997. This contrasted with short-term borrowings by foreign institutions operating in Korea, which increased by US$ 2.2 billion on the previous year's level. The level of foreign exchange reserves against the increase in the short-term indebtedness dropped.

Table 1.2 Total External Liabilities by Category and International Reserves (US$ billions)*

	1996.12	1997.9	1997.12
Long-term Liabilities	71.4 (43.4 %)	82.5 (45.8 %)	94.8 (60.0 %)
Public Sector	6.1	NA	22.3
Domestic Fin. Institutions	40.0	NA	47.2
Foreign Fin. Institutions	3.5	NA	4.4
Private Corporations	21.8	NA	25.3
Short-term (less than 1 year)	93.0 (56.6 %)	97.6 (54.2 %)	63.2 (40.0 %)
Domestic Fin. Institutions	60.0	NA	27.2
Foreign Fin. Institutions	13.0	NA	15.2
Private Corporations	20.0	NA	20.9
Total External Liabilities	164.3 (100.0 %)	180.1 (100.0 %)	158.1 (100.0 %)
Usable Int'l Reserves	29.4	22.1	8.9

*Includes offshore banking and overseas branches' borrowings.

Source: Bank of Korea, 1999

Appendix 1.2 A Boom in the Mid-1990s and Capital Account Opening

It is now very clear that there was a boom in Korea during the mid-1990s, caused by the pursuit by the Korean government of a high economic growth policy which was well beyond the economy's optimum capacity.[14] The macroeconomic management policy aiming at high growth, was underpinned by a capital account liberalization policy. The ratio of capital transactions (capital inflow plus capital outflow) against trade transactions (export plus import) jumped from 62.4% in 1993 to 101.9 % in 1997. In particular, the liberalization of certain categories of capital account transactions was material: the relaxation of trade credits and of foreign currency borrowing to finance the importation of equipment facilities and capital goods.

Table 1.3 Macroeconomic Indicators Showing a Boom

	90	91	92	93	94	95	96	*87-8*
Real GDP growth (%)	9.5	9.1	5.1	5.8	8.6	8.9	7.1	*11.4*
Inflation per Annum (%)	8.9	9.3	6.2	4.8	6.3	4.5	5.0	*5.5*
Investment growth in equipment facility (%)	18.8	12.1	-1.1	-0.1	23.6	15.8	8.2	*16.0*
Import growth in capital goods (%)	13.8	18.2	1.6	0.1	32.1	32.5	10.0	*29.6*
Import growth in consumer goods (%)	10.0	19.8	6.2	2.4	24.6	27.8	21.2	*26.2*
Export plus Import of Goods to GDP Ratio	53.2	52.1	51.4	49.9	52.1	57.1	57.8	*63.3*
Current Account to GDP Ratio	-0.7	-2.8	-1.3	0.3	-1.0	-1.9	-4.7	

Source: Bank of Korea, various issues on statistics

[14] See Bank of Korea, *A Report to the Special Investigation Committee on the Foreign Currency Crisis: Circumstances and Developments of the 1997 Foreign*

As Table 1.3 shows, the importation of capital goods and consumer goods rose substantially. Importation of consumer goods remained high, even up to 1996. The investment growth ratios during the period of 1994-95 exceeded those of 1987-89 when the Korean economy recorded huge current account surpluses.

Opportunities for the industrial sector to finance its foreign currency requirements were significantly improved and the funds financed from abroad through domestic financial institutions were mostly used for importing manufacturing facilities and capital goods. It could finance foreign funds on their own in the way of issuing securities denominated in foreign currencies in international capital markets. Beyond this, foreign direct portfolio equity investment, which started in 1992, was another resource for financing the industrial sector's investment. However, the biggest source of foreign currency funds was to get foreign currency borrowings from the financial sector. The borrowings jumped in 1994-95.

Currency Crisis, January 1999, p 10.

Appendix 1.3 Major Events and Characteristics by Time Periods in 1997

In the wake of the crisis, the Board of Audit and Inspection summarized the major factors which brought it about (Board of Audit and Inspection 1998).

First quarter of 1997;

- There was the collapse of two *chaebol*: Hanbo Steel (23 January), and Sammi Steel (19 March). The failure of the *chaebol* caused a downgrade of the credit ratings for the long-term liabilities of three major DMBs (Choheng, Korea First, and Korea Exchange Bank).
- Due to a reduction in credit lines of international banks to Korean banks, some DMBs had liquidity problems.
- Highest trade deficit recorded in the quarter: US$ 7.4 billion
- The BoK intervened in the foreign exchange market, thus reducing international reserves. Foreign funding including long-term funding was liberalized and the limit for foreigners' portfolio investment in the Korean stock market was increased.

Second quarter;

- When Jinro (21 April), Daenong (20 May), and Hansin Kongyoung (2 June) all collapsed, Standard & Poor's (S&P) downgraded credit ratings for the short-term liabilities of Korea First Bank, which was the largest creditor of Hanbo Steel and Jinro.

- Cap on foreigners' portfolio investment into the Korean stock market was further increased (2 May) from 20% to 23 %. US$ 1.2 billion worth foreign funds (net value) flowed into the Korean stock market.
- After the end of April, trade deficits substantially decreased mainly due to the strength of the Japanese Yen.
- The Korean won was depreciated and the liquidity problem of banks appeared to calm down.

Third quarter;

- Foreign currency crises in Southeast Asian countries occurred: Thailand (2 July), Indonesia (14 August).
- Kia Motors collapsed on 15 July. The situation of financial institutions' foreign funding deteriorated. Due to a delay in resolving Kia Motors, the financial market was extremely unstable.
- Moody's (26 July) and S&P (6 August) placed five major DMBs under the watch list. The sovereign rating was adjusted to negative from stable.
- Outward exceeded inward foreign portfolio investment.
- The won-dollar exchange rate appreciated above 900 on 19 August, which was the first time since the market average exchange rate system was introduced in 1988. The foreign exchange market was extremely unstable.
- On 25 August the government promised its guarantee of financial institutions' external debts but, due to the lack of legal back-up, the promised guarantee failed to restore external credibility.

- The credit lines of international banks to Korean financial institutions further reduced. The BoK had to support financial institutions to enable them to settle their accounts.

<u>Fourth quarter;</u>

- Big companies continued to collapse: Taeil Precision (24 October), Haitai (1 November), and New Core (4 November).
- Resolution of the Kia Motors problem was delayed and eventually the decision to nationalize it increased the instability of the financial system.
- Hong Kong stock market crisis (23 October).
- S&P (2 October, 24 October), Moody's (28 October, 31 October) downgraded Korea's sovereign credit rating and the ratings of Korean banks.
- Despite a further increase in a cap on foreign portfolio investment in the stock market (from 23% to 26%), no additional funds flowed into the market.
- Due to the failure to renew matured external liabilities as well as to attract new foreign funds, the foreign currency situation deteriorated badly.
- The international reserves of the BoK were used to support Korean banks; accordingly, the level of reserves rapidly decreased.
- The band within which the foreign exchange rate could change was enlarged from 2.5% per day to 10% per day.
- The Korean government publicly asked for help from the IMF on 21 November.

Chapter 2 Regulatory Framework: Hierarchy and Institutional Inertia

2.1 Introduction

Although developmental state literature has produced institutional explanations for various important issues in East Asian countries, such as economic growth, export-orientation and macroeconomic stability and adjustment policy (e.g., Haggard 1990; Haggard and Kim, et. al. 1990; Haggard and Kaufman, et al. 1992; Haggard et al. 1993; Wade 1990; Woo 1991), the literature did not pay much attention to the financial regulatory institutional framework, i.e., the governance structure for financial regulation, of the developmental state.[1] The governance structure for regulation refers to the way in which power is exercised and allocated with regard to the supervision and regulation of financial institutions. Thus, governance is the issue of the allocation of power (i.e. what powers and to whom), as well as of the exercise of power (i.e. the question of how), the processes and procedures (Lastra 2001: 1).

Favourable comments by economists about East Asian economies also focused on the institutional strength of those economies (e.g. World Bank 1993). Both powerful technocratic bureaucracies, shielded from political pressures, which devise and implement well-honed interventions, and the central role of government-private sector

[1] An exception is Haggard, Maxfield, and Lee (1993), which studies the

cooperation were indicated as institutional characteristics of the economies (World Bank 1993: 13). However, the literature by political economists as well as economists largely overlooked the institutional weakness of the developmental state in relation to the issue of financial supervision. For example, the World Bank's *Miracle* report in 1993 misconstrued the financial regulatory framework in Asian economies as follows:

> "Central banks and departments of finance in the HPAEs (Highly Performing Asian Economies) appear to have been generally more successful in supervising commercial banks, which have reported a relatively low proportion of nonperforming loans in their portfolios (p. 212)."

Also, in comparison with prudential regulation of economies in Latin America and Sub-Saharan Africa, the Miracle report describes:

> "The more effective prudential regulation of East Asian banks is apparent in the ease with which most of them adopted the international capital adequacy requirements set by the Bank for International Settlements (BIS) to ensure that banks do not take on inappropriate levels of risks. ... Most East Asian economies continue to rely on close contact between supervisors and banks to encourage prudence. This routine, often daily interaction enables regulators personally to assess the riskiness of a bank's portfolio (p. 213)."

However, this chapter claims that the institutional framework of financial regulation was deficient in at least two aspects: the hierarchic nature of authority in the framework, and institutional inertia. The first aspect, which is more important, i.e., centralization of the regulatory authority within the Finance Ministry, have been

---

financial regulatory framework in developing countries, including Korea.

perceived by the developmental state literature as an asset of the developmental state, but it turned out to be an impediment to the introduction and implementation of sound prudential regulation. It also enabled special interests to have strong influence on regulatory change. The second aspect, which was a result of financial repression during the 1960s and 1970s, has not been put under the spotlight in the explanations of the regulatory failure. The institutional inertia, which was caused by the bureaucratic interests of related institutions, prevented the regulatory framework from adapting to the new situation, created by the financial liberalization of the 1980s and 1990s.

This chapter is in three parts. Section 2.2 introduces the historical origin of the framework and its structural features. It shows that the growth-oriented regulatory framework, which had the structural characteristic of centralization of the authority within the Finance Ministry, was adopted when the developmental state emerged at the beginning of the 1960s. It also examines the regulatory framework just before the crisis and questions with the existing explanation (e.g. Stiglitz 1999a) in the literature on the framework, that is, fragmentation of the framework, in Korea.

Section 2.3 is concerned with the institutional inertia of the regulatory institutions. Institutional transformation in the developmental state was unbalanced. It is well-known that financial liberalization, including capital account liberalization, was substantially advanced, while the institutional reform for ensuring prudential regulation, such as an establishment of an independent prudential regulatory institution, was stalled by the influence of strong bureaucratic interest among the regulatory authorities. Section

2.4 concludes with the implications for this thesis.

2.2 Evolution of the Institutional Framework and its Structural Features

2.2.1 Formation of Regulatory Institutional Framework and the Emergence of the Developmental State, 1960s-70s: Financial Repression

The origin of the regulatory institutional framework is traced to the emergence of the developmental state in Korea at the beginning of the 1960s when the Park Chung-Hee military regime started.[2] The establishment of the super-ministry, the Economic Planning Board (EPB) with both planning and budgetary authority, and the start of the formulation of five-year plans have been indicated as the most significant institutional changes made at the beginning of the 1960s (Chang and Evans 1999: 23). Equally important, however, is the fact that a particular form of financial structure was set up, being governed by a regulatory framework with developmental characteristics.[3]

As Johnson's distinction between the 'regulatory state' (exemplified by the post-war American state) and the 'developmental state' (represented by the post-war Japanese or French states) illustrated, developmental objectives put an emphasis on dynamic

---

[2] After taking office through a military *coup d'etat* in 1961, Park Chung-Hee remained as the President of Korea until 1979 when he was assassinated by the Chief Director of the Central Intelligence Agency in Korea (KCIA).

[3] Financial structure is defined as "the mechanism guiding the flow of savings and in-vestment, determining the options of industrial policy, and managing financial flows to different sectors" (Woo 1991).

considerations in industry, such as improving productivity and achieving efficient structural change, for which the financial structure served as a means.[4] In order to establish such a regulatory framework, the country revised the Bank of Korea Act, the General Banking Act and the Korea Development Bank Act, among others.

The financial structure was characterized by three elements: subordination of the BoK's power to issue currency to the will of the government (i.e. the Ministry of Finance), the transfer of authority for foreign exchange business and for the supervisory authority over financial institutions from the Bank of Korea (BoK) to the Ministry of Finance (MoF), and an increased role for the Korea Development Bank (KDB) in the country's economic development. All these elements were made possible by changes in the regulatory institutional framework during the 1960s and this regulatory framework for the Korean financial structure was largely adhered to for the following three decades.

The Bank of Korea Act of 1950 was substantially revised on 24 May 1962 in two ways. First, the ultimate responsibility for establishing financial policy and management was transferred from the BoK to the MoF. Second, the Finance Ministry was given supervisory authority over the business of the BoK. As a result, the BoK became subordinate to the government (the Finance Ministry). In addition, the Foreign Exchange Management Act was passed in 1962 as a result of which related regulations which had been included in the Bank of Korea Act were removed. Hence, the function of the BoK for establishing foreign exchange policy and as the principal body for foreign currency

[4] On the distinction of objectives between the developmental and regulatory state, see Chang (1997).

management was transferred to the government.

Kim (1965) described the leaders of the military coup as follows:

> "The leaders ... had a tendency of regarding the central bank as a convenient vehicle for financing economic development. Such a view promoted the amendment of the Bank of Korea Act as a prerequisite to the ambitious Five Year Economic Development Plan. Attainment of monetary stability and international equilibrium are relevant, according to new viewpoints, only when they may be a prerequisite for the attainment of economic development, or at least when they are not conflicting with the latter objective. According to this view, gains from the attainment of higher levels of income and production outweigh the risks of price instability" (Kim 1965: 16).

The Korea Development Bank Act was revised at the end of 1961 to enlarge its paid-up capital by five hundred times from 40 million won to 20 billion won and its sphere of business, from electricity and coal industries to export and import substitution industries, such as shipbuilding and steel industries.[5] In addition, the Korean government established specialized banks in the years 1965 -67, such as the Industrial Bank of Korea (for small- and medium-sized enterprises), the Kookmin Bank (for households), and the Housing Bank (for construction companies and housing financing), in order to provide policy loans in those special areas.

In addition, the 'Provisional Act on Financial Institutions' was approved in 1961. It entrusted the Governor of the Office of Bank Supervision (OBS) in the BoK with the power to select directors of financial institutions. Under that Act, the government controlled, through the OBS, the management appointments for all financial institutions. The voting rights of the shareholders of the then private deposit money banks, which had been exercised by a small number of individuals, were suspended by the government. After nationalization of the commercial banks, all shareholder rights were transferred to the Government.

Moreover, deposit money banks (DMBs) had to deposit their funds with the KDB in 1967, and were asked to buy Industrial Financing Bonds, a major funding source of the KDB. DMBs also had to fund some projects, which were guaranteed by the KDB. In other words, DMBs were asked to support development projects in addition to carrying on their own commercial banking function.[6]

After setting up the financial institutional structure during the 1960s, the Korean government rationed credits to particular industries. There were a series of measures to support favoured areas. By the August 3 1973 Decree, the government froze the private debts of companies. It also asked banks to swap short-term loans, which they had already made, for long-term loans at low interest rates.[7] Some strategic areas, such as the exporting sector, were favoured by the Decree (Woo 1991: 129). In December 1973, the National Investment Fund Act was approved. Financial institutions supplied the resources of the Fund, which were then injected into the heavy and chemical industries. These

---

[5] See Chapter 6, Table 6.1.

[6] The OBS indicates, "The reason why commercial banks in Korea had to deal with long-term financing was due to the weakness of the corporate financial structure as well as the inexistence of direct capital markets. Thus, commercial banks directly involved themselves in development financing" (Office of Bank Supervision 1995).

[7] Chapter 7 will address this issue in greater detail.

accounted for over 60% of long-term investments of the financial institutions (Presidential Committee for Financial Reform 1997d: 8).[8] In 1974, the government asked the BoK to increase the amount of rediscounting for Korean banks to enable them to fund the demand from the heavy and chemical industries. As a consequence, during the period between 1966 and 1981, banks supplied 70% of all export financing, which was funding by means of the rediscount facilities of the BoK (Cho, Kim, and World Bank 1995).

The regime's determination to achieve economic development was underlined by the formation of a new regulatory institutional framework. The scope of the government measures went beyond mobilizing direct/indirect funding for target industries. Bank facilities for consumers and for housing were also tightly restricted. Only specialized banks, wholly-owned by the government, could provide such facilities, but in a restricted way. In return, the government limited the number of new entrants to the banking business and protected financial institutions from bankruptcy. During the 1960s and 1970s, specialized banks and DMBs were de facto government financial institutions. The financial institutions allocated financial credits in accordance with government policy (Presidential Committee for Financial Reform 1997d: pp. 9-10).[9]

[8] When the Fund started, banks had to contribute to the Fund 10-30% of the increase in deposits with the banks. Insurance companies had to contribute 40 –50 % of insurance premiums and various public funds had to contribute 90% of their cash reserves.

[9] This section focuses mainly on the regulatory framework rather than financial regulatory policy. As regards the policy, see "Financial Reform without Tears: Korea, 1964-70" and "Misaligned Interest Rate and Capital Inflows: Korea Again." Both articles were included in McKinnon (1973).

2.2.2 Hierarchic Authority among the Regulatory Institutions

The *de jure* regulatory authority for prudential regulation over banking was the Monetary Management Board of the Bank of Korea. In accordance with the BoK Act and the General Banking Act the Board of the BoK had supervisory authority over banking business. In reality, however, the Finance Ministry had a strong influence on the Board and thus subjected monetary as well as banking regulatory policy to the policy objective of the Ministry, i.e., growth.

2.2.2.1 Subordination of the BoK to the Finance Ministry

The relationship between the Monetary Board and the BoK has been conflictual.[10] The BoK considered that the Monetary Board was part of its internal organization and thus the government should not intervene in the business of the Board, while the Finance Ministry's view was that the Board was an administrative council under the jurisdiction of the Ministry, established by Article 4-2 of the Government Organization Act.[11] Thus, the Ministry argued it had power to supervise the Board

[10] Article 7-1 in the Bank of Korea Act stipulated that "the Monetary Management Board is located in the BoK." In this regard, the Board appeared to be an internal organization of the BoK. However, by saying that "The Monetary Management Board supervises the BoK over its business, management, and administration" (Article 7-2 in the BoK Act), the Board appeared to be independent from the BoK. Moreover, the Act prescribed that "The Minister for Finance concurrently holds the post of the Chairperson of the Monetary Management Board." This strengthens the latter view.

[11] The article stated that "An administrative council can be located in an administrative organization, when the latter needs to separate part of its function, which was under its jurisdiction, from the administrative organization." (See Bank of Korea

comprehensively.[12]

In addition to the conflict regarding the *de jure* status of the Monetary Management Board, BoK Governors had often been forced out of office before completing their term and the majority of the Board members was government officials or proposed by the government. Before the 1997 crisis, only 4 out of 20 Governors had completed their term of office.[13]

Thus, it should be said that the Monetary Management Board was controlled, *de facto*, by the Finance Ministry. In addition to the Finance Minister automatically being a member of the Board as Chairperson, the Ministry could recommend another member of the Board. Then, the Minister for Agriculture and Forests and Minister for Commerce, Industry and Resources (the successor ministry of the MCI) each proposed two members of the Board. The other two members of the Board were to be recommended by the Korea Federation of Banks (KFB). In reality, however, after the candidates for these two appointments had been named by the Finance Minister, the staff of the Board used to

---

2000: 17).

[12] The view of the BoK on this is summarized as follows: (i) the Board was established by the Act of the BoK; (ii) the budget for managing the Board was included within the BoK's budget; (iii) names and addresses of members of the Board were registered in the register of the BoK. The BoK, therefore, maintained that the Board was part of the BoK. In contrast, the Finance Ministry claimed that (i) the relationship between the Board and the BoK was like supervisor and its supervisee; (ii) if the Board was assumed to be an internal organization, it meant that the minister for finance as the Chairperson of the Board was inferior to the governor of the BoK; (iii) members of the Board were public servants while the staff of the BoK were not. Thus, the Board could not be an internal organization of the BoK. There was a confrontation among the regulatory authorities but also among Board members and the members of the Committee for Finance and Economy in the National Assembly (Bank of Korea 2000: 17-8).

[13] The term of the BoK governor was (and still is) 4 years, but none remained in

obtain signatures on the nomination forms from the members of the KFB, i.e., Presidents of DMBs and specialized banks. Accordingly, the Finance Minister could choose the majority of the Monetary Management Board.

In addition, the Finance Ministry had both 'supervisory authority over BoK business' and 'the power to sanction the BoK's budget and to approve the Bank's accounts'. Though 'its power to sanction …' was revoked in 1982, the Finance Ministry held its prominent position over the BoK by maintaining its supervisory authority over BoK business in accordance with Article 7-6 of the BoK Act.[14]

2.2.2.2 Origin of the Ambiguous Provisions in the BoK Act

The origin of the ambiguous provisions in the BoK Act on the relationship between the Monetary Board and the BoK, i.e. the monetary authority, which had become a major source of conflict between the Finance Ministry and the BoK, is related to the emergence of the developmental state. It goes back to the latter part of the1940s when the Korean government was re-established after World War II. With help from Federal Reserve Board (FRB) officials in the US, the original BoK Act, which was enacted in 1950, clearly stated that its primary concern was with monetary stability. The Act was also unique in terms of clearly endowing the BoK with authority for monetary, foreign currency and financial supervisory policy. However, because of the Korean War and the

---

office when the president changed.

[14] An anonymous BoK officer indicated that the Finance Ministry frequently threatened to use its power of on-site examination over BoK business, whenever there occurred conflicts between the Finance Ministry and the BoK. However, there had hardly

military *coup d'etat* in 1961, it could not carry out its role as stipulated in the Act. When the military government started to pursue government-led economic development at the beginning of the 1960s, however, the BoK was forced to transform itself in order to support the economy's development. Thereafter, the Finance Ministry legitimately intervened in the business of the Bank.

When the Republic of Korea government was established in 1948 after thirty-six years' occupation by Japan and three years' occupation by the US military administration, there were three reasons to establish a central bank. First, the legal basis for existing institutions and regulations, which had remained in force since the Japanese occupation, had to be re-enacted. Second, the accumulated government budget deficits had to be corrected in order to achieve a stable balance of payments. Inflationary pressure had to be eased by restraining monetary growth. Third, these requirements were underlined by strong political and external considerations. In regard to its economic policy, the newly-established government had to gain the confidence of the Economic Cooperation Administration of the US (ECA) and international financial institutions (Bank of Korea 2000: 389-91).

The Korean government sought the advice of the US Federal Reserve Board (FRB) in June 1949. The FRB dispatched two staff members: Dr. A. I. Bloomfield, then Director for Balance of Payments in the New York FRB, and Mr J.P. Jensen, then Deputy Director for Banking Supervision in the New York FRB. A significant change made after consultation with them was that the Monetary Board of the BoK came to exert authority

---

been any such on-site examinations.

over monetary and foreign exchange business which had previously been under the jurisdiction of the Minister of Finance and the financial supervisory authority in accordance with the Government Organization Act. After having discussed the legitimacy of the proposal, the government finally approved it and sent the bill to the National Assembly. The bill was approved on April 1950 and became effective on 5 May 1950.[15] With respect to authority over banking supervision, the bill stated that the BoK would have authority over monetary and foreign exchange policy which had previously been held by the Finance Ministry.

The BoK Act may look unusual because it focused on monetary stability. However, this is understandable not just because the FRB officials were responsible for the final draft but also because inflation had been a major concern of the government. Since the government budget relied mainly on monetary growth, with the BoK as the monetary authority and no appropriate regulations having been established, monetary growth by financial institutions was enormous.

However, after the 1961 military coup, the military regime started to promote government-led economic development. The BoK Act had to be revised significantly in accordance with the regime's policy priority, i.e., economic growth. As the military regime sought resources for investment not only from foreigners but also from domestic investors, the BoK had no option but to approve the revision. The role of the government

---

[15] Under Article 109 of the then BoK Act, the authority of the Finance Ministry over monetary policy was transferred to the BoK. Article 111 of that Act stipulated that other legislation which conflicted with the BoK Act was repealed. Under this act, the Bank of Korea became independent of any government intervention over monetary

in mobilizing resources strengthened and the institutional structure had to be transformed in order to suppon government domestic financial and foreign exchange policy.

The Finance Ministry drafted the new bill revising the BoK Act and this was approved in May 1962 by the National Assembly. The major change was that the ultimate responsibility for deciding and managing monetary policy was transferred to the government. The new bill also made it clear that the Finance Ministry had supervisory power over BoK's business. The legal and operational independence of the central bank which had been made clear in the original BoK Act was annulled. "In order to clearly establish that the ultimate responsibility for monetary policy was with the government, the Monetary Board was even renamed the *Monetary Management Board*"(*emphasis added*) (Bank of Korea 2000: 394-8). This meant that the Board of the BoK would simply manage monetary policy in accordance with government policy. This was to establish an institutional framework relying on the note-issuing power of the BoK to fund economic development (Presidential Committee for Financial Reform 1997d: 9).

As indicated, the Finance Minister could ask for decisions made by the Board to be reconsidered and the accounts of the BoK had to be approved by the Finance Ministry. Moreover, a new act called the Act for Foreign Exchange Management was passed in 1962; most of the BoK's previous authority over foreign exchange business was removed and transferred to the government.

With respect to banking supervision, the Department of Bank Supervision in the

---

policy (Bank of Korea 2000: 393).

BoK was enlarged and renamed the Office of Bank Supervision (OBS). The OBS was given more powers than the equivalent department of the BoK had previously had, and the new BoK Act enabled the OBS to establish multiple deputy head positions (Bank of Korea 2000). Table 2.1 below shows how the functions of the BoK were reduced by the 1962 revision of the BoK Act.

Table 2.1 Objectives of the BoK in accordance with the BoK Act

Original Act (1950-62)	Revised Act (1962-97)*	Present Act (1998-now)
Article 3. the principal objectives of the Bank should be: 1. To promote the achievement and maintenance of domestic monetary stability and national economic development 2. To further orderly economic progress and development and the fullest and most efficient utilization of the nation's resources by promoting the liquidity, solvency and efficient functioning of the nation's banking system 3. To administer the nation's international reserves in the interests of achieving and maintaining an orderly pattern of international trade and exchange relationships.	Article 3. 1. Same as in the original act 2. Same as in the original act 3. (revoked)	Article 1 (Objective) This act is to establish the Bank of Korea, to pursue price stability by establishing and implementing efficient monetary policy and thus help bring about sound economic development of nation.

Source: Derived from Bank of Korea (2000) and Kim, B-K. (1965: 14)
*There had been a further four revisions to the Act during that period. The main features of the Act remained unchanged until the 1998 Act was passed.

2.2.3 The Regulatory Institutional Framework, 1980s-1990s: Contending with Existing Explanation

The regulatory institutional framework in Korea prior to the crisis maintained its original form, which reflected the growth-first policy objective of the developmental state. Above all, a major difference in its regulatory structure from that of many other countries was that all the responsibility for financial regulation/supervision was concentrated with the Finance Ministry.[16] Moreover, the degree of centrality of the authority was very high. As mentioned earlier, such centralization facilitated regulatory capture by private interests.

Regulators of financial institutions in many other countries are either the central bank/monetary agency or specialist regulators. It was said that Korea's central bank/ monetary agency had authority over banking, along with special regulators over securities and insurance (Goodhart 1998: 183-185). This is interpreted to have referred to the Bank of Korea and the Monetary Management Board in the BoK. In reality, however, the Finance Ministry was responsible for all the crucial areas of financial regulation/ supervision over financial institutions, though there were complex variations in respect of banking, securities and insurance.

On the surface, Korea appeared to have had a multiple regulatory institutional

[16] A similar feature can be found in Germany and Japan.

structure (see Table 4.2).[17] Focussing on banks only, the regulatory authority over banking accounts in banks was the Monetary Management Board of the Bank of Korea and thus the banking accounts were supervised by the OBS, an arm of the BoK, while trust accounts in banks were exclusively regulated by the Finance Ministry in accordance with the Trust Business Act. Because the size of assets in the trust accounts of the DMBs almost reached the same level as the deposits in bank accounts in the 1990s (see Table 4.3), the Monetary Management Board and the OBS were responsible for the supervision of only half of the operations of the DMBs.[18]

Noting this complex and multiple regulatory agency structure, existing literature tends to suggest the "fragmentation of regulatory structure" (Stiglitz 1999a). It is argued that the fragmented regulatory structure caused regulatory arbitrage by financial institutions. At a conference held in Korea in the wake of the crisis, Joseph Stiglitz claims:

> "The unlevel regulatory playing field in the past has given NBFIs (*non-bank financial institutions*) an advantage, reducing the franchise value of the banks (*deposit money banks*) that try to compete with them. ... Korea has taken a step in the right direction by consolidating supervisory functions in one agency (the FSS), which makes it harder for financial institutions to evade supervision by choosing to submit themselves to the weakest supervisory regime (*emphasis added*)" (Stiglitz 1999a).

---

[17] The regulatory arrangement may be categorized in three different ways, i.e., by institution, by function or by objectives.

[18] The DMBs were allowed to do trust business in the 1980s. Before that, only Trust Bank was authorized and this Bank was subsequently merged with Seoul Bank.

The IMF also shares that view. The DMBs were under the direct authority of the Monetary Board (the governing body of the BoK) and the OBS, while specialized banks and non-bank financial institutions (NBFIs) were under the authority of the Ministry of Finance and Economy (MoFE), although the MoFE delegated on-site examination of the NBFIs to the OBS. Hence, it is argued that a persuasive explanation for the deficiencies in prudential regulation in Korea before the crisis is that the lack of a unified system created the conditions for regulatory arbitrage and the development of risky practices, especially in the commercial banks' trust business and in the merchant banks that were crucial in the build-up of the crisis (Baliño et al. 1999: 16). This view is consistent with the argument in the literature on financial regulation.

> "A multiple regime … creates a potential for regulatory arbitrage and inconsistent regulation between different institutions conducting the same type of business" (Goodhart et.al 1998: 146-7).

In fact, due to the complexity of the regulatory structure, the trust account business of the DMBs, which, before the crisis, was as big as the banking business, was left without any serious regulation. This is also confirmed by the fact that some of the DMBs had non-bank financial subsidiaries, such as merchant banks and leasing companies. Through promoting trust business and connected lending to their subsidiaries, some of the DMBs may have circumvented regulatory authority and thus made it difficult for the authority to judge the viability of the banks it supervised.

However, another aspect of the structure, which caused more serious problems, was that most of the regulatory authority was concentrated within the Finance Ministry.

Specialist regulators, such as the OBS, did not have any substantial authority over regulation in general but only over some limited areas of supervision *stricto sensu*.[19] In fact, the Presidential Committee for Financial Reform in 1997 recognized that "though the regulatory regime appeared to be a plural one, in reality government-led decision-making was still dominant." Accordingly, the committee argued, "The autonomy and independence of intermediated regulatory institutions lacked self-development and originality. This is because prudential regulation is assumed as enforcement of government-led financial policy" (Presidential Committee for Financial Reform 1997b: 223).

[19] This refers to supervision over banking in a narrow sense, i.e. licensing, on-site supervision, reporting and sanctioning.

Table 2.2 Regulatory Responsibility over Financial Institutions prior to the Crisis

Classification		Regulatory authority	Regulatory institutions for examination by right	Regulatory institutions entrusted for inspection
DMBs	National commercial banks, Local banks, Foreign banks branches in Korea	Monetary Management Board (OBS)	OBS, DIC *1)	
Specialist banks	Banking business section in National Agricultural Cooperative Federation, in National Federation of Fisheries Cooperatives, in National Livestock Cooperatives Federation	Monetary Management Board (OBS)	OBS, DIC *1)	OBS
	KDB, Industry Bank	MOFE	BAI, DIC*1)	OBS
	Exim Bank	MOFE	MOFE	OBS
	Housing Bank, Long-term Credit Bank	MOFE	MOFE, DIC*1)	OBS
NBFIs	Credit Unions	MOFE	MOFE	OBS
	Mutual Savings and Finance Companies	MOFE	MOFE	OBS, FCM
	Trust Accounts of Banking Institutions	MOFE	MOFE	
	Merchant Banking	MOFE	MOFE	OBS
Securities	Securities companies, Securities financing companies	MOFE, OSS*2)	OSS	
Insurance	Life insurance	MOFE, OIS*2)	OIS	
	Non-life insurance companies	MOFE	MOFE	
Others	FCM	MOFE	MOFE	OBS
	FCG	MOFE	BAI or MOFE	
	Investment trust corporations, SEC	MOFE	MOFE	OSS*3)
	Credit card companies	MOFE	MOFE	OBS
	Leasing companies	MOFE	MOFE	OBS

*1) Limited inspection was only allowed.
*2) Limited regulatory authority was given.
*3) Inspection over investment trust corporations only was authorized.
BAI (Board of Audit and Inspection), MoFE (Ministry of Finance and Economy), OBS (Office of Bank Supervision, OSS (Office of Securities Supervision), OIS (Office of Insurance Supervision), DIC (Deposit Insurance Co.), FCM (Fund for Credit Management), FCG (Fund for Credit Guarantees)
Source: Presidential Committee for Financial Reform (1997a: 221)

Table 2.3 Deposits held in Banking Accounts and Trust Accounts

	1990	1991	1992	1993	1994	1995	1996.6
Banking accounts*	92,540.2 (76.2)	111,105.3 (75.2)	122,090.5 (69.6)	135,265.6 (63.7)	161,391.8 (60.1)	188,107.1 (56.2)	195,487.4 (54.0)
Trust accounts	29,174.6 (24.0)	36,628.1 (24.8)	53,256.3 (30.4)	77,184.2 (36.3)	107,299.5 (39.9)	146,696.8 (43.8)	166,744.5 (46.0)
Total	121,714.8	147,733.4	175,346.8	212,449.8	268,691.3	334,803.9	362,231.9

*Banking accounts include deposits in Korean currency, foreign currency accounts, CD net issues, papers sold, RP sold and net issues of financial bonds.
Source: Bank of Korea (1995). *Present Conditions of Foreign Currency Funding*

*Table 2.4 Regulatory Structure Focusing on Key Regulated Financial Institutions**

Classification		Regulatory authority	Regulatory institutions by right for examination	Regulatory institutions when entrusted for examination
DMBs	Banking business	Monetary Board	OBS	
	Trust business	MOFE	MOFE	
KDB, EXIM		MOFE	MOFE, BAI	OBS
Merchant banks		MOFE	MOFE	OBS

* Derived from Table 2.2

Intermediate regulatory authorities with special expertise did not have operational independence from the government (in the case of the BoK) or were directly controlled by the Finance Ministry (in the case of the OBS). The soundness of financial institutions, which should have been the major concern of the specialist regulators (intermediate regulatory institutions), i.e., the OBS, OSS, and OIS, was thus subordinated to the objective of the Finance Ministry, i.e. growth.[20]

The dominance of the Finance Ministry in exerting regulatory authority over financial institutions caused serious regulatory problems. Above all, the authority for regulation was separate from the intermediate regulatory institutions that could make on-

[20] The OSS and the OIS represent the Office of Securities Supervision, and the Office of Insurance Supervision respectively. These two regulatory institutions, along with the OBS, were called intermediate regulatory institutions, which meant that the

site examinations. This made the intermediate regulatory institutions difficult in implementing and enforcing strict supervision. Moreover, the Finance Ministry was the subject of regulatory capture by private interest; the Ministry interfered with sound regulatory implementation by intermediate regulatory authorities as shown in the case of the BoK's foreign currency deposits with domestic banks in Chapter 4, Section 4.6.

As for the BoK, it lost interest in prudential regulation. It tended to pay attention to the area of monetary stability rather than the area of financial stability. Moreover, although the OBS was part of the BoK, both institutions behaved as separate institutions, due to the characteristic hierarchy of the regulatory institutional structure. Consequently, the soundness of banks was not a major concern either of the BoK or of the Monetary Management Board.

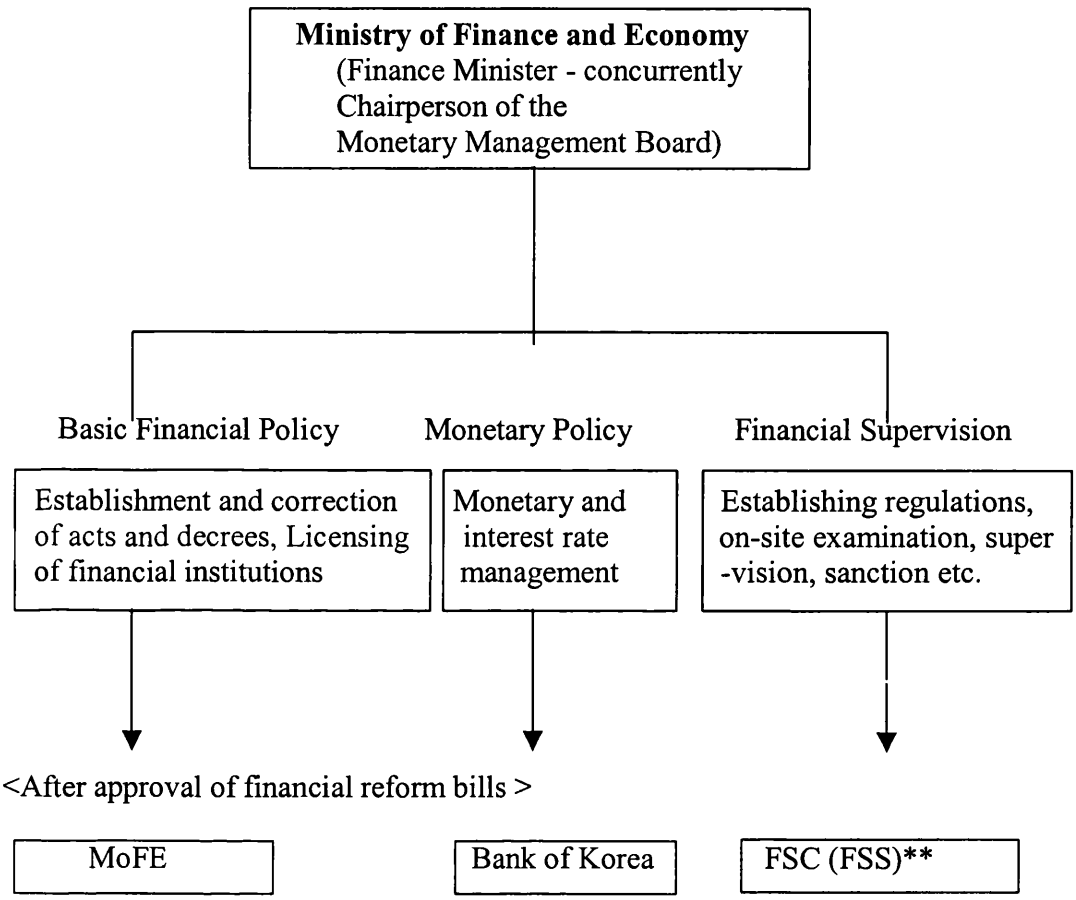
A document entitled 'The Early Necessity to Deal with Parliamentary Bills for Financial Reform,' which was written by the President's senior advisor for economic affairs and was submitted to the President, Kim Young-Sam, on November 21 1997, shows that overall financial administration was under the jurisdiction of the MoFE. This document aimed to enable the President to explain the government's position regarding proposing the bills, which were then brought up for discussion in the National Assembly. The document included the chart shown below.

---

ultimate authority for regulation was somewhere else, i.e., the Finance Ministry.

Chart 2.1 Major Flame of the Legislation for Financial Reform (As at Nov. 21, 1997)

<Present> Overall financial administration under jurisdiction of the MoFE



*To be effective on April 1, 1998
** FSC and FSS represent Financial Supervisory Commission and Financial Supervisory Service.

Source: Presidential Secretariats, *The Early Necessity to Deal with Parliamentary Bills for Financial Reform*, 21 November 1997.

In sum, regulatory authority for supervision over banks, the most crucial areas of the financial supervision, appeared to be complicated, but in fact the Finance Ministry maintained its comprehensive responsibility for all related areas. It was true that there was some delegation of administration to the intermediate regulatory agencies. However, that delegation was not significant. This kind of insufficient delegation bore a close resemblance to the spirit of Japanese administrative law.[21]

2.3 Institutional Inertia of the Regulatory Authorities

Since the 1980s there were institutional changes in the Finance Ministry in response to economic and political constraints. What was remarkable is that the changes were aimed at facilitating liberalization and deregulation, while institutional reform for strengthening prudential regulation was stalled by institutional inertia which originated from the bureaucratic interests of the relevant institutions, i.e., the Finance Ministry (MoF and MoFE) and the BoK.

2.3.1 Financial Repression and Bureaucratic Interest of the Finance Ministry

In a "repressed" financial system, the government maintains artificially-low interest rates, thus inducing an excess demand for credit, and accordingly leading to preferential credit schemes with government-directed programmes that supply lending to "targeted" sectors, activities and individual firms in quantities and at interest rates that would not be extended by existing financial institutions acting independently of

[21] Bureaucrats in Korea had a view that every phenomenon should be subject to their administration. Accordingly, delegation had to be strictly limited and supervised by them. In Korea, Acts, which are passed by the National Assembly, are usually loosely-worded and delegate the details and rules for their implementation to Decrees and Ordinances, which are made by ministries. The strength of the bureaucracy may be due to

government guidance (McKinnon 1973; Haggard and Lee 1993: pp 5-6). Though proponents of intervention in financial markets assumed a competent and "strong" government would maximize social welfare by offsetting and correcting financial market imperfections, models of rent seeking and regulatory capture posed an argument that government intervention was likely to reflect the preference of powerful interest groups, such as rising manufacturing groups, the banking sector or personal networks tied to top executive officials (Bhagwati 1982; Haggard and Lee 1993: pp. 7-8).

Also, the "government failure" arguments (e.g., Mueller 1979; Cullis and Jones 1987) suggested, "the government is not the benevolent, all-knowing, and all-powerful agent… the government is an organization which is run by groups of self-seeking individuals (politicians seeking re-election and bureaucrats seeking higher salaries and more power) and is influenced by interest groups, with the result that it implements policies that serve these groups rather than the public interest" (Chang 1997: 709). In Korea, the period of financial repression during the 1960s and 1970s gave birth to a group of "self-seeking individuals" centring around the Finance Ministry, known in Korean press as the "Mofia."

"Mofia" is a compound word of "MoF (Ministry of Finance)" and "Mafia."[22] Lee Hwan-Kyun, then Minister for Construction and Transportation in 1997, told journalists about personnel affairs regarding the "Mofia". He, who had previously been the deputy minister of the Finance Ministry, mentioned that there was a "principle of 3-3"

these legislative practices.

[22] The Mafia is a criminal organization in the USA, consisting of immigrants

in the Finance Ministry, which meant that those who retired from the ministry as high-level officials would take positions for three years at 'A level' related institutions controlled by the Finance Ministry, e.g., as members of the Monetary Management Board in the BoK, Presidents of DMBs. After that time those people would work for another three years in a similar capacity at 'B level' institutions in the financial sector, such as auditors of regional banks or presidents of merchant banks (Kim, H-K 2000).

Having maintained their personal ties and organizational power, members of the *Mofia* have taken positions in the financial sector as much as possible. In 1995, there were 95-100 former MoF members who were taking positions at director level or above in the financial sector (Minutes of the Special Investigation Committee on the 1997 Foreign Exchange Crisis at the National Assembly, January 1999). Among the *Mofia*, core members had graduated from the best high school, Kyung-gi, and passed with almost the best marks the national examination for selecting administrative officials. They usually worked in the department of financial policy, which is responsible for financial regulation/supervision of the financial sector, "*Lee-Jae Kook.*"[23] Even in the aftermath of the crisis, fifty-five former MoF officials took positions at director level or above in the financial sector (Minutes of the Special Investigation Committee on the Crisis, January 1999). The reason for such a surprisingly high figure was, needless to say, due to the fact that the Finance Ministry exerted absolute power in financial regulation and supervision, including investigation and sanctions, over the financial sector. Former

---

from Italy.

[23] This department changed its name into the Department of Financial Policy after 1995, as a result of integration with the EPB. "Lee-Jae" and "Kook" mean management of financial affairs and department, respectively.

staff of the BoK and the OBS also took positions in the financial sector but the number from those institutions was much smaller than that from the Finance Ministry.[24] Where the authority for financial supervision should be located was a burning issue among the Finance Ministry and the BoK for it was directly related to the interest of those institutions.[25]

2.3.2 Failure to Set Up a New Regulatory Framework

The bureaucratic interests of the Finance Ministry, symbolized by the "Mofia", has been a major impediment to setting-up a new regulatory framework since July 1987, when junior BoK staff announced that the Bank should be independent of the government. As the major point of the announcement was that the Chairperson of the Monetary Management Board, which is responsible for monetary and financial supervisory policy, should be occupied by the BoK Governor, the issue of the BoK's independence was directly related to the issue of the financial regulatory framework. The MoF responded to the announcement by proposing an amendment to the BoK Act which was summarized by two points. The first was that the Chairperson of the Monetary Management Board should occupy the position of the BoK Governor and the second was that the OBS should be separated from the BoK. In this regard, the issue of who would be responsible for supervision of the financial sector was the major difference between those two

[24] As at 20 January 1999, 27 people at director level and above were former staff of the OBS, OSS (Office of Securities Supervision), and OIS (Office of Insurance Supervision) (Minutes of the Special Investigation Committee on the Crisis, January 1999).

[25] See section 2.2.2.3 above.

institutions.

Such a conflict between the Finance Ministry and the BoK also occurred in 1995. Table 2.5 is a comparison of the proposals from the BoK and the Finance Ministry in 1995.

Table 2.5 Different Proposals on the BoK Act in 1995 Compared

Classification	Then BoK Act	Position of the MoF	Position of the BoK
Chairperson of the Monetary Management Board	Minister of Finance	Chairperson would be the BoK Governor	The BoK Governor would be the Chairperson
Selection Process of the Chairperson	Recommended by the minister of finance, appointed by the President	Recommended, among members of the Monetary Management Board, by the Finance Minister, appointed by the President	The BoK Governor (the Chairperson of the committee) should be recommended by the premier, appointed by the President
Supervision of the BoK by external auditor	By the Finance Minister, and BAI*	BAI only	BAI only
Financial supervisory authority	BoK (the OBS) over DMBs	Separated from the BoK and integrated with the OSS and the OIS into the FSS. The new FSS is controlled by the MoF. **	BoK

*BAI refers to Board of Audit and Inspection.

** The new regulatory authority (Financial Supervisory Service) in the 1995 bill was different from that of present one (Financial Supervisory Service) in that the former was going to be directly controlled by the Finance Ministry. However, the present one is controlled by a government council (Financial Supervisory Authority), which is located under the premier. Thus, the present one is not controlled by the Finance Ministry.

Finance Ministry that Wanted to Maintain its Regulatory Authority

When junior BoK staff announced that the BoK should be independent of the influence of the government on 28 July 1987, it was perceived as a symbolic incident for economic democratization. It was at a time when political parties were negotiating to revise the then Constitution to change the indirect presidential election system into a direct one. The Finance Minister responded to the announcement by saying that the impartiality of monetary policy and the central bank could be secured by amending subordinate legislation to the constitution rather than by revising the constitution itself.

During the presidential election in December 1987, candidates from the then opposition parties committed themselves to a policy of the central bank's independence from the government, but the election result was a victory for Roh Tae-Woo from the ruling party, who did not clearly express his position on this issue. As a general election in April 1988 following the presidential election resulted in opposition parties commending the majority of the National Assembly (parliament) in Korea, the issues of the central bank's independence and the location of the financial regulatory authority were finally addressed by the National Assembly in 1988 and 1989. Opposition parties prepared a unitary amendment bill to the BoK Act. The gist of the amendment was, firstly, that the Chairperson of the Monetary Management Board held the additional post of the BoK Governor, and secondly, that regulatory authority over the DMBs should be placed in the BoK while the Finance Minister should have the right to ask the Board to investigate certain DMBs. The Finance Ministry concurred that the BoK Governor should hold the addition position of the Chairperson of the Monetary Management Board, but announced that regulatory authority should be located within the Ministry. The core contentious issue was not the neutrality of the BoK and monetary policy, but who would have supervisory authority over financial institutions.

The position of the Finance Ministry changed over three occasions in 1988, 1995 and 1997. On the first two occasions, the MoF (and MoFE) wanted to have direct authority of financial regulation by controlling the OBS in 1988 (and a new intermediated authority, FSS, in 1995). In 1997, however, the MoFE suggested the installation of a new regulatory authority, Financial Supervisory Commission ("FSC"), an administrative council under the jurisdiction of the premier. Thus, the FSC controls the Financial Supervisory Service ("FSS"), which is independent of the influence of the Finance Ministry.

Proposals from the Presidential Committee and the MoFE Compared

However, bureaucratic interests in the Finance Ministry continued even in the 1997 proposal to revise the BoK Act. This is well-expressed when we compare the 1997 proposal of the Ministry with a proposal from the Presidential Committee for Financial Reform. The Committee, started in January 1997, presented four reports on financial reform throughout 1997 and its suggestion on the financial regulatory framework came out in its second report in June 1997. Although it was eclectic in terms of trying to compromise the bureaucratic interests of both the MoFE and the BoK, the MoFE did not accept the proposal from the Committee and revised it.

The main points of the proposal by the Presidential Committee was that the BoK should focus on monetary policy to ensure price stabilization but, in order to stabilize the country's payment system, it thought that part of the authority of the BoK over prudential regulation should be recognized. Thus, the FSC would be absolutely responsible for the regulatory authority of various aspects such as licensing, prompt corrective action, disclosure, governance structure, and exception to prohibited matters.

However, in relation to some issues, i.e., management guidance, limits on single persons and groups and large exposure, and limits on guarantees against the equity capital of DMBs, the Monetary Management Board of the BoK should possess regulatory authority with a condition that the Monetary Management Board should consult with the FSC if it wanted to change such regulations. As regards some other issues such as on-site examinations and sanctions, regulatory authority should be with the FSC, but the BoK itself can exert such examinations to maintain its regulatory authority of sound management guidance and ask the FSC to impose sanctions on certain financial institutions (The Presidential Committee for Financial Reform 1997b: 181-250).

However, the proposal from the Presidential Committee was not accepted by the Finance Ministry. While the proposal from the Committee allowed the BoK to maintain a considerable amount of financial regulatory authority over the financial sector, the bill from the government (the MoFE) aimed at depriving the BoK of most regulatory authority, although it ensured the BoK's independence from the government in monetary policy. All supervisory authority would be delegated to a new financial regulatory body, the Financial Supervisory Commission, which would be located under the Premier. The argument of the government was that the authority, since it belonged to the government function, could not be delegated to non-governmental institutions such as the BoK (Monthly Chosun, 1997).

The MoFE bill faced fierce opposition from BoK staff, who sabotaged most BoK business, including foreign exchange market management, lobbied the political parties and demonstrated in the street. This episode shows that not only bureaucrats in the Finance Ministry but also BoK staff were embedded with vested interests in relation to regulatory authority.[26] After all, the bill was unable to gain approval in the National Assembly, although the government tried very hard to achieve this between July and November 1997. The bill, however, was finally legislated after the country asked for help from the IMF.

What should be noted is that the transfer of the regulatory authority from the MoFE to the FSC does not mean that the bureaucratic interests of the Finance Ministry (represented by the Mofia) have not been protected. The Finance Ministry changed its original position, which was going to entrust all the regulatory authority, i.e. the right to propose bills regarding regulatory policy and supervision, with the FSC. Rather, it maintained the first two areas within the Finance Ministry itself. Moreover, almost all members of the very department that is responsible from regulatory authority in the Finance Ministry moved to the FSC. Also, the FSC has been trying very hard to extend its role and number of officials since 1998. Whenever the number of officials increased or some of them retired, the gap has been filled with officials from the MoFE. Those who

[26] An unnamed BoK staff member also confirmed this in an interview in March 2002.

retired from the FSC have been taking crucial positions in the financial sector. In sum, the bureaucratic interests of those responsible for regulatory authority have remained intact.

Limited Institutional Change in the 1980s-1990s: Financial Liberalization

Haggard and Maxfield (1993) argued in their study on developing economies in Asia and Latin America, "[E]xternal economic and political constraints have influenced major changes in financial market policy, including the current trend toward liberalization" (p. 20). In fact, Korea experienced external economic and political constraints on at least three occasions: the political and economic crisis at the end of 1970s and the beginning of 1980s, US government pressure for financial liberalization in the latter half of the 1980s, and the strong influence of business in government decisions during the mid 1990s.

As we have examined, the regulatory institutions were embedded with vested interests, thus preventing the framework from adapting to a new situation. However, it cannot be argued that the government did not at all respond to political and economic constraints. Kong (2000) indicates that the authoritarian industrialization pattern of the 1960s and 1970s was giving way to economic liberalization and democratization in the 1980s due to the following three factors:

> First, international economic and political trends exerted positive and negative inducements for greater economic openness. Second, the high interventionism of the 1970s had accomplished its aim of giving Korea the productive capacity required for her future export and defense plans. The economic agenda shifted from the creation of capacity to making that capacity efficient, meaning

that markets would inevitably have to play a bigger role. Third, authoritarian industrialization unleashed popular expectations that undermined its foundations of political stability. The combination of these three factors helps to explain why Korea's authoritarian industrialization pattern (or Korea Inc.) had become unsustainable by the end of the 1970s (Kong 2000: 14).

2.4 Conclusion

This chapter has set out two crucial aspects of the financial regulatory institutional framework in Korea prior to the crisis: its hierarchic order with centralization of the authority in the Finance Ministry and institutional inertia based on the bureaucratic interests of the Finance Ministry and the BoK.

With regard to the first aspect, which is more important, the framework was set up at a time when the developmental state was emerging in the 1960s, and it remained by and large unchanged until the outbreak of the crisis. This study has argued that the regulatory institutional framework has always been hierarchic, with the Finance Ministry being at the zenith of the related authorities. The Finance Ministry facilitated its developmental objectives, which were consistent with business interest, without proper emphasis on prudential regulation. Although there had been three key financial regulatory institutions, among which two of them (the BoK and the OBS) had policy objectives of stabilization and prudential regulation, those objectives hardly worked as the principal policy of the regulatory framework. The precept that institutional centralization was a principal requirement for the developmental state also applied to the financial regulatory framework, but the structural feature turned out to be weakness rather than strength as far as prudential regulatory issues are concerned.

As for the second aspect, financial repression gave birth to strong vested interests in the Finance Ministry with regard to financial regulation. A group of "self-seeking individuals" called the "Mofia" was formed and resisted any institutional change which could weaken the Ministry's power in financial regulation. Such bureaucratic interests were also observed in the BoK, thus obstructing regulatory institutional reform during the 1980s and 1990s.

The fact that the government responded to external economic and political constraints with institutional change in the Finance Ministry and the EPB may suggest its vulnerability to external events and the flexibility of the institutions in the developmental state in light of the changing situation at the same time. However, the rigidity of the regulatory institutional framework on the basis of bureaucratic interests, which prevented the country from introducing a new regulatory framework means that such flexibility was limited and its direction was constrained in the domestic context of close business-government relations. As a result, liberalization and deregulation could be accelerated (by changes in the Finance Ministry) but prudential regulation could not, as was seen in the failure to introduce a new regulatory framework.

Chapter 3 Explaining the Selective Financiai LIberalization in Korea, 1980s and 1990s

3.1 Introduction

What was the source of financial sector liberalization in Korea during the 1980s and 1990s? This is an important question because financial liberalization, including capital account liberalization, was central to the undermining of the Korean developmental state model because financial repression had previously substituted for effective prudential regulation. Moreover, Corsetti et al. (1998) argued that moral hazard problem led to the financial crisis when financial liberalization was occurring.

As Honohan (1999) indicates, financial repression such as interest rate ceilings had the effect of helping avoid excessive competition between banks and of handing a good profit margin to banks as long as entry was limited, whereas financial liberalization had resulted in, for example, increased competition in the financial services industry and increased volatility of asset prices. Caprio, Honohan and Stiglitz (1999) argue that "All this has meant greatly altered incentives for risk-taking, risk management and corporate governance of financial intermediaries." (p.1)

Competing approaches in IPE (International Political Economy) literature have suggested various explanatory variables for financial liberalization.[1] In relation to the issue of regulatory failure in Korea, existing explanations are classified into two groups: the exogenous explanation focussing on US government pressure (e.g. Wade

[1] For competing approaches to explaining financial liberalisation, see Chapter 1, pp. 36-41.

and Veneroso 1998) and the endogenous explanation considering regulatory capture by private interest or corruption (e.g. Haggard 2000; Kang 2002). According to the exogenous factor explanation in particular, the removal of capital controls, which was forced by US government pressure, caused the dismantling of the developmental state. It is claimed that the economy had high corporate debt-to-equity ratios, thus capital controls were more necessary in Korea than in any other countries (Wade and Veneroso 1998: 31).[2]

In order to evaluate these two explanations, the issue of capital account opening, among the various issues regarding financial sector deregulation, can be a good case study.[3] Capital account opening was the very area where external and internal forces interacted with each other, influencing the government in order to get favourable policy outcomes. To what extent did such external pressure coerce the Korean government to introduce capital account liberalization prematurely? How did the preference of domestic interest groups affect the government in policy outcomes?

There were some important events regarding capital account liberalization in Korea. From the latter half of the 1980s, the US started to press the Korean government on the issues of the foreign exchange rate system and overall financial liberalization, including capital account opening throughout the 1990s. In 1988, the US Congress approved the Omnibus Trade and Competitiveness Act, of which

---

[2] Also see Chang, Park, and Yoo (1998), Wade (1998, 2000) and Chang, Palma, and Whittaker (2001).

[3] In fact, the Asian crisis has sparked controversy on the effects and causes of capital account liberalization on an economy. Eichengreen (2001) argues, "Capital account liberalization, it is fair to say, remains one of the most controversial and least understood policies of our day." See also Cooper (1999), Dooley (1996), Edwards (1998), Mathieson and Rojas-Suarez (1993), Quirk and Evans (1993), Rodrik (1998).

Section 3004 required the US President to negotiate with other countries on exchange rate and economic policies to reduce the then increased US trade deficits. Korea, along with Taiwan, was particularly targeted by the Act. In 1989, the Korean government announced its plan to introduce a Market Average Exchange Rate System from the following year (1990), instead of the then Basket System.[4] It also adopted a negative-list system for the management of foreign exchange in September 1992.

From 1990, the Korean government started bilateral talks with the US government, i.e. the Financial Policy Talks, required by the 1988 Trade Act in the US. The Korean government announced a blueprint for financial deregulation and market opening in March and June 1992, respectively. In addition, the third schedule for financial liberalization and market opening was finalized as part of the Five-Year Plan for the New Economy in early July 1993 (BoK 1994: 38). After the Korean government applied for the country's entry to the OECD in March 1993, multilateral negotiations with the OECD member countries on financial liberalization issues, focusing on capital account liberalization, was under way. Korea succeeded in joining the club at the end of 1996, exactly a year before the 1997 crisis.

This chapter focuses on particular regulatory outcomes regarding financial liberalization, examining the policy choices of the developmental state in the context of external and internal pressures, by period, i.e. in the latter half of the 1980s, the beginning of the 1990s and the mid-1990s, and the negotiation period for OECD entry. Section 3.2 introduces the main points of the exogenous and endogenous explanations on financial liberalization in Korea. Section 3.3 focuses on the outcomes regarding the

[4] On the Basket System, see section 3.3.1.

foreign exchange rate, ignited by US pressure in the late 1980s, and the bilateral Financial Policy Talks between the US and Korean governments in the 1990s. Section 3.4 is concerned with the multilateral talks surrounding Korea's entry to the OECD. Section 3.5 provides a conclusion and implications for the thesis.

3.2 Present Explanations for Financial Sector Deregulation in Korea

Exogenous Factor Explanation

In his 1998 article in *World Development*, Robert Wade claims the existence of "alliance" with "the interests driving capital account liberalization without a framework of regulation." The alliance consisted of US and UK financial firms, cooperating with their country's treasuries and with the IMF, the WTO and the OECD. It is claimed that the US and UK governments believed their financial firms to be "at a chronic disadvantage in the Asian system of long-term relationships and patient capital. This alliance, supported by segments of Asian political and financial elites, achieved dramatic domestic financial sector liberalization and capital account opening in Asia over the 1990s, setting up the condition for crisis."(Wade 1998: 1535)

Wade argues that, "Korea provides a case study of the wider US campaign." US pressure started at the end of the 1980s, "when Korea lost some of the economic grace it had enjoyed from US geopolitical interests."[5] He suggests the US

[5] More vaguely, Woo-Cumings argues that "financial liberalization in Korea was triggered by a much larger global forces – and that this is not surprising since the course of the Korean political economy is critically influenced by events that occur in New York and Washington, the epicentres of world capitalism and politics. The story of the 1980s and the early 1990s, then, is less a story of Korea "reforming" after behaving badly in the past than of adjusting to new realities in Washington" (Woo-Cumings 1997: 91).

government pressured the Korean government in direct and indirect ways (Wade 2000: 15).

As regards direct pressure, the US Treasury complained, through the Financial Policy Talks from 1990, of restrictions of access to the Korean market for US banks and securities firms, i.e. restrictions on access to local funding sources. Above all, controls on foreign exchange and capital flows preventing foreign banks from competing with Korean banks was unsatisfactory to the US Treasury. Wade argues that the results of these talks were embodied in the Korean government's Blueprint for Financial Liberalization in 1992. This Blueprint became the basis for the incoming Kim Young Sam government's Five Years Plan for Financial Liberalization of 1993. By 1994 the US Treasury had achieved some of its agenda: higher ceilings on foreign participation in the Korean stock market, and "the Korean government had taken two steps, specifically wanted by the Treasury, that were to lead directly to the crisis: the conglomerates (*chaebol*) were free to borrow internationally; and new merchant banks were free to set up and borrow abroad" (Wade 2000:15). Dissatisfied with the results of financial liberalization, however, the US Treasury set out a detailed list of further suggested changes, including interest rate liberalization and the removal of limits on lending to the 30 largest conglomerates.

As regards indirect pressure, Wade argues that that pressure occurred at the Asia Pacific Economic Cooperation (APEC) meetings as well as OECD entry negotiations. Wade (2000) argues that the US Treasury began to take a strong interest in pushing financial liberalization through APEC. After becoming unhappy with the APEC process, however, the US Treasury "resumed its arm-twisting of the Korean government to remove capital controls faster than the Korean government had planned, dangling the bait of US support for Korea's entry into the OECD – an all-important objective of the Korean government, the very symbol of its arrival in the ranks of the developed nations." (p.16)

The US Treasury set out its negotiating position with the Korean government which was shown in an internal Treasury memorandum, in which it required as a condition of US support that "the Korean government let foreigners buy Korean bonds; also that the Korean government let Korean companies borrow abroad; and let foreigners buy Korean stocks more easily." Wade suspects that "these changes would make for a major change in the close relations between Korean companies and Korean banks – away from an organization relationship towards an arms-length market relationship – and hence further dismantling of the basic structure of the developmental state" (Wade 2000: 16).

However, Wade does not appear to be fully confident that US pressure determined the regulatory outcomes on capital account liberalization in Korea as some questions were left open. Notably:

> "[T]his account does not pin down the importance of this external pressure relative to the wishes of segments of the Korean policy-making elite; nor does it say where the Korean government gets its policy 'preference' from. To what extern did the Korean government move less fast than the US wanted? Does the fact that the Korean government moved much faster to let Korean firms borrow abroad than to let foreign financial firms operate in the domestic market suggest that the government retained some degree of autonomy?"(Wade 2000: 17)

Endogenous Factor Explanation

Some of the developmental state literature argued that a developmental state ensured a policy commitment to economic growth and cooperation with the private sector that avoided an emphasis either on private profit or the state's socialization of wealth (e.g. Johnson 1999: 57-58). Others emphasized how "strong" governments enjoyed political independence from the private sector (e.g., Haggard 2000: 20). In this regard, state autonomy was indicated as one of most crucial factors, which enabled governments to control the policy agenda and rendered them able to "govern (or discipline)" private firms (Amsden 1989, Haggard 2000).

However, as previously mentioned, some of the recent explanations for the regulatory outcomes in Korea indicate that either there was an exchange between government and business of 'favours' (the corruption argument, e.g. in Kang 2002) or political interference in the design or implementation of regulatory reform, including financial liberalization, undermining its stated objectives (the capture of liberalization argument, e.g. in Haggard 2002).

While Kang's corruption argument is based on the effects of macro-level institutional arrangements, i.e. politicians-business relations, on the policy environment, thus overlooking the effects of micro-level institutional arrangements, i.e. particular financial regulatory institutions-financial sector and business relations, on particular policy outcomes, Haggard's "capture" argument suggests some evidence on how particular regulatory outcomes were distorted by the growing influence of private interest.

For example, Haggard (2000) argues, "The creation of new merchant banks and the liberalization of the CP market was a major factor in the expansion of short-term financing; it is also a case study in how financial reforms can be captured not only in their implementation but in their basic design. ... In the 1990s, the IFCs expressed a strong interest in transforming themselves into merchant banks because of a number of privileges those institutions enjoyed." These domestic developments, along with growth-oriented macroeconomic policy, "took place against the backdrop of a gradual opening of the capital account", thus leading to the situation where "the government was unduly lax with respect to bank borrowing, particularly with the merchant banks." (Haggard 2000: 37-38)

In sum, both exogenous and endogenous factor explanations are similar in terms of arguing that the original features of the Korean developmental state such as strong state autonomy and macroeconomic stability were twisted by either exogenous or endogenous pressures. Which one is more convincing?

3.3 Pressure from the US: Exchange Rate and Financial Liberalization

3.3.1 Background and First Stage in the Late 1980s

Contrary to the arguments of Wade (2000) and Woo-Cumings (1997), US pressure started in the latter part of 1986, that is, it did not reflect any decrease in US geopolitical interests. Mr Mulford, US Treasury Undersecretary designate, indicated in a hearing before the US Senate in 1989:

"the U.S. began discussions with Korea on the matter of currency in the latter part of 1986 when it became obvious after the Plaza agreement that the currency adjustments that were taking place among the major currencies were not being followed by certain other countries, including Korea" (Hearing before the Subcommittee on International Finance and Monetary Policy of the Committee on Banking, Housing, and Urban Affairs, US Senate 101st Congress, First Session on the Second Annual Report Submitted to Congress by the Treasury Pursuant to the Requirement contained in the 1988 Omnibus Trade Bill, November 16, 1989).[6]

The pressure resulted from the view of the second Reagan administration that the chronic US current account deficit was due to the strength of the US currency. In January 1985, with James Baker at its head, the US Treasury believed that the appreciation of the US dollar had been a major cause of the US deficit and that both the exchange rate and the deficit were problems that needed to be addressed. The sale of US dollars, which was co-ordinated with other industrialised countries most visibly at the Plaza in September 1985, helped reverse almost the entire 1981-1984 appreciation over the two years after Baker took office.

While the US exchange rate depreciated, notably against the Japanese and German currencies, some other countries like the newly-industrialized countries ("NICs") were favoured by the newly-arranged exchange rate system, and were thus able to record huge surpluses in their current accounts. This was unacceptable both to the US government and Congress. Korea, along with Taiwan, was thus particularly targeted by the US from the latter part of 1986.

[6] This was the purpose of the provision in that legislation was to institutionalize an ongoing reporting and consultation process between the administration and the congress.

In 1988, the US Congress approved a new Trade Act, the Omnibus Trade and Competitiveness Act of 1988 (H.R. 3) (Refer to Appendix 3.1).[7] SEC. 3004 of the Act requested the US President to negotiate with other countries on exchange rate and economic policies to achieve "more appropriate and sustainable levels of trade and current account balances, and exchange rates of the dollar and other currencies consistent with such balances." The negotiations were both bilateral and multilateral.

Regarding the bilateral negotiations, the Secretary of US Treasury was required to consider "whether countries manipulate the rate of exchange between their currency and US dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade." At the same time, "if such manipulation had been occurring with respect to countries that have significant bilateral trade surpluses with the US, the Secretary of the Treasury had to take action to initiate negotiations with such foreign countries on an expedited basis, in the international Monetary Fund or bilaterally, for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and to eliminate the unfair advantage."[8]

This new policy of bilateralism originated from efforts to forestall protectionist legislation emanating from Capitol Hill. Cheng and Haggard (1996) defined this as a more aggressive use of market power to achieve economic goals. They argued that the new bilateralism was distinctive in three areas.

---

[7] This is the Act which is widely known as 'Super 301.'
[8] See US Trade Act of 1988 Sec. 3004 (Appendix 3.1).

First, the US played the role of *demandeur* in widening the trade policy agenda to include new issues such as services, the protection of intellectual property and trade-distorting investment measures. These issues provided the core of the new round of trade talks but these were also the issues of bilateral negotiations with Korea, Taiwan and, to a lesser extent, Singapore.

Second, the US became more aggressive in retaliating against the perceived violation of existing international commercial law. The banner of "reciprocity" and "fair trade" provided the rationale for increased pressure on the NICs to open their markets, and even to balance their trade with the US on a bilateral basis. In order to fend off legislative measures, the Reagan administration launched a comprehensive attack on unfair trade practices in 1985. The NICs were major targets of this attack. Protectionist pressures were strongest precisely in the sectors in which the East Asian NICs were most competitive, such as footwear, textiles and apparel, and steel.

The third issue is concerned with alternative means for managing trade imbalances. The US was to address trade problems through multilateral action on exchange rates and macroeconomic policy. This strategy was pursued by the US, Japan, Germany, France and Britain, the so-called Group of Five, as a result of the Plaza and Louvre accords on exchange rates and macroeconomic policy was the incident in the early and mid-1980s. In the late 1980s, the US pursued the same policy in dealing with the NICs and this time it resorted to bilateral pressure (Cheng and Haggard 1996: 306-307).

In looking at the details of US pressure on the Korean government, one should note that the focal point of US pressure changed. At first, the US focused directly on the appreciation of the value of the Korean currency, the won, and on pressure to change the then exchange rate system (See Table 3.2). In 1988, Korea had been identified as a country which manipulated exchange rates in two consecutive Treasury reports requested by the Sec. 3004 of the 1988 Act. Later, during the latter part of 1989, the US changed the direction of its pressure towards financial services and comprehensive financial market liberalisation. Its interest at this stage was largely the operation of US financial institution branches in Korea, represented by the so-called "national treatment". The method of bringing pressure to bear also changed. The method initially was extensive bilateral negotiations, while later multilateral and regional negotiations as well as bilateral ones were employed.

The first stage lasted until 1989 when the Korean government stated that it would change its exchange rate system into the 'Market Average System ("MAR")' from the following year, i.e. Mar. 1990. Until 1990, the system in Korea was the Managed Basket System (hereafter, the Basket system). The Korean government could directly intervene to affect the level of the exchange rate under the Basket system. The Bank of Korea announced every day's exchange rate. The formula for the change rate (R), i.e. change (%) on previous exchange rate, was

$$R = \beta \cdot (\text{SDR basket}) + (1 - \beta) \cdot (\text{Korea's own basket}) + \alpha$$

The Korean government did not inform the public about either the size of ß or Korea's own basket and currency weights but the basket was presumed to include five major currencies: those of the US, Japan, Germany, the UK and Canada. Currency weight was supposed to be based on trade amounts but the weight attached to the US dollar was likely to be greater than the trade volume between the US and Korea would imply because the dollar served as the payment currency for more than 90 per cent of external transactions in Korea. In short, the won/dollar exchange rate was determined mainly by two factors: the weighted average change in major trading partners' exchange rates vis-à-vis the US dollar and an adjustment factor (α) based on policy considerations (Wang 1993: 153-170). The adjustment factor was estimated to be as big as between 20 and 40 per cent during the period of 1982-86 (Kwack 1990: 90).

Table 3.1 below is a summary of the US Treasury's demands regarding the Korean exchange rate against the US dollar. It shows that US pressure was direct and concrete and it was effective in raising the value of the Korean currency, the Won, against the US dollar.

Table 3.1 The US Treasury's Demand for Appreciation of the Won

Period of negotiation	US demand (as of end of month, Won/US$, %)	Realised foreign exchange rates (as of end of month, Won/US$, %
April 1987 (Conference at ADB)	March to June: 846.9 to 780 (7.9% appreciation demanded)	June: 808.9 (4.5% appreciation)
April 1988 (Baker and Dallara in Seoul)	March to June: 746.2 to 700 (6.2 % appreciation demanded)	June: 728.3 (2.4 % appreciation)
December 1988 (Talk between Assistant Secretaries)	Did not specify target FX rates; "continuous appreciation" demanded	N/A
February 1989 (Talk between Secretaries)	Did not specify target; "appreciation up to the appropriate level" demanded	N/A
March 1989 (Talk between Assistant Secretaries)	March to May: 671.9 to 650 (3.3% appreciation demanded)	May: 666.7 (0.8% appreciation)
April 1989 (Talk between Assistant Secretaries)	March to June: 671.9 to 657 (2.2% appreciation demanded)	June: 667.2 (0.7% appreciation)
August 1989 (Letter from Secretary Brady)	"Continuous appreciation and proposal of regular meeting on financial markets, exchange rate policy, and capital markets"	N/A

Source: Ministry of Finance in Korea, *Data for Members of the Committee for Finance at the National Assembly, September 1989.*

3.3.2 Second Stage in the 1990s

As Korea changed its exchange rate system into a more market-oriented one, MAR, and Korea's global trade and current accounts were in deficit (which was after 1990 except for the year 1993), US pressure changed. The situation is clearly set out in the statement of Brady, Secretary of the US Treasury, in the US Senate First Annual Hearing on International Economic and Exchange Rate Policy in May 5, 1989 as follows:

> "Our negotiations with Korea in the coming months will be aimed at obtaining assurance of continued appropriate appreciation. Moreover, we will seek to engage the Korean authorities in a broad dialog on their capital markets, including exchange controls and the banking and securities markets. Such discussions would be aimed at improving the efficiency and openness of these markets. In addition, we will seek to obtain an understanding that comprehensive capital and exchange controls used to manipulate the exchange rate would be dismantled over the medium term and that market forces instead would be allowed to determine the rate."[9]

In his prepared statement for the US Senate Hearing in November 1989, Mr Mulford said:

> "I would like to note that Korea's Ministry of Finance has recently agreed to commence talks with Treasury on financial policies and markets. We hope to make progress in those talks on the fundamental issue of Korea's exchange rate determination system"[10]

---

[9] Hearing before the Committee on Banking, Housing, and Urban Affairs, US Senate 101st Congress, First Session on The Treasury Report to Congress on International Economic and Exchange Rate Policy, May 5, 1989: 27

[10] ibid.

As Brady mentioned, the Financial Policy Talks between the US and Korean governments in February and November 1990 did not explicitly focus on the level of the won/dollar exchange rate. The US Treasury sought to "encourage the liberalisation of Korea's exchange rate system and of the capital and interest rate controls that impede the full operation of market forces."

US pressure at this time was not as strong as it had been in the 1980s. This was due to the fact that US government "discerned no activity *(of the Korean government)* in the foreign exchange market which would signify intervention to influence the exchange rate" *(emphasis added)*. However, the US government maintained its pressure on the Korean government because "Korea maintains a system of foreign exchange and capital controls that limit trade and investment flows and thereby dampen the influence of market forces in the foreign exchange market."[11]

Lawrence Summers argued before the US Senate on 25 May 1992 that, since these controls limited US ability to export to and invest in Korea, and particularly limited the scope of US financial institutions' activities in Korea, the US maintained its efforts to promote market opening.[12]

---

[11] Statement of Lawrence H. Summers, Under Secretary of the Treasury before the Subcommittee on International Finance and Monetary Policy of the Committee on Banking, Housing, and Urban Affairs, US Senate 103rd Congress. First Session on Countries that Manipulate Their Exchange Rates to Gain Unfair Trade Advantages with the United States, May 25, 1993.

[12] US pressure moved on to China at this time from Korea and Taiwan in previous years. Summers stated in his statement before the US Senate in 1992 that "At the present time, only China is found to be manipulating its foreign exchange system"(US Senate hearing, 1994).

Access by US financial institutions to the Korean market was one of main issues in the talks between the US and Korea at this time. This shows that though the 1988 Trade Act resulted from protectionist attitudes of certain industries such as footwear, textiles, and steel, the US Treasury defended the interests of US financial institutions in implementing what the Act required.

> **Mr. Mulford**. Well, the first thing we will do is attempt to engage them (Korea and Taiwan) again on the question of currency, on the question of access to their financial market, and on the question of the openness of their financial markets. We will also engage them in discussions about broad macroeconomic policies, structural changes in their economies and so on. If these talks are relatively successful...
>
> **Senator Pressler**. These talks would last 18 months?
>
> **Mr. Mulford**. No. These are talks that have been going on. We have engaged them in the past and we will continue to do so in the future. And *in particular, so far as the Treasury is concerned, we are interested in access to their financial markets and the development of capital markets within Korea, including the liberalisation of their internal banking and securities markets and so on.* These things, if we can make some progress, will have an effect on the exchange rate. It is not just a question of asking the Korean authorities to move the exchange rate. Obviously that's part of it and we will continue on that front as well because they do control the exchange rate today. But we will seek to have them alter their exchange rate mechanism toward greater freedom and make the other changes that I have mentioned in an effort to transform their economy to some extent so that the exchange rate can more freely reflect the economic fundamental. *(emphasis added).*[13]

3.3.3 Influence of Special Interests in Korea

As described, the US applied pressure in two different ways. The first way

[13] The Treasury also preferred a floating exchange rate system because it thought it reflected market fundamentals.

was to do with financial issues, including foreign exchange rate appreciation, access of US financial institutions to the Korean market, and liberalisation of Korean financial and capital markets. The second was to do with non-financial issues, including a reduction in import restrictions, improvement of domestic demand growth, and restructuring of the Korean economy to reduce dependence on exports. It is interesting to note that Korea was more willing to accept the second type of demands than the first. The underlying reason for this attitude lay in the country's domestic politics.

On the Exchange Rate Issue

Exports were a crucial factor for growth, being very much affected by the foreign exchange rate. Surpluses during 1986-1988 resulted from the real depreciation of the exchange rate against the US dollar. During the first two years after the Plaza Accord in 1985, Korea kept the won close to the dollar which meant substantial depreciation against the yen and other currencies and it basked in the resultant stimulus to its exports. In this respect, Korea was vulnerable to any fresh realignment of major world exchange rates which would make its price-sensitive exports of textiles, electronics and footwear less cost-competitive.

In September 1989, The Korean Foreign Trade Association (KFTA) distributed a report, entitled "Korea's Exchange Rate Policy", to the US government, the US Congress, the media, research institutions, various US political groups in the US, and many Korean organizations (Wang 1993: 166). It was published just one month before the report of the US Treasury to the US Senate was released in October 1989.

In the report, the association stated that the US Treasury's designation of Korea as a "currency manipulator" was unjustified and could damage trade relations. Its arguments consisted of the following three points. First, Korea did not manipulate its currency to a greater extent than other countries. Its trading system alone could not be used as evidence of intent to gain an unfair trade advantage. Second, Korea has not had 'significant' or 'sustained' surpluses. Its surpluses of 1986-1988 were the first after four decades of chronic, massive trade deficits. Third, Korea's surpluses lasted only for a short period and were necessary to correct the huge imbalances created by years of massive trade deficits. Even those short-term surpluses rapidly disappeared.

The KFTA report also pointed out that since the Plaza Accord (September 22, 1985), the won had appreciated in real terms to the same extent as the new Taiwanese dollar and only slightly less than the Japanese yen (See Table 3.2).

*Table 3.2 Appreciation of Three Countries' Currencies since Plaza Accord**

	Korea	Japan	Taiwan
Nominal	32.4%	72.8%	53.3%
Real	18.6%	21.2%	18.4%

* Between 22 September 1985 and end of August 1989
Source: Y-K Wang (1993: 165)

From the viewpoint of *chaebol*, trade liberalisation was much more attractive than exchange rate appreciation because they owned general trading companies bringing in imported goods. The companies, which were the flagship firms of the *chaebol*, were trading not only goods for affiliated companies but also those for most SMEs (small- and medium-sized enterprises) which did not belong to the *chaebol*. They obtained high profits from the margins they charged on items which were reasonably priced abroad. They were pleased with the improving domestic growth policy, including that of constructing 2 million houses. With their own construction subsidiaries, the *chaebol* led speculative investment in property, which drove up housing costs as well as the value of real properties they owned.

On the Financial Liberalization Issue

Since the late 1980s, a strong voice in favour of financial liberalization, in particular in relation to corporate financing, emerged from the private sector. In September 1991, the Korean government approved by a cabinet meeting a Presidential decree for the establishment of the Private-Sector Consulting Committee for the Relaxation of Administrative Regulations.[14] The establishment of the Committee implies in many aspects that influence of private business on government decisions had grown.

Its five members came from the private sector and the committee was under the jurisdiction of the Premier. The Chair was occupied by Yoo Chang-soon, the Chair of the Federation of Korean Industries (FKI), which was the association of big business in Korea.[15] Two members were the Chairs of the Korean Business Association (KBA) and the Association of Small- and Medium-sized Enterprises. The remaining two were university professors, who specialized in administrative reform issues.[16]

---

[14] In accordance with the Presidential decree, the committee lasted for a limited period of six months.

[15] Mr Yoo was former BoK Governor (1961-62), Minister of Commerce and Industry (1962-63), Minister of the EPB (1963), and Premier (1982). He was also Deputy Chairperson of the FKI (1981), Chairperson of the KFTA (1981-82), Special Advisor to the FKI (1983-89).

[16] The Committee had six general secretaries, who were all the research

The Private-Sector Consulting Committee for the Relaxation of Administrative Regulations aimed not only to examine and ask for the repeal of useless administrative regulations, but also to propose ideas of the delegation of government functions to the private sector.[17] The establishment of the Committee was based on the premise that in order to promote the international competitiveness of Korean corporates, the deregulation of excessive administrative regulations had to proceed (Private-Sector Consulting Committee for the Relaxation of Administrative Regulations 1992).

The Committee argued that the government would find it difficult to recognize the negative effects associated with the regulations. It was also argued that even though the government might recognize some such problems, the bureaucrats could not repeal such regulations because doing so would lead to a reduction in the business areas of the bureaucrats. Thus, the Committee argued proposals were better initiated by the private sector.[18]

Amongst other things, the Committee drafted proposals for relaxing regulations regarding corporate financing and financial sector liberalization.[19] Trade-related credits, foreign currency loans, overseas financing including the issue of

---

fellows of Korea Economic Institute, which was the research body of the FKI. The secretaries led all the meetings, held by areas.

[17] It also included the issue of the delegation of central governmental functions with regard to local government.

[18] See Private-Sector Consulting Committee for the Relaxation of Administrative Regulations (1992) p.4.

[19] There were three other sections of the Committee, i.e. two sections on people's life (such as education and environment) and another section on corportate business (such as business entry and employment).

securities abroad by corporates and outward foreign direct investment were the subject of deregulation/relaxation. The regulations in the areas, the committee claimed, caused damage to the competitiveness of domestic firms in relation to foreign firms which enjoyed fewer restrictions (Private-Sector Consulting Committee for the Relaxation of Administrative Regulations 1992: 276-291).

As regards financial sector liberalization, the Committee considered adjustment of the regulatory framework, and regulations over deposit money banks (DMBs), including entry qualifications, interest rates, and governance, and business over short-term financial companies such as investment and finance companies (IFCs) and merchant banks.

In relation to the regulatory framework and regulations over the DMBs, the Committee claimed that, as the financial sector's public role for economic development (in particular the segment of the DMBs) had been emphasized, regulation over the financial sector had had various conflicting objectives over time. Moreover, some areas were regulated by more than one authority which caused inefficiency. It also maintained that overemphasis on the public role of the sector delayed innovation of the sector, thus becoming a factor which obstructed its international competitiveness. Regarding short-term finance companies, it suggested that the function of the companies should be reconsidered from the perspective of development of the overall financial sector.[20]

[20] Ibid. pp. 292-309

3.3.4 Domestic Politics and Policy Choice

At first glance, US government pressure appears to have been successful in achieving favourable regulatory policy outcomes for financial liberalization from the late 1980s up until the mid-1990s. However, it should be noticed that the pressure was successful in some areas, but not in others. Such pressure was only successful when it coincided with the preferences of the domestic corporate sector such as the *chaebol*. In addition, it was the financial sector which enjoyed large profits by intermediating international capital flows, as a result of capital account opening.

First, regarding the issue of the exchange rate, the Korean government changed its exchange rate system, i.e., from the Basket to MAR system in 1989 (effective from March 1990). However, it was clear that the Korean government favoured trade liberalization to the continuous appreciation of the Korean currency against the US Dollar as demanded by the US government.

The Presidential Commission for Economic Restructuring, established in April 1988, submitted a report to President Roh in October 1988. The report called for the internationalisation of the Korean economy, including a reduction in the country's surplus on its current accounts by means of liberalisation of import restrictions rather than by rapid appreciation of the currency. For example, the Korean government used *ad hoc* measures to satisfy Washington and to avoid US pressure for exchange rate appreciation. Notably, the government made a US$ 2.6 billion fund from its foreign exchange reserves available for corporates to finance the import of capital goods from the US. It announced a long 'shopping list' (US$ 2.6bn worth of extra US goods) that Korea was expecting to buy from the US in 1987 (Financial Times, 14 May 1987).

Most of the goods were substitutes for imports that would otherwise have come from Japan. One hope of such purchases was that by increasing imports from the US, the strength of US pressure for an appreciation of the exchange rate would decline.[21]

The MAR system, adopted by the Korean government, while appearing to be market-oriented, was still far from being a free-floating exchange rate system. The MAR was based on the weighted average of the previous day's inter-bank rates for Korean won–US dollar spot transactions. BoK announced the foreign exchange rate every day and then allowed the rate to fluctuate within a certain band (See Table 3.3). The Korean government finally decided to change its Basket system to the MAR system at the end of 1989, while the exchange rate levels and the system to determine them was still highly controversial in both countries.

During the 1986-89 period, it was very clear that the Korean government tried to keep the value of its currency down against the US dollar. The Korean government argued that, in order to pay off its high level of foreign debt, trade surpluses must continue. Emphasis on exports had been the first preference for both the government and the private sector in Korea during that period. Devaluation of the currency was not a controversial issue.

---

[21] Thus, it gave birth to a reduction in Korea's imports from Japan (with whom it ran a deficit of US$ 5.3bn in 1986). Also, Korea was moving towards a faster removal of import barriers. According to Mr Park Un Seo, a senior official in the MoTI (Ministry of Trade and Industry), 40% of import items were on the restricted list in 1980. By July 1987 the proportion was supposed to be down to 6.5% and it would drop below 5% in 1988. Similarly Korea was moving to reduce its very high tariff structure on items that could be imported. The average tariff rate was 19% in 1987 but would be reduced to 17% by 1988.

Table 3.3 Change in Korean Exchange Rate Regime

Period	Regime	Characteristics
1955-1972	Bretton Woods Era	Inflation/Devaluation
1973-1979	Pegged to US dollar	Inflation/Devaluation
1980-1989	Managed Basket Peg	Current Balance Target
1990-1997	Market Average Rate System*1)	Stable Real Exchange Rate
1997-present	Free Floating Rate System	Market Oriented, but still with Strong Government Intervention

*1) With a band, within which the exchange rate could fluctuate, of +_0.4% initially. It was widened to +_ 0.6% in Sep. 1991 and was extended up until +_2.25% at the end of 1995.
Source: Based on Black (1996)

US Pressure was not the only reason for adopting the MAR system. The government objective of a low inflation rate as well as an increase in the size of the domestic economy against exports and imports meant that it would not have to intervene in the foreign exchange market too much.[22] However, even after the change in the exchange rate arrangement, the Korean government still had various policy measures that could be used to affect the foreign exchange rate, e.g., by coordinating the size of foreign exchange demand by financial institutions and industrial sectors in at least the following two ways. The MoF let the Bank of Korea lend some of its foreign reserves to Korean financial institutions, which had a big appetite for lending such foreign currency to non-bank corporates. Moreover, the Finance Ministry imposed a quota on certain industrial sectors and certain *chaebol* within which that sector and the *chaebol* could borrow foreign exchange.

As the Korean government had announced the introduction of the MAR

[22] During the period of 1986-89 when the country recorded huge trade surpluses, the Korean government must have intervened in its foreign exchange market to keep its exchange rate low.

system, and Korea's trade surplus disappeared, the focus moved from the exchange rate to comprehensive financial liberalisation policy. In sum, the policy choice of the Korean state, in response to US pressure on the exchange rate, largely reflected domestic business preferences, i.e. in relation to overall price competitiveness for export, and the interests of trading companies and the banking industry.

Second, the Financial Policy Talks between the US and the Korean government at the beginning of 1990 resulted in Blueprints in March and July 1992 and a plan for financial deregulation under the Five-Year Plan for the New Economy in 1993. However, this does not mean that US preferences were wholly reflected in the Korean government's decisions. Strong domestic pressure from corporates and the banking sector as well as government concern on macroeconomic stability were operating, thus overriding certain outcomes of the plans.

All in all, the strong emergence of a voice for financial liberalization from domestic business coincided with US government pressure in the same direction (Private-Sector Consulting Committee for the Relaxation of Administrative Regulations 1991). Korean business strongly wanted (a) an increase in opportunities to use international capital at a cheaper price than domestic interest rates, and (b) domestic financial sector deregulation. In its document submitted to the National Assembly, the Ministry of Finance in Korea indicated in relation to the Blueprint and reform of the foreign exchange system that "capital account opening were needed in the interest of Korean business." (MoF 1995)

Also, the authorities did not want the national ownership of Korean corporates threatened by capital market opening. In order to protect national ownership of Korean corporates, the authorities put certain limits on the amount of equities within which foreigners could buy and limited the amount which a single foreigner could own. As Table 3.4 shows, it was only 5% up until the end of1996. In the wake of the crisis, the IMF demanded to extend the limit substantially, thus the Korean government had to increase it by 50%. Originally, the government was going to extend the limit for foreign individuals to 10% by 2000 according to an agreement with the OECD, though aggregated limits were going to be completely liberalised (BoK 1997). As a result of consultation with the IMF, foreign direct investment was de facto liberalized in Korea.[23] Preference in favour of national ownership by the government was paralleled by the interest of Korean corporates.

Table 3.4 Regulation on the Limit of Foreign Portfolio Equity Investment

	1992	93	94	95	96	97.1-10
Outstanding balance of capital inflows*1)	2.1 <0.7>	7.8 <2.3>	9.7 <2.5>	12.0 <2.6>	16.5 <3.4>	17.2
Ratio of foreigners*2) ownership (%)	4.13	8.74	9.22	10.02	11.51	10.43
Number of equities being reached to limits*3)	147	165	125	115	55	36
Ratio of aggregate equity ownership limits*4)	10	10	12	15	20	23
Ceiling of individual companies within which single foreigner were permitted to own	3	3	3	3	4 (April) 5 (Oct.)	6 (May) 7 (Nov.)

*1) End of period, US$ Billion, Ratio against GDP
*2) End of period, equities owned by foreigners/ aggregate equities in the stock market
*3) and *4) End of period
Source: Extracted from Bank of Korea, *Development of Capital Account Liberalization and Change in the Structure of Balance of Capital Accounts*, Monthly Statistics Review, December 1997

Moreover, the authorities were worried about the performance of domestic financial institutions, especially the DMBs, because they were neither efficient nor competitive enough to survive against their foreign counterparts (Frankel 1993; Oum 1991).

[23] As a result, the amount of foreign direct investment to Korea has

Korea initially welcomed foreign banks as providers of foreign capital. Foreign banks earned easy profits while helping to finance Korea's chronic current account deficits in the 1970s and early 1980s. Until 1986, they had a large and profitable niche in bringing much needed foreign loan funds into the country. Under the so-called swap scheme, the BoK gave each foreign bank the right to bring in a given amount of foreign currency. The central bank swapped the currency for won for periods of up to a year, and guaranteed to repurchase the won at the same rate at which it was sold. The central bank paid the market rate of interest for the foreign currency and allowed the banks to put a 1 per cent spread on loans they made with the won. It was a sweet deal while it lasted. Insofar as they enjoyed this positive discrimination, there was no serious reason for opening up the market.

However, from 1986, when the Korean economy started to record huge trade surpluses, foreign banks suddenly found themselves without a clear role to play, locked on the periphery of mainstream banking in Korea while struggling to build a way in. The Korean economy did not need foreign loans and so, in the face of howls of protest from the foreign banks, the central bank reduced the swap quotas and the spread allowed on the won loans. The BoK had continuously reduced the limit of swap with foreign banks, which had been the main source of local currency funding, by 10% every year between 1987 and 1989. In view of the appreciation of the Korean currency, the practical effect of the reduction in local currency funding from the stand-point of the foreign banks, was estimated to be 47%, according to a report of the US Treasury (US Treasury 1990). Even after 1989, when the current account went back

substantially increased since 1998.

into deficit, Korea had another method of foreign exchange. Financial and non-bank corporates could finance foreign funds on their own initiative. Its net foreign debts were just 4% of GNP as of October 1991 compared with 39% in 1985.

The result was a lot of dissatisfied foreign banks, sitting on the edge of a potentially greater market yet unable to expand their business rapidly. Some concessions had been offered to meet the foreign banks' complaints that they could not have adequate access to win funds through normal channels, but the government seemed unwilling to let them have any further special privileges. The issues between the US government (and foreign institutions in Korea) and the Korean government were about non-discrimination towards foreign institutions.

The right-hand column of Table 3.5 shows that there was abolition of some of the remaining restrictions imposed on foreign bank branches. However, it does not appear that interests in US bank branches in Korea were preferentially dealt with by the Korean government. In fact, the Korean authorities liberalized the restricted business areas of domestic financial institutions in advance before liberalizing foreign financial institutions. Accordingly, the business profits of foreign institutions rapidly decreased.

Table 3.5 National Treatment of Foreign Bank Branches

Reducing Preferential Treatment	Lifting Discriminatory Restrictions
Gradual reduction of the ceiling on foreign bank branches' swap facilities since November 1987 (4 times)	Permitted access to rediscount facilities at the Bank of Korea for export financing (March 1985) - Expansion of the scope of rediscounts to general commercial bills (August 1986). - Also allowed to borrow funds from BoK as a means of financing possible shortages of reserve requirements (August 1988)
Lowering the guaranteed yield on swap facilities from February 1985 (1.0% - 0.75% - 0.5% - 0.3%)	Allowed to handle non-specific money-in-trust (September 1985), and additionally permitted to handle specific money-in-trust (May 1991)
Imposition of compulsory lending ratio to small enterprises (25%) on foreign bank branches (March 1985)	Allowed to sell negotiable certificates of deposit (September 1986) and expansion of the ceiling on their issuance (7 times) - As of Feb. 1994, the ceiling on CDs issuance is the larger of 250% of not worth or 20 billion Won
Raising this mandatory ratio (35%) for those foreign banks branches that make use of the central bank's rediscount facilities for commercial bills (August 1986)	Removal of the ceiling on in-country capital (hitherto 12 billion Won) (May 1991
Abolition of exemption from corporation tax on interest income from foreign currency loans (January 1989)	Scrapping the guidelines on foreign banks' establishment of additional branches (June 1991)
Lifting preferential treatment on foreign exchange overbought positions of foreign bank branches (September 1989)	Multiple branches of foreign banks regarded as a single entity under the revised General Banking Act of December 1991 Clarification and simplification of the banking supervision regulations (April – September 1992)

Source: Bank of Korea (1994: 17)

In sum, financial liberalization plans at the beginning of the 1990s were ignited by US pressure which started in the late 1980s. However, domestic politics rather than such external pressure can largely explain the regulatory liberalization outcomes.

3.4 OECD Entry Negotiations

If the preferences of governments in advanced countries reflect the interests of their financial sector, those preferences would have been clearly shown during the negotiation for Korean entry into the OECD in 1996. In this regard, Korea's negotiation with the OECD member countries is a good case study in testing the exogenous factor argument.

However, as at the end of 1996, when Korea at last joined the OECD, there were still substantial restrictions in many areas. While some areas such as overseas financing and trade credits were substantially liberalized as business had long wished, others such as foreign investment in the Korean bond market, and friendly M&As of Korean corporates including financial institutions by foreigners, were severely restricted. During the same period, short-term interest rates intermediated by non-bank financial institutions, were almost completely liberalised, while interest rates on deposits, which were largely intermediated by the DMBs, were still restricted by the regulatory authorities.

By the standard of the OECD Codes of Liberalization of Capital Movements (hereafter the OECD codes), capital controls in Korea were more restrictive than in any other OECD member. The number of reservations (41) in the codes of capital movements (91 in total) was much higher than the average of all OECD countries (7). It was far behind any OECD member country, for example, Turkey or Mexico.

Table 3.6 Ratio of Reservation in the Codes of Liberalization on Capital Movements[1)]

Country	No. of reservations	Ratio of reservation (%)	Country	No. of reservations	Ratio of reservation
Luxemburg	0	0.0	Sweden	5	5.5
Netherlands	3	3.3	Switzerland	5	5.5
U.K.	3	3.3	Italia	7	7.7
Austria	4	4.4	Germany	8	8.8
Denmark	4	4.4	Japan	8	8.8
Ireland	4	4.4	France	9	9.9
Canada	5	5.5	U.S.A.	10	11.0
Finland	5	5.5	Belgium	11	12.1
Greece	5	5.5	Portugal	13	14.3
Iceland	5	5.5	Australia	14	15.4
New Zealand	5	5.5	Turkey	16	17.6
Norway	5	5.5	Mexico	27	29.7
Spain	5	5.5	OECD average	7.4	8.2
			Korea	41	45.1

1) Number of reservations in Korea is as of January 1997, while that in other OECD countries is as at the end of 1995.
2) Ratio is calculated as (the number of reservations/ aggregate number of the Codes, which is 91).

Source: Kim (1997)

3.4.1 US Leverage Behind the Negotiations?

With regard to the US policy on financial liberalization towards the Far East, Lawrence Summers described in the US Senate in 1994 the need for multilateral and regional negotiations with Asian countries, including Korea, as follows:

> From the beginning of its term of office, this Administration saw the need for more vigorous economic engagement with the Asia-Pacific region. President Clinton took the bold step of hosting the first ever meeting of APEC economic leaders in Seattle in November of last year to initiate important consultations at the highest level... Within the APEC group, certain East Asian economies like China, Korea, and Taiwan are not only growing rapidly; they have become important players in the global economy. Their external policies matter to the global system as well as to the United States economy. We must therefore engage them regularly and consistently to promote trade and exchange liberalization. That means using all available and appropriate multilateral, regional, and bilateral means – the GATT, APEC, the OECD,

and the international financial institutions – as well as bilateral negotiations.[24]

In particular in relation to the issue of Korean financial liberalization:

> It remains Treasury's judgement that neither Korea nor Taiwan is manipulating its exchange rate within the meaning of Section 3004. Nevertheless, Treasury remains concerned about certain financial and foreign exchange policies in both countries, particularly capital controls, which discourage investment and impede the operation of market forces in exchange rate determination. Treasury will continue to work closely with Korea on these issues as it implements its 5-year financial sector liberalization plan and with Taiwan in the context of GATT access process. Regarding Korea's financial liberalization, I would like to welcome Korean Finance Minister Hong's recent statement that Korea will implement the financial sector liberalization plan 1 or 2 years ahead of schedule to facilitate OECD entry.[25]

The US government concentrated its pressure in particular on the financial liberalization issue in the multilateral negotiations surrounding Korea's entry to the OECD rather than the Financial Policy Talks with Korea which started in 1990 on a bilateral basis.

For example, Financial Policy Talks in April 1994 and March 1995 were held at the US Treasury, not in Korea. The issues in the talks were not restricted to what the US demanded. In addition to the issue of financial liberalization in Korea, the business circumstances of the branches of Korean banks in the US were dealt with. Korea explained the liberalization measures which it had implemented, such as interest rate liberalization (the 1994 talks), the blueprint of 1992 and the reform of the foreign exchange system (1995 talks), and the US government regarded these

[24] Ibid.
[25] Ibid.: 34

measures favourably. Regarding the business activities of Korean banks in the US, Korea asked the US to resolve some 'bottlenecks' that the banks were experiencing and the US promised to do its best to resolve the problems. Contrary to the conventional wisdom (such as Wade 1988, 2000), the US government was reported to have expressed its determined support for gradual liberalization in Korea when in the 1995 talks Korean representatives pointed out the cost of big-bang style liberalization, as shown by the Mexican crisis (MoF, 1995).[26]

When both parties met again in May 1995 in New Zealand, the situation was not very different. The main issue at that time was financial services negotiations at the World Trade Organization (WTO). The Korean representatives explained that the extent of their liberalization plan was the most that could be adopted under the circumstances (such as the gap between international and domestic interest rates), and the US supported the Korean position, a MoF document stated (MoF, 1995).

In the OECD entry negotiations, however, the US position was relatively aggressive. It was the strongest voice, among the member countries, for speedy financial liberalization including capital account liberalization in Korea. According to a document of the Ministry of Foreign Affairs and Trade (MoFAT), Non-European countries, such as the US, Japan, Canada, Australia, and New Zealand, expressed their pleasure because Korea's entry would add momentum to OECD efforts to overcome its Europe-centric activities. However, "the US opposes a particularly lax level of conditions is applied to Korea. In the areas of capital movements, insurance, and financial sector, additional liberalization measures of Korea are required, the US

---

[26] The US representatives at these talks were Mr Shafer, Under Secretary for

believed."[27]

Kim Choong-Soo, chief negotiator for the country's OECD entry, stated in a meeting of overseas ambassadors, "The US supports Korean entry, but its position is that technical requirement should be in advanced fulfilled. It hopes to talk about this issue in bilateral talks between both countries' representatives in the OECD. In relation to the entry of PIT (Partners in Transition), Clinton, the US President, promised its support for the entry of the PIT. But, concerning the area of foreign direct investment, the PIT countries are more liberalized than Korea and Mexico." (MoFAT 1999: 12) In fact, the chief negotiator revealed that "I discussed on various issues regarding capital account opening with the US and UK representatives. In addition to official meetings, I met those representatives informally, for example, during lunchtime. People from the US in particular knew very well the situation of financial regulations in Korea, sometimes more than me." (Interview with Dr Kim Choong-Soo in August 1999) The UK position was that it supported Korea's entry but that Korea embark on further liberalization (MoFAT 1999: 13).

Leading European countries expressed their hope that the terms and conditions of entry should be strict, in particular with reference to financial issues as did the US. The UK focused on the financial sector, i.e. insurance and investment, while France was concerned with finance. Germany considered particularly investment and tax and the Netherlands focussed on finance and liberalisation on

---

International Affairs of the US Treasury, and four other officials.

[27] This draws on a document (MoFAT 1999) of an overseas ambassadors' meeting, which was held in Seoul, February 5-9 in 1996. The document was summarized by the Department of International Economy in the MoFAT, and was submitted to the National Assembly in 1999. The title of the relevant section is

capital movements. Other countries, which were not so influential in the OECD, supported the Korean position, but indicated that they would follow the opinion of the majority at the same time. In sum, powerful governments, such as those in the US and UK, had a certain level of leverage on the Korean government's decisions on capital account opening through having an influence on Korea's entry to the OECD.

3.4.2 Restrictions over Capital Movements of Foreign Non-Residents

Restrictions against the standard of the OECD codes of liberalization of capital movements were concentrated on capital inflows, while those on capital outflows were relatively liberalized. Restrictions were applied to most types of capital inflows, i.e., investment in domestic securities by "non-residents"; the issue of securities abroad by "residents"; and financial credits and loans granted by "non-residents" to "residents". By contrast, the regulatory authorities relaxed controls over investment in overseas securities and deposits, though some controls over financial credits and loans granted by "residents" to "non-residents" in the domestic currency remained.[28]

A letter to the Korean government dated 17th July 1996 from Christian Schricke of the OECD secretariat, who was then Chairman of the joint meeting with Korea of the CMIT (Committee on Capital Movements and Invisible Transaction) / CIME (Committee on International Investment and Multinational Enterprises), is probably the most informative document setting out the nature of undesirable

"Responses of the OECD member countries."

[28] Reflecting the twin elements associated with liberalisation, a common vision is made between a) actions initiated by non-residents in the country concerned, and b) actions abroad initiated by residents. Refer to OECD (1995).

restrictions on capital flows from the perspective of international standards. It also shows very well what the controversial issues were between Korea and the OECD countries. It was entitled "Chairman's conclusions on the joint CMIT/ CIME meeting with Korea held on 4-5 July 1996". In response to the letter, the Korean government put forward its position to the joint meeting in a letter called "Confidential: Korea's Response to the Chairman's Conclusions on the Joint CMIT/CIME Meeting with Korea, July 1996".[29]

Before looking into particular issues of capital account opening, which were at issue between the OECD and Korea, it should be noted that the overall position of the two sides throughout the negotiations in 1996 were different in respect of the pace and eventual complete abolition of the remaining capital controls. This issue was raised in the letter from the OECD saying that "Delegates requested the Korean authorities to adopt as an objective the completion of the abolition of remaining capital controls progressively over the next five years." (Paragraph 9 of the Chairman's conclusions)

Kwon (1996) describes the then situation in terms of the pace of capital account opening, and the fact that the OECD countries argued that in order to reduce the international-domestic interest rates differential, which was the very concern of the Korean government, opportunities for international financing should be extended. Regarding the issue of completion of capital account opening, the OECD asked the

[29] Both documents (letters) were submitted to the National Assembly in Korea by the Foreign Ministry of Korea in 1998. The joint meeting to which the letters refer is the second meeting of the Joint Committee: the first one was held on 11-12 April 1996. After the first one, the Chairman produced recommendations to the Korean government on the then disputed issues between Korea and existing OECD members. The Korean government had again put forward its position to the Committee and the second joint meeting discussed that position. The letter came after

Korean government to suggest the time schedule for complete liberalization of capital flows (Kwon 1996: 152-153).[30]

In "Korea's Response to the Chairman's Conclusions," the Korean government stated its position, which was expressed in paragraphs 5-9. As these paragraphs clearly show the overall position of the Korean authorities in response to such external pressure, they are cited in full below:

> 5. As for the delegates' request, identified in paragraph 9 of the Conclusions, for the Korean authorities to adopt as an objective the completion of the abolition of the remaining capital controls progressively over the next five years, we would like to emphasize, first of all, that this is the basic policy direction to which the Korean government is strongly committed. We believe that the Korean government's credible track record of financial liberalization clearly provides evidence for the fact that Korea shares the same views concerning the market economy and economic policies with the OECD Member countries. On the other hand, we also believe that Korea's progressive liberalization approach to some parts of financial services sectors should be understood in the light of Korea's current macroeconomic conditions.
>
> 6. Korea is determined to remove the remaining capital controls, once the domestic-international interest rates differential reaches a level such that excessively large capital inflows would not induced. Given the current interest rate levels, the Korean government believes that the differential should narrow down to within two percentage points. The government's constant efforts through various policy decisions has set in motion a significant downward trend in domestic interest rates and price levels toward stability. On the basis of this trend, the closing of the domestic-international interest rates differential to within two

that second meeting.

[30] Kwon Jae-Joong, who was then Research Fellow in the Institute of International Economic Relations, was involved in the OECD negotiations.

percent is expected to be achieved within five years.

7. Furthermore, even if the interest rate differential does not narrow to the expected levels, as long as the macroeconomic conditions continue to stabilize according to the government's expectations – e.g., inflation stabilizes within 3% -- removal of remaining capital controls could be completed within five years (MoFAT 1996).

The Korean government then describes its view on the sequence of different areas of capital account liberalization and concludes as follows:

8. Such liberalization will start with the removal of the remaining restrictions on loans with FDI character, trade credits, and friendly M&As. The next liberalization step will be to free the issuance of domestic securities in foreign capital markets by residents, non-resident purchase of debt securities, and financial credits and loans by non-residents to residents.

9. The Korean government pledges that it will strengthen to the furthest possible extent its efforts through its policy decisions to foster an environment conducive for maintaining stable macroeconomic conditions and narrowing the interest rate differential, which would enable the abovementioned liberalization to take place within the next five years" (MoFAT 1996).

As the above paragraphs show, the Korean government presented its position that removal of the remaining capital controls should not interfere with "stable macroeconomic conditions". In Korea, unstable macroeconomic conditions appeared to be defined as monetary growth and appreciation of the exchange rate resulting from excessive inward foreign capital flows. To what extent was the stated policy objective of macroeconomic stability maintained?

Four Major Issues of Inward Capital Flows

The "Chairman's conclusions on the joint CMIT/CIME meeting with Korea held on 4-5 July 1996", was a five-page (A4 size) letter, consisting of 10 paragraphs. Among others, paragraph 6 was important in that it identified four problem areas, namely, (1) M&As of Korean firms and banks by foreign investors; (2) ceiling on individual foreign portfolio equity investment; (3) the issue abroad of Korean capital market securities and the use of the proceeds; and (4) long-term borrowing from abroad, financial credits and loans with a maturity of five years or more trade-related credits.[31]

The areas were, according to the "Chairman's conclusions" letter, those which most delegates of OECD countries considered "should be improved by narrowing further the scope of certain reservations and/or by providing legally binding dates by which these reservations would cease to apply after Korea's accession" . In the light of its importance, we set out paragraph 6 in full and examine the response of the Korean government to the identified areas.

First, as regards M&As by foreign investors, the letter states:

> "the threshold concerning the size of Korean enterprises beyond which friendly M&As by foreign investors require prior approval should be raised and eventually eliminated within a

---

[31] As a matter of fact, the Chairman put forward five issues, not four. The fifth area identified by the OECD Chairman's letter was to do with restrictions on outward direct investment by small Korean investors with respect to investment in OECD countries. The Korean government clarified that investment by companies had already been fully liberalized by 1 June 1996. Although remaining restrictions applied to individuals, such as the then ceiling of US$ 1 million per individual not requiring government approval, the limit was well above any actual investments made, the government replied (in the "Confidential: Korea's Response").

> reasonably short timeframe, and Korean banks meeting the threshold condition for friendly M&As should be included in the list of enterprises eligible for friendly M&A (item I/A). In addition, foreign investors should be able to contact the targeted enterprises directly without government intervention, and there should be no restrictions on the organization form which friendly M&A might take" (in the "Chairman's conclusions on the joint CMIT/ CIME meeting").

'The threshold' in the letter refers to the original proposal by the Korean government before the second joint meeting. The proposal was that companies with paid-up capital of 100 billion won or more (approximately US$ 125 million), or total assets of 1 trillion won or more (approximately US$ 1.25 billion) were required to obtain prior approval of the government for a friendly M&A by foreign investors. In response to the Chairman's request, the Korean government responded that it would increase the threshold to total assets of 2 trillion won (approximately US$ 2.5 billion) or more and revoke another regulatory standard based on paid-up capital. As a result, the number of Korean enterprises requiring prior approval of the Korean government for friendly M&As fell from around 150 to approximately 70.

However, the Korean government stuck to its original position over M&As of banks, which were subject to the General Banking Act, requiring prior approval and the limitation of the ratio of shares held by a single shareholder in accordance with the Act being 4 %. The Korean government argued that this limitation applied equally to domestic investors and the government could not discriminate in this regard in favour of foreign investors.[32] The chief negotiator on the country's entry to the OECD, Dr Kim Choong-Soo, recalled that "This was the hottest issue in the negotiations. The

---

[32] "Confidential: Korea's Response to the Chairman's Conclusions on the

position of the Korean government was strong. The basis of such a position was that it would not allow any commercial bank to be controlled by foreign investors." (Interview with Kim Choong-Soo) As already indicated, foreign direct investment (FDI) was the very concern of the US government. It can be said that the US had leverage over Korea's entry and wanted to get more relaxed regulation on FDI by foreigners but the outcome did not reflect this US preference.

Second, as regards foreign portfolio equity investments, the letter from the OECD suggests:

> "Any remaining ceiling on individual investments should be at least 10 per cent by the year 2000. Should a ceiling remain in the year 2000, individual investments exceeding this ceiling should be permitted, subject to Korean regulations on foreign direct investment"(in the "Chairman's conclusions ").

In response to the issue of the ceiling on foreigners' individual investments on listed firms, the Korean government affirmed its commitment that, by the year 2000, the ceiling would be increased to 10%, and individual investments exceeding that ceiling would be permitted, subject to Korean regulations on foreign direct investment [33]. As at the end of June 1996, the ceiling on foreign portfolio equity investment in listed firms in the Korean stock market was 4% for individuals and 18% in aggregate (see section 3.3.4 above on Korean government concerns regarding national ownership).

Third, as regards issues of Korean securities abroad and the use of the

---

Joint CMIT/CIME Meeting with Korea, July 1996.

proceeds, the letter from the OECD indicates:

> "the provision which allows the Ministry of Finance and Economy to block otherwise permitted issues abroad of domestic capital market securities should not be applied to issues on OECD capital markets, without prejudice to Korea's right to invoke the derogation provisions of Article 7 of the Code (item IV/A1). Remaining limitations on the use of the proceeds from issues of domestic capital market securities abroad and the qualifications to be met by resident enterprises wishing to issue such securities abroad should be gradually eliminated"(in the "Chairman's conclusions ").

Regarding the issue of securities in OECD countries, the Korean government promised that it would amend the regulations by the end of 1996 so that otherwise permitted issues in OECD capital markets of domestic capital market securities would not be blocked. With respect to the ability of resident enterprises to be able to issue securities abroad, the government promised that it would change the then positive list system to a negative list system by the end of 1999. Under the negative list system, all conditions for the issuer except item d) of Korea's proposed reservations, which requires the issuers to be a firm which has no negative effect on the international creditworthiness of the country, would be eliminated.[34]

However, in relation to the use of proceeds, the government clearly declined the demand of the Chairman. It made clear its position that in addition to the then allowed usage of the proceeds, it would only allow the issuance of securities up to the end of 1997 in order to finance major infrastructure projects, in which the participation of the private sector would be promoted (in the "Confidential: Korea's

---

[33] ibid.
[34] ibid.

Response").

In other words, the government stated its intention that thorough liberalization of the use of the proceeds would not be allowed. For reference, the then allowed usage of the proceeds was for importing capital goods, overseas investment, early repayment of foreign debt etc., which was approved by the Finance Minister.

Fourth, as regards long-term borrowing from abroad, the Chairman of the joint meeting argued in the letter as follows:

> "Remaining restrictions on long-term borrowing from abroad should be gradually eliminated over a reasonably short timeframe, starting with loans of five years or more having a FDI character and financial credits and loans with a maturity of five years or more (without prejudice to Korea's right under the Code to prevent contracting parties from later shortening the maturity of the credits and loans concerned), inward trade credits through the full liberalisation of deferred payments and advanced receipts, and foreign purchases of domestic debt securities." [35]

The request by the Chairman in respect of long-term loans was only partially accepted by the Korean government. The government replied that it held the view that such loans should be liberalized but in a progressive manner. Thus, the government affirmed that loans made by a foreign-invested enterprise from its parent enterprise or affiliates abroad, for the importation of capital goods within specified ceilings (in the words of the government, 'FDI-character loans') would be liberalized from January 1997. From the end of 1999, 'FDI character loans' made by a foreign-invested

[35] Long-term credits mean credits with maturity of one year and more.

enterprise in the manufacturing sector would not be restricted on their usage within specified ceilings from the end of 1999. However, the Korean government did not specify the date for full liberalization of FDI character loans and financial loans, due to the then differential between domestic and international interest rates and the need to ensure macroeconomic stability.[36]

Concerning trade-related credits, the government stated that it would gradually extend the permitted period, but initially only for small- and medium-sized enterprises (SMEs); trade-related credits for other companies (i.e. *chaebol*) would be considered later. With regard to foreign purchases of domestic debt securities, the government stuck to its original position, which was that the government will allow foreign purchases of long-term non-guaranteed bonds issued by SMEs by the end of 1997 and on those issued by other enterprises (*chaebol*) by the end of 1999. Full liberalization in this area would take place when Korea's "macroeconomic conditions" allowed, the government stated.[37]

3.4.3 Restrictions over Capital Movements of Korean Entities

The Chairman's letter and the response of the Korean government clearly reveal the nature of the then implemented capital account liberalization and the different views over the issue between OECD countries (underpinned by US and UK views) and the Korean government. However, a crucial aspect of the then capital account liberalization was overlooked in both documents: liberalization over capital

[36] "Confidential: Korea's Response to the Chairman's Conclusions on the Joint CMIT/CIME Meeting with Korea, July 1996.
[37] Ibid.

outflows for residents, i.e. Korean entities. This was due to the fact that the Codes only related to capital flows and operations between residents and non-residents.

However, as OECD countries had their preference for the way that capital account liberalization was effected, so too did Korean entities (i.e. domestic residents and non-residents of Korean firms such as overseas affiliates of Korean firms) in Korea, in particular the *chaebol*, the strongest interest group. Controversy between the Korean government and the *chaebol* was centred on the extent to which enterprises in the industrial sectors (dominated by c*haebol*) could finance themselves in international capital markets.

The controversy between the Korean government and Korean entities was subtle but can be viewed in two ways, i.e. direct and indirect funding/financing. First, as far as direct financing/funding was concerned, the opportunities for the industrial sector, including the *chaebol*, were mixed. 'Domestic residents', located in Seoul, such as the main offices of the *chaebol,* were not allowed financial credits. The amount of securities in the forms of convertible bonds (CB) or depositary receipts (DR) which could be issued in international capital markets (long-term) by domestic residents were annually allocated (at the beginning of each year) by the Securities Exchange Commission in accordance with the Finance Ministry's policy. Moreover, the proceeds of the financing had to be deposited with a Korean bank and 20% of the proceeds had to be used to buy bonds called 'bonds for small and medium-sized firm development.'[38] Furthermore, the rest of the proceeds were regulated to be used for

[38] Foreign Exchange Management Regulation, Article 10-85

six purposes only.[39]

In relation to this, Dr Oum Bong-Sung, senior advisor to Deputy Premier for Economic Affairs in 1988-1992 and to the Minister of Finance in 1992-1994, indicated that the issue of equity was also considered. He argued, "If controls over capital flows were all lifted, the *chaebol* would be the main subject able to attract foreign funds in the end. The benefit would be concentrated with the *chaebo*l, rather than with SMEs, who would have difficulty in attracting foreign funds by themselves. Thus, we thought it would be better for financial institutions to intermediate foreign funds in the forms of foreign currency loans to corporate firms. The size and the use of the loans should be restricted by regulations." (Interview with Oum Bong-Sung).

However, overseas affiliates of the c*haebol*, in particular affiliates of general trading companies of the *chaebol* located abroad, could raise short-term as well as long-term funding without any significant restriction. As a result, the debts of overseas financing by Korean firms significantly increased during the mid-1990s. This was particularly important in causing the 1997 crisis because it was not calculated as part of external liabilities by the World Bank's criterion, but, in fact, most of the liabilities were guaranteed by the main offices of the *chaebol*, thus being regarded as part of the external liabilities of Korea by foreign investors. The amount of debt raised abroad by overseas affiliates of Korea's thirty biggest *chaebol* was

[39] Foreign Exchange Management Regulation, Article 10-80, regulated the funds to be used in the following six ways: for importing capital equipment; for FDI or overseas projects; for importing parts for producing finished goods having the condition of over 3 years' deferred-payment export; for introducing the latest technology and paying for the service fees; for early repayment of foreign currency debts; and for opening up new overseas markets.

almost US$ 40 billion as at the end of 1996 (MoFE 1996).[40]

As regards such substantial liberalization of overseas financing, the position of the Korean government was that such financing would not affect the monetary aggregate in Korea. In order to justify that position, the Korean government tried to prevent any proceeds of overseas financing from flowing into Korea in the guise of trade-related credits. In accordance with the Foreign Exchange Management Regulation (Article 11-7), the Finance Ministry limited the use of the proceeds of overseas financing to twelve purposes, including funds required for export or import, for purchasing goods overseas (mainly for affiliates of general trading companies), for funds required for construction and services (mainly for affiliates of construction companies), for deep-sea fishery business, for operational costs for marine transport business, for distribution and administration expenses for firms, etc.

Among the number of methods by which firms could raise foreign currency funds, restriction over how to use the proceeds of overseas affiliates of Korean firms was relatively more liberalized. The major beneficiaries of this regulation were definitely the overseas affiliates of the general trading companies, which were the flagships of the *chaebol*, general trading companies comprising not only a unit for exporting and importing goods but also for construction.[41]

---

[40] Chapter 4 deals with the details.

[41] For example, Daewoo Corporation was a general trading company, which included a construction unit, and it was the major flagship company among the Daewoo group. Overseas affiliates of Daewoo Corporation, such as Daewoo U.K. Ltd. and Daewoo Hong Kong Ltd, had actively attracted foreign currency funds, over US$7 billion in outstanding value when Daewoo Corporation was liquidated in mid-1999. This did not include the foreign liabilities of the main office of Daewoo

Second, while direct financing of firms was relatively restricted by the Korean regulatory authorities, opportunities for indirect financing, i.e., through domestic financial institutions, were greatly extended. Foreign funds, which were mainly intermediated by financial institutions, flowed into the ultimate beneficiaries, i.e., the *chaebol.* The holding of overseas portfolio investments by financial institutions and the lending to SMEs of foreign funds were relatively small. Two major indirect ways for funding were 'foreign currency loans' (long-term) and trade-related credits (short-term).

Foreign currency loans were denominated in foreign currency and therefore the exchange rate risk of the loan was borne by the borrower. The Ministry allowed foreign currency loans for the following purposes. For the DMBs they were allowed for the import of equipment, machinery for planning shipbuilding, payments for high technology and service for SMEs, and funding for foreign direct investment (FDI) of the industrial sector. The Export-Import Bank of Korea (Ko-exim Bank) was allowed to lend for projects which were co-financed with a DMB and leasing companies were allowed to extend foreign currency loans for firms to import equipment.[42] The Ministry of Finance regulated the ratio of how much the financial institutions could lend against the project value. Big companies, such as the affiliates of *chaebol*, could usually borrow 70% against a project's value while SMEs could borrow 100%.

By setting a ceiling on the interest rates payable on 'foreign currency loans' made to the industrial sector by financial institutions, Korea's regulatory authorities

---

Corporation (Kim, 1999).

[42] See Kim (1996). This book is an analysis of the preferences of the most influential interest groups, including the Federation of Korean Industries (FKI) and

guaranteed lower interest rates for 'foreign currency loans' than those for ordinary won currency loans from Korean banks. Moreover, in order to extend the opportunities for such indirect financing by Korean firms, the BoK deposited part of its international reserves with Korean banks as the source of the foreign currency loans.[43] Therefore, the loans became the most popular and in fact the main funding method for enterprises.[44] Foreign currency loans had not previously been used to finance payment for importing machinery from abroad. However, during the 1990s the permitted use of foreign currency loans had been liberalized and in 1995 included such payments.

Regulations regarding trade-related credits (such as export advances and deferred payments), another way of indirect financing, were considerably relaxed during the mid-1990s. Because the BoK re-lent to the banks providing the trade-related credits a proportion of the value of those credits which allowed the companies to finance their exports at low interest rates, the credits being in the nature of loans furthered government policy.

3.5 Conclusion: Constraints and Policy Choice

The exogenous factor argument for financial liberalization, identified by Wade (1998, 2000), argues that US pressure compelled the Korean government to

---

the Korea Federation of Banks (KFB).

[43] Chapter 4 deals with details.

[44] Foreign currency loans refers to loans which were denominated in foreign currency. Thus, borrowers had to repay the loans in foreign currency to the domestic banks/non-bank financial institutions. Foreign currency loans were the main means of asset management of financial institutions: the source of the loans was of course financial institutions' foreign currency funding.

move toward what the US preferred. However, evidence of capital account opening during this period shows that domestic preference was more favoured than international preference. The Korean government during this period appeared to keep to its original position of maintaining a macroeconomic stability-first policy in the negotiations, thus maintaining relatively strict regulation over capital flows of foreign non-residents.

However, in fact, this position was disingenuous for domestic entities. After all, the Korean government was at the time allowing excessive capital flows by increasing opportunities of overseas financing and foreign currency loans for corporates and the financial sector. This suggests the regulatory outcomes and the policy objective of the government were strongly affected by domestic private preferences.

Also, it should be noted that the OECD (including the US and UK) had a reasonable argument, in particular with regard to the sequencing of capital account liberalization. As it turned out, Korea liberalized short-term capital inflows such as trade-related credits more than long-term ones such as inward FDI, which was arguably perverse. In conclusion, contrary to Wade's argument, increases in short-term capital flows should be traced to the inherent institutional characteristics of the developmental state, such as the goal of national ownership and close government-business relations, rather than US pressure. Close business-government relations in the developmental state and the strong influence of the private sector on government decisions, more than any other factors, can largely explain regulatory outcomes in capital account opening.

Appendix 3.1 – Omnibus Trade and Competitiveness Act of 1988 (H.R. 3)

Sec. 3004. International Negotiations on Exchange Rate and Economic Policies

(a) Multilateral Negotiations. – The President shall seek to confer and negotiate with other countries –

(1) to achieve –

(A) better coordination of macroeconomic policies of the major industrialized nations; and

(B) more appropriate and sustainable levels of trade and current account balances, and exchange rates of the dollar and other currencies consistent with such balances; and

(2) to develop a program for improving existing mechanisms for coordination and improving the functioning of the exchange rate system to provide for long-term exchange rate stability consistent with more appropriate and sustainable current account balances.

(b) Bilateral Negotiations. – The Secretary of the Treasury shall analyze on an annual basis the exchange rate policies of foreign currencies, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade. If the Secretary considers that such manipulation is occurring with respect to countries that (1) have material global current account surpluses; and (2) have significant bilateral trade surpluses with negotiations with such foreign countries on an expedited basis, in the International Monetary Fund or bilaterally, for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar to permit effective balance of payments adjustments and to eliminate the unfair advantage. The Secretary shall not be required to initiate negotiations in cases where such negotiations would have a serious detrimental impact on vital national economic and security interests; in such cases, the Secretary shall inform the chairman and the ranking minority member of the Committee on Banking, Housing, and Urban Affairs of the Senate and of the Committee on Banking, Finance and Urban Affairs of the House of Representatives of his determination.

Sec. 3005. Reporting Requirements

(a) Report Required. – In furtherance of the purpose of this title, the

Secretary, after consultation with the Chairman of the Board, shall submit to the Committee on Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate, on or before October 15 of each year, a written report on international economic policy, including exchange rate policy. The Secretary shall provide a written update of developments six months after the initial report. In addition, the Secretary shall appear, if requested, before both committees to provide testimony on these reports.

(b) Contents of Report. – Each reports submitted under subsections (a) shall contain –

(1) an analysis of currency market developments and the relationship between the United States dollar and the currencies of our major trade competitors;

(2) an evaluation of the factors in the United States and other economies that underlie conditions in the currency markets, including developments in bilateral trade and capital flows;

(3) a description of currency intervention or other actions undertaken to adjust the actual exchange rate of the dollar;

(4) an assessment of the impact of the exchange rate of the United States dollar on –

(A) the ability of the United States to maintain a more appropriate and sustainable balance in its currency account and merchandise trade account;
(B) production, employment, and non-inflationary growth in the United States;
(C) the international competitive performance of United States industries and the external indebtedness of the United States;

(5) recommendations for any changes necessary in United States economic policy to attain a more appropriate and sustainable balance in the current account;

(6) the results of negotiations conducted pursuant to section 3004;

Appendix 3.2 Blueprint for Financial Sector and Market Liberalization

1. Plan for Deregulation of Interest Rates

	Lending rate	Deposit rate	Bond issue rate
First Step (initiated in Nov. 1991)	- Bank overdrafts and discounts on commercial bills, apart from loans assisted by BoK rediscount - Discounts on commercial paper and trade bills of investment and finance companies -overdue loans	-Short-term, large denomination deposit instruments such as CDs, trade bill, commercial papers and RPs -Long-term time deposits with a maturity of at least 3 years	- Corporate bonds with a maturity of at least 2 years
Second Step (initiated in Nov. 1993)	- All loans of banks and non-bank financial institutions, apart from those provided through government or BoK rediscounts	- Long-term deposit with a maturity of over 2 years of banks and non-banks	-Corporate bonds with a maturity of less than 2 years -Bank debenture, Monetary Stabilization Bonds, government and public bonds
Third Step	<1994 -1995> - Loans financed by BoK rediscounts such as discount bills <1996> - Loans with banking funds compensated for interest rate gap by government funds such as special equipment loans	-Further deregulation of short-term marketable products - Phasing out regulations on issues and maturities - Deposits excluding demand deposits - Introduction of financial product linked to market rate such as MMC and MMF	
Fourth Step (some time in 1997)		- Setting up plan for gradual deregulation of demand deposits - Reviewing an abolition of restrictions on short-term marketable instruments	

2. Plan for Foreign Exchange Liberalization

Stage I (1993)	Stage II (1994-95)	Stage III (1996-97)
<Foreign exchange rate> -Expand the range of daily interbank foreign exchange rate fluctuations from 0.8% to 1.0%	- Gradually expand range of daily interbank foreign exchange	- Pursue the settlement fo a free floating foreign exchange rate system
<Foreign exchange position> -Raise the ceiling on overall foreign exchange oversold position: from US$ 10 to 20 million	-Improve foreign exchange position management systems by simultaneously considering bills bought and net worth - Adjust the oversold position limit of spot transactions considering the situation of the foreign exchange market	- Change the main object of foreign exchange position control toward the promotion of the soundness of foreign exchange banks
<Documentation requirements> -Raise the ceiling on foreign currency deposits without need to present underlying documents: from US$ 200 to 300 million - Extend the time limit for submitting underlying documents: from 30 to 45 days	-Exempt forward transactions among foreign currencies from underlying documentation requirement -Abolish ceiling on foreign currency deposits exempted from underlying documentation -Expand ceiling on forward transactions between foreign exchange and Korean won	- Completely exempt normal transactions from underlying documentation requirements, but maintain the principle of real demand
<Korean won internationalization> -Permit visible export or import settlement in Korean won up to US$ 100,000 -Allow non-residents to open won accounts freely without restrictions	-Raise ceiling on settlement in won for visible transactions	- Progressively permit full settlement in Korean won for visible and also invisible transaction

3. Plan for Capital Market Opening

	Stock market	Bond market	Others
Stage I (1993)	-Eliminate ceiling on foreigners' stock investment in companies with over 50% of equities owned by foreigners		-Allow foreign investment trusts and investment consulting companies to participate in the equity of domestic investment trust firms (up to 10% for all foreign firms, and up to 5% for each)
Stage II (1994-1995)	-Raise stock market investment ceiling for foreigners -Accord national treatment in stock market investment to those residents who are defined as foreigners under the Securities Exchange Act -Relax requirements for opening branches by foreign securities companies	-Allow international organizations to issue won-denominated bonds in the domestic market -Allow direct purchase of equity-linked securities such as convertible bonds issued by small and medium sized enterprises (SMEs) -Allow underwriting of government and public bonds at international interest rate in the primary market -Allow foreigners to invest in bond-type beneficiary certificates, as a way of indirectly opening the bond market	-Permit establishment of domestic representative offices of foreign credit rating firms -Expand the ceiling on capital participation by foreign investment trusts and investment advisory firms
Stage III (1996-1997)	-Continue to raise the direct stock investment ceiling for foreigners -Lower capital requirements for branches of foreign securities	-Allow direct investment in SMEs' long-term and non-guaranteed bond	-Raise the ceiling on equity participation in domestic credit rating company by foreign credit rating agencies

Source: Ministry of Foreign Affairs and Trade (1999: 118-126)

Chapter 4 Regulatory Institutions and Regulatory Failures

4.1 Introduction

Appropriate prudential regulation/ supervision is essential to restrain moral hazard, which is inherent in banks, regardless of the existence of government deposit insurance. Thus, financial supervision aims to prevent banks from risky behaviour in an economy and it is particularly important when foreign capital flows into the economy. Most analysts of the crisis, even those who focus on the central role of capital movements in triggering the crisis, agree that Korea did not impose appropriate prudential regulation/ supervision. What is required in the analyses is a political economy explanation for the inappropriate prudential policy, in particular with reference to the close business-government relations in the developmental state.

It is now very clear that in Korea, both foreign investors and domestic financial intermediaries assumed that the Korean authorities would protect Korean financial institutions, in particular deposit-taking banks, from insolvency. No bank had failed until 1998, when six banks (most of them regional) were obliged to be taken over by Korean nationwide banks. In "Korea Inc.", however, prudential regulation/supervision had been underdeveloped. This is understandable because a prudential framework may consist of three different factors, which ensure sound behaviour of financial institutions: public regulation and supervision, internal controls, and market discipline (Ariyoshi *et al.* 2000).

Among those three factors, Korean financial institutions lacked internal controls and market discipline. Lastra (1996) also indicates that some elements of supervision *stricto sensu* (in narrow terms) are essentially market-oriented ones, such as ratings made by private rating agencies, and reporting by independent external auditors.[1]

With regard to the point that the banks lacked market discipline, some developmental state theorists agree that the state inherently promoted moral hazard in the banking sector.[2] The Korean state had such a close business-government relationship that this gave rise to a number of political dangers, including the socialization of private risk-taking: continued government involvement in the financial system reduced incentives to banks to monitor their lending (Haggard and Mo 2000).

Also, in the words of Woo-Cumings, "State interventionism in the market" is "Janus-faced."

> The state can achieve its goal by manipulating the financial structure, but once it does so, it has to socialize risk, either through inflationary refinancing (monetary means) of the nonperforming loans to bail the firms out, or through expansion of the state equity share of the banks (essentially fiscal means) so as to write off the bad loans. ... This sort of financial system was what enabled industrial policy in South Korea and in Japan; the downside was the problem of moral hazard (that is, bailing out firms in trouble) and socialization of the risk (Woo-Cumings 1999: 13).

---

[1] On the classification of prudential regulation supervision, see Lastra (1996).

[2] Since less reliance can be placed on internal mechanisms, externally-imposed regulations should be relatively more important in emerging countries (Goodhart 1998: 104).

In addition, Haggard indicates that close business-government relations in the developmental state had, in spite of its potential benefits, a number of significant risks. First is an increasingly concentrated industrial structure, which could lead to the "too big to fail" problem. Second, continued government involvement in the banking sector, which had pumped credit into the *chaebol*, weakened banks' incentives to monitor their corporate clients aggressively. Third, financial reforms were captured not only in their implementation but also in their basic design, as a result of intense lobbying from *chaebol* (Haggard 2000).

What is missing in these explanations, however, is a detailed investigation of institutional features at micro level, i.e. the effects of the characteristics of the financial regulatory framework and of private influence on particular regulatory outcomes in the context of close business-government relations. This chapter aims to fill the gap.

This chapter consists of seven sections including this introductory one. The following section 4.2 examines the state of regulatory legislation which was characterized by centralization of regulatory authority within the Finance Ministry. Section 4.3 focuses on private pressure for deregulation during the mid-1990s, which resulted in relaxation of key prudential regulations and reorganization of the government. Section 4.4 examines prudential regulation/supervision outcomes before the crisis. It shows how prudential supervision in a narrow sense, i.e. licensing, on-site supervision, reporting and sanctioning was systematically distorted in the developmental state. It also assesses the crisis management function of the Korean government and whether it was effective in restraining the moral hazard problem in financial institutions. In section 4.5, the enforcement of key prudential rules, such as capital adequacy requirements, large exposure limits and regulations regarding foreign currency exposures, are investigated in detail.

Section 4.6 reveals an important aspect of the bureaucracy-BoK-financial sector relationship, which was determined by the government-bureaucracy-industry triangle. This aspect has been largely overlooked in the literature. The Bank of Korea (BoK) in accordance with the order of the Finance Ministry deposited its foreign currency assets (*de facto* international reserves) with domestic banks.[3] In other words, *de facto* international reserves, which could normally be used to finance lender-of-last-resort operations in emerging economies, were used to promote the developmental objective of the state in favour of the private sector.

Section 4.7 draws conclusions and sets out implications for the thesis. It argues that prudential regulation was strongly influenced by private interest and complicated as Olson's classical work in 1982 predicted. Strong private pressure constrained the Korean government and bureaucracy to repeal key prudential regulations and interferred with the introduction of necessary prudential measures during the 1990s. Governmental

---

[3] Generally, the foreign currency assets of a central bank should be the same as the international reserves of the bank. In Korea, however, there was a big gap between these two categories. The BoK divided its foreign currency assets into two different accounts; internal and external. Only foreign currency assets in the BoK's external account, such as the bank's deposits with Citibank in New York were the international reserves of the bank. Assets in internal accounts, such as the BoK's foreign currency deposits with the main office of Korea First Bank, were not calculated as part of its

institutional features facilitated such perverse pressure. The centralization of the regulatory framework facilitated private preference for the sacrifice of prudential objectives of intermediate regulatory institutions, such as the BoK and the OBS.

4.2 State of Regulatory Legislation

Prior to the crisis, there were three Acts regarding banking regulation. The General Banking Act stipulated a comprehensive basis of regulation. Although an outline of the regulations was prescribed in the General Banking Act and its Ordinance, the formulation of detailed rules was entrusted to the Monetary Management Board of the BoK in accordance with the BoK Act. In addition, authority for inspection of foreign exchange business was a requirement of the Foreign Exchange Management Act. Due to the scarcity of foreign exchange, foreign exchange flows had traditionally been under the strict control of authorities. In relation to regulations applied to non-banking financial institutions (NBFIs), there were various acts for individual groups of NBFIs such as the Merchant Banking Act for merchant banks.

Rather than promoting sound banking, that legislation was originally aimed at regulating banks in such a manner as to achieve the policy objective of the Finance Ministry (and the government), i.e. growth. It is difficult to find in those statutes any clear policy objective to encourage sound banking. For the first time in its sixth revision in December 1982, the General Banking Act included, as one of its objectives, the phrase "sound management of banks". This was at the time that deposit money banks were

---

international reserves.

privatised. However, until December 1991, on its seventh revision, there was still no specific prescription in the Act, which can be regarded as prudential regulation. Even after the seventh revision, prudential regulations which were introduced were not strongly implemented. By contrast, key regulations were repealed during the mid-1990s, reflecting the interests of the private sector.

The Foreign Exchange Management Act was also not concerned with prudential regulation. The objective of the Act was threefold: to smooth international transactions, to achieve a stability on the balance of payments; and to ensure the stability of the value of the currency. It was established at the end of 1961 to promote the efficient use of foreign exchange, which had been scarce. The Act therefore focussed on foreign exchange controls, enhancing exports and restraining imports. Although the details had changed, for example, imports were no longer discriminated against, these three objectives of the Act were unchanged until the crisis. Although some controls had an indirect effect on prudential regulation e.g. on the foreign exchange exposure limits of the DMBs, the Foreign Exchange Management Act did not include any specific clauses aimed at ensuring sound banking practice. For example, regulatory authorities set limits on O/B (over-bought) and O/S (over-sold) positions. When assets and debts were the same, it was called "square". However, it did not prescribe crucial elements of prudential regulation, such as rules on liquidity mismatches, as emerged in the context of the Korean crisis.[4]

[4] When foreign currency assets exceed foreign currency debts, the bank is over-

Changes in the General Banking Act

After its enactment in 1950 and enforcement in 1954, the General Banking Act had been revised nine times up to the time of the crisis. When technical revisions resulting from changes in government organization are excluded, there were five revisions. The first three, i.e., first, fourth, and sixth revisions in 1962, 1977, and 1982 respectively, were made in order to support the government-led economic development. The Bank of Korea Act was also revised at exactly the same time. The latter two rounds of revisions were designed only to promote prudential regulation: the seventh in 1991 for limits on single exposures and the eighth in 1994 for large exposures.

In order to strengthen the credit rationing system, supporting the first Five-Year Economic Development Plan, which commenced in 1962, the first revision in May 1962 increased the limit for the holding of risky assets that banks could own, from ten times to fifteen times a bank's equity capital. Risky assets were defined as the total assets of the bank minus cash, deposits with the BoK and/or foreign financial institutions and investment in monetary stability bonds of the BoK. The limit for investments in corporate bonds and securities with over three years' maturity also increased. The minimum equity capital for banks, as required by the General Banking Act, increased by 50 %, i.e., from Korean won 100 million to 150 million. The Bank of Korea Act was revised at the same time. The ultimate authority for financial policy moved to the Finance Ministry from the BoK at the time of this revision.

---

bought (O/B); over-sold (O/S) is the opposite.

Under the fourth revision in 1977 (undertaken in order to increase external confidence), the Act increased the limit that a bank was able to guarantee, from fifteen times to twenty times its equity capital plus reserves. Also, loans guaranteed by the central or local government or jointly-guaranteed with other financial institutions and insurance companies were excluded from the limit. Thus, the actual amounts guaranteed far exceeded the limit set in the Act. Moreover, in order to encourage large-size banking, the minimum size of equity capital for a bank was raised to Korean won 25 billion and 1 billion for nationwide and regional banks respectively. Previously, it was Korean won 1.5 billion for nationwide banks and 0.15 billion for regional ones.

The sixth revision, enacted in December 1982, repealed the Provisional Act on Financial Institutions of 1961 which had entrusted the right of selection of the presidents and directors of financial institutions with the Office of Bank Supervision (OBS). This coincided with the privatisation policy of the deposit money banks (DMBs). The maximum number of bank shares owned by a single person was, however, restricted to 8%, in order to prevent too much money being lent to single persons.[5] The maximum bank guarantees for single persons was limited to 50% of the bank's equity capital.

Regulations aimed at promoting prudence by banks were included in the seventh and eighth revisions. To guard banks against possible instability of financial markets as a result of financial liberalization, the seventh revision of 1991 obliged banks to ensure the soundness of their business, by enlarging their equity capital and maintaining adequate

[5] Single person is a legal term, which includes companies.

liquidity. In addition, the lending limit to a single exposure was reduced to 20% from 25% of the bank's equity capital, and the maximum bank guarantee for single persons decreased from 50% to 40% of equity capital.

Under the eighth revision in December 1994, the maximum number of bank shares to be owned by a single person was halved, from 8% to 4%.[6] With respect to exposure to single persons, the maximum lending was reduced to 15% (from 20%) of equity capital and the maximum amount guaranteed by a bank was reduced to 30% (from 40%) of equity capital. Limits for large exposures were introduced for the first time. When a single exposure exceeded 15% of the bank's equity capital, the amount of the exposure was termed a large exposure. The fixing of the aggregate limit for the large exposures was entrusted to the Monetary Management Board to determine and the Board decided that the limit should be 500% of equity capital (see section 4.5.2).

The changes in the General Banking Act (Table 4.1) show that, except for the limits on single and large exposures, prudential regulatory considerations were rare. Even, in relation to such prudential regulations, the large exposures limit of 500% was hardly "prudent". In addition, as we examine later, such limits were applied to banking accounts of the DMBs only. Moreover, even the regulations on single and large exposure originated partly from the government wishing to promote fair trade, rather than exclusively from the wish to promote sound banking. Specific measures on capital adequacy requirements were not enacted prior to the crisis. Until then, the OBS had

[6] There was an exception for "financial speciality entrepreneurs" who carry on

merely issued management guidance, which was subordinate regulation to Act and Ordinance, on capital requirements. Moreover, criteria of loan classification, which were crucial in terms of implementing capital requirements, were lax from the perspective of international standards. Furthermore, implementation of such regulations was not strict. Regulations included many exceptions and ambiguous prescriptions, which enabled regulatory authorities to make arbitrary decisions.

---

financial business exclusively. However, none qualified under this criterion.

Table 4.1 Key Changes in the General Banking Act

Revision	Ownership/ Governance	Size of assets/ Paid-in capital	Single exposure	Large exposure
1st (May 1962)		Extension of limit on risky assets (10 to 15 times against equity capital)		
4th (Dec. 1977)	Introduction of the requirement for bank management to comply with comprehensive orders from the OBS Governor	-Extension of limit on bank guarantees (15 to 20 times of equity capital) -Increase in minimum capital requirement (Won 1.5 to 25 billion for nationwide banks, Won 0.15 to 1 billion for regional banks)		
6th (Dec. 1982)	-Revocation of the requirement for bank management to comply with comprehensive orders from the OBS Governor -Limit of shares to be possessed by a single person (within 8%)		Limit of guarantee for single person (50% of equity capital)	
7th (Dec.1991)*1)		-Extension of minimum capital (over Won 100 billion) -Limit on investment in securities (25 % of on demand deposits to 100% of equity capital)	Reduction in single exposure (loans: 25% to 20% of equity capital, guarantees: 50% to 40% of equity capital)	
8th (Dec. 1994)	Reduction in limit of shares to be possessed by a single person: 4 % of aggregate shares with voting rights		Reduction in single exposure (Loans: 20% to 15 % of equity capital, guarantees: 40% to 30% of equity capital)	Limit on amount of loans - 15% of equity capital to single persons, companies, - 500% of equity capital to groups

*1) Introduction of duty to ensure sound banking, by way of sufficient equity capital and adequate liquidity.
Source: Derived from OBS (1995)

Impact of Institutional Centralization on the Process of Prudential Regulation

Prudential regulation/supervision consists of four different stages, i.e., licensing, supervision *stricto sensu*, sanctioning and crisis management. It may seem natural that licensing and sanctioning of financial institutions should be under the jurisdiction of the Finance Ministry. Prior to the crisis, however, other areas were also under the control of the Finance Ministry. Specialist regulators, such as the OBS in respect of banking business, could conduct examination over financial institutions' businesses in accordance with guidelines determined by the Finance Ministry and the BoK. However, because power for the enactment and amendment of regulations over supervision *stricto sensu* was the responsibility of the Finance Ministry, the role of the OBS was limited to on-site examination, i.e., whether banks were adhering to existing regulations and government policies or not.

As regards crisis management, the last stage of prudential regulation, the BoK appeared to share part of the responsibility because the Monetary Management Board of the BoK possessed the Lender-of-last-resort (LLR) function. In reality, however, it was also controlled by the Finance Ministry (see section 4.4.4). Moreover, foreign currency assets of the BoK, which could be used to prevent systemic risks in a foreign exchange crisis period, were used instead to fund foreign currency loans to Korean banks.

The BoK, in accordance with the order of the Finance Ministry, deposited its foreign currency assets with Korean banks, at a low interest rate, i.e. lower than at the rate payable by the banks on the international bank-loan market. The size of the foreign currency assets deposited with domestic banks by the BoK, which was not calculated as part of the international reserves, exceeded the level of the official international reserves at the end of 1996. This is the most extreme example showing the inadequacy of prudential regulation prior to the crisis and will be dealt with, in detail, in section 4.6 of this chapter.

4.3 Fervour of Deregulation: Pressure from the Private Sector

Deregulation has emerged as a core objective of the government since 1993. The negative effects of over-regulation had been indicated by the private sector and the government had been concerned about regulatory relaxation from the beginning of the 1980s. However, deregulation was not regarded as one of the major priorities of the government until 1993 when the new Kim Young-Sam administration took office and prescribed such a priority in its New Economy Five-Year Plan.

The Kim Young-Sam administration formed various institutions for deregulation (see Table 4.2) in consultation with the private sector. Deregulation policy was strongly conducted by the senior advisor to the President for Economic Affairs, Park Jae-Yoon, who even formed a team called the "Regulatory Reform Inspection Team" and checked the state of regulatory relaxation by ministries.[7] A new senior post in the Presidential

[7] The team conducted such inspections for a limited period, i.e. between January 1994 and June 1994. The team consisted of thirty people from the government (11 ministries such as Premier's office and BAI) and 27 people from five private sector interest group associations, such as FKI. The senior advisor, Park Jae-Yoon became the Finance Minister in 1994.

secretariat, Secretary for Regulatory Reform, was established at the beginning of the Kim Young-Sam's government in March 1993.

Table 4.2 Government Institutions for Regulatory Relaxation

Title	Establishment	Business	Ministries charged
Committee of Economic Regulatory Relaxation	March 1993	Review on proposals of regulatory relaxation by ministries	MoF (MoFE)
Committee of Administrative Reform	April 1993	Decision of regulatory reform regarding the life of the people	Prime Minister
Industrial Deregulation Committee	July 1993	Investigation, deliberation and reform of industrial regulations	Ministry of Trade and Industry
Planning Team of Strengthening National Competitiveness	December 1994	Regulatory relaxation and increase in policy transparency	Presidential secretariats
Committee of Conducting Globalization	January 1995	Relaxation of regulations interfering with globalization	Prime Minister
Special Committee of Strengthening National Competitiveness and Economic Institutional Reform at the National Assembly	December 1993	Review on government's regulatory reform for strengthening national competitiveness and economic institutional reform	National Assembly
Committee of Corruption Prevention		Evaluation and audit on government's regulatory relaxation	Board of Audit and Investigation
Ministry of Government Administration (MoGA)	December 1993	Administrative help for regulatory reform	MoGA

Source: Private Sector Committee of Strengthening National Competitiveness (1996: 128)

In June 1993, the "Special Act of Industrial Deregulation" was introduced (Private Sector Committee of Strengthening National Competitiveness 1996: 129). In accordance with the Special Act, the Industrial Deregulation Committee was established. The committee consisted of five people from the government and nine people from the private sector. The role of the Committee was to review industrial regulations, which were pinpointed as the subject of reform by the private sector, and to recommend regulatory change to relevant ministries. Ministries had to submit reform measures in response to any recommendation. The Committee recommended the reform of 47 regulations to the Finance Ministry, of which 43 were related to financial and tax issues (Industrial Deregulation Committee 2002).

The establishment of such institutions as the Industrial Deregulation Committee was driven by the private sector, represented by the "Private Sector Committee of Strengthening National Competitiveness". The Committee was formed in 1993 in order to concentrate the collective power of private sector interests by five private sector interest group associations, including Federation of Korean Industries (FKI), Korean Foreign Trade Association (KFTA), and Korea Chamber of Commerce and Industry (KCCI). Those five associations delegated twenty-seven people to the "Regulatory Reform Inspection Team" in the Presidential secretariats and inspected the situation of regulatory reform in the government. The Chair of the Committee was held by the Chairperson of the FKI, Choi Jong-Hyun (the owner of SK group, which was then the fourth biggest *chaebol*).

Among various areas of regulation, financial regulations (including foreign exchange controls) were targetted as core regulations, along with those of real estate and employment, which, the Committee argued, prevented corporations from developing international competitiveness. It has been claimed that the existence of such regulations was due to the bureaucratic interests of related ministries and insufficient understanding of the corporate situation. What should be noted was the aim of financial regulatory relaxation from the viewpoint of the Committee, that is, a reduction in interest rates. The Committee claimed that a backward financial market resulting from financial regulation was interferring with the development of the real economy. An increase in opportunities of corporate finance and a reduction in credit controls over the biggest groups (*chaebol*) were particularly suggested by the private sector. Also, the Committee argued for entry liberalization and a universal banking system by repealing regulations on the segmentation of financial business areas. Moreover, it demanded preliminary screening in newly-introduced regulations and the insertion of 'sunset' clauses and the name of the proposers in such regulations (Private Sector Committee of Strengthening National Competitiveness 1996: 157-171).[8]

Such private pressure for deregulation gave birth to a substantial decrease in a number of key regulations and institutional changes in the financial system and regulatory authorities during the Kim Young-Sam administration period. As regards economic regulations, as many as 1971 regulations were indicated as the subject of relaxation, of which 1342 regulations were relaxed during the period between March 1993 and May 1994. In 1995, a further 501 regulations were indicated for relaxation (MoFE 1995). Some key regulations, such as the limit on overseas financing of corporations and on the use of proceeds by such financing, and the limit of a compulsory

[8] A 'sunset' clause requires overall examination of regulation and its maintenance after a certain period of time.

ratio of long-term funding for long-term lending by financial institutions, were relaxed during the period.

As regards institutional change in the financial system and regulatory authorities, an extension of business by different financial sectors and an increase in the number of financial institutions were observed.[9] Among others, most important was perhaps the reorganization of the government, which integrated the Economic Planning Board (EPB) and Ministry of Finance (MoF) into the Ministry of Finance and Economy at the end of 1994. The Private Sector Committee of Strengthening National Competitiveness argued that core regulatory reform such as that regarding corporate financing and foreign exchange made slow progress because bureaucrats were not willing to remove related regulations. It was claimed that this was due to the fact that the bureaucrats regarded regulatory relaxation as a reduction in their power. In order to defend bureaucratic territories, bureaucrats disguised their interest in maintaining regulations with policy objectives, thus rejecting regulatory relaxation, the committee argued (Private Sector Committee of Strengthening National Competitiveness 1996: 130). The reorganization of the government at the end of 1994, represented by the integration of the EPB and the MoF into the MoFE, occurred under such pressure. Accordingly, regulatory reform was only proceeding in the direction of deregulation. Re-regulation was hardly tried.

Officers of the Finance Ministry stated that it was difficult to remove capital controls at the same time as strengthening prudential regulation in Korea during the mid-

[17] As regards the increase in the number of investment and trust companies and

1990s (Testimony of Yoon Cheng-Hyun at the Special Investigation Committee on the Crisis 1999). Most advocates of liberalization and deregulation appeared to have equated capital account liberalization with the relaxation of regulations, regardless of whether those regulations included a prudential element or not.

A document published by the BoK shows that during the process of financial liberalization during the 1990s, a number of financial supervisory measures were also removed. In 1995, the BoK planned to remove 105 financial regulations and actually repealed 61 rules during the first half of the year, of which 44 rules were related to banking supervision (Bank of Korea 1995b).

After the crisis, Joseph Stiglitz argues, "Many of the so-called reforms undertaken under the name of financial market liberalization may have served to weaken, rather than strengthen, the financial sector." He continues, "The advocates of liberalization and deregulation seldom go so far as to advocate free banking; but by failing to understand the roles and functions of financial market regulation - and constraints under which it operates - they have left the financial sector in many countries far weaker" (Stiglitz 1999b: 44). This explanation is in accord with the experience of Korea.

---

merchant banks, refer to Table 7.1, Chapter 7.

4.4 Prudential Supervision in Detail

4.4.1 Licensing

"Licensing is a key first step in the supervisory process; it acts as catalyst or filter to prevent bad banks and dishonest people from entering the banking system" (Lastra 1996: 110).[10] Although licensing policies should strike a balance between the financial market's stability and its efficiency (Lastra 1996: 110), policies in Korea appeared to be greatly influenced by the fervour of liberalization and deregulation, in particular during the first half of the 1980s and the mid-1990s.

As already described, licensing of short-term finance companies and mutual credit companies was liberalised in 1982: any person who fulfilled the single condition of capital size qualified for a licence. As competition in the industry intensified, the balance sheets of the companies started to deteriorate. The companies were again allowed to obtain foreign exchange business licenses by converting themselves into merchant banks in 1994 and 1996.[11] However, the only criterion for that transformation to be allowed was the equity capital, i.e. there was neither a 'fit and proper' test nor emphasis on good corporate governance. The transformation occurred in the name of enhancing competition and in the interest of consumers. However, there was the strong interest of the industrial

[10] "Bank charters are grants from sovereign governmental authorities to applicants who wish to engage in banking under terms and conditions that thus become authorized. (...) The terms and conditions of bank charters include privileges, obligations and restrictions" (Newman, Milgate, and Eatwell 1992a: 125).

[11] Merchant banks automatically get a business licence for foreign exchange business as a foreign exchange transaction bank in accordance with foreign exchange management law.

sector, in particular the *chaebol*.[12] Because there was no rigorous authorization procedure for a licence, it could arguably be said that in practice the procedure was abandoned. Management competence, integrity of the industry, and the future prospects for the industry were not considered. The policy objective of promoting growth and liberalization as well as the special interests of the *chaebol* may have been achieved but there was no serious concern in ensuring that financial institutions were prudent.[13]

Historicaliy, in the developmental state, the value of having a banking licence was extremely high. It was a situation of oligopoly, and thus it was said, "Once you have a banking licence, you can survive." Moreover, the ability to run a foreign exchange business was a privilege. Until the latter half of the 1980s, this business was only undertaken by the Bank of Korea and the Korea Exchange Bank. After that banks were allowed to do business. The transformation of short-term finance companies into merchant banks during the mid-1990s meant that the companies got the privilege of being able to conduct foreign exchange business without being adequately prepared. Some of the new entrants were partly owned by the *chaebol*, and others by construction companies which had close connections with politicians. The construction industry is indicated as frequently suffering from liquidity problems.

[12] As shown in Chapter 7, the companies were a major financing source of the *chaebol*.

[13] Regarding the non-existence of a "fit and proper" test for new entrants of merchant banks during the 1990s, see Chapter 7.

4.4.2 Supervision stricto sensu

Supervision *stricto sensu* is defined as "the monitoring of the safety and soundness of a bank during its 'healthy' life."[14] The monitoring process comprises the oversight of "asset quality, capital adequacy, liquidity, earning and management, including internal systems of control and security systems." Focusing on 'soundness,' prudential supervision aims at collecting information about the condition of a bank. Regulatory authorities exercise it through different measures and instruments, including reports, ratings, on-site examinations, in-house surveillance and consultations with high-level management. It is supplemented by reports from independent external auditors (Lastra 1996: 111).

Reporting from Independent External Auditors

Prior to the crisis, due to the weakness of Korean accounting standards, the financial statements of banks were not regarded as reflecting their true condition. In order for banks to maintain 'suitable' financial statements, accounting standards were often changed. For example, banks were allowed to have a grace period to determine the market value for bank loans and assets in securities during the mid-1990s. With respect to loan classification, the criteria on asset quality were much looser than international standards. Because the intermediate supervisory body (OBS) manipulated the accounting criteria in order to cover losses and thus ensure the achievement of the Finance Ministry's policy objectives, such as special loans for industry restructuring during the mid 1980s,

---

[14] In this sense, supervision *stricto sensu* can be distinguished from prudential regulation, which is concerned with mandating prudential rules for banks; supervision is the monitoring process carried out to make sure that these rules are followed by financial

financial institutions did not feel any serious need for internal controls. This is a clear case of regulatory forbearance driven by industry pressure.

Financial statements did not reflect the real business state of financial institutions. Financial institutions were not required to be examined by external credit ratings agencies. Moreover, There were three domestic credit ratings agencies, all of which were owned by financial institutions and were never independent of the interest of the financial sector and government influence. Financial institutions had their accounts audited by auditors of their own choice.[15] The auditors themselves had few incentives to conduct arms-length investigations, as there were no sanctions for mis-reporting.

According to a survey on the credit ratings of Korean companies given by domestic credit ratings agencies, 98% of credit-rated companies were graded as suitable to invest i.e. higher than B which is equivalent to BBB in the criteria of S&P. 57.4% was ranked at the highest three levels i.e. A1 – A3 which are equivalent to AAA – A in the criteria of S&P. Among US companies examined by S&P, only 22.4 % was ranked at the three highest levels and 42.3% was judged as investment grade, which is suitable for issuing commercial paper (Table 4.3). In case of 40 companies liquidated in 1997 in Korea, no company was graded as junk even immediately before their bankruptcies (Cho 1999:14-17). Thus, loans made by financial institutions to those companies were classified as normal rather than as Non-Performing Loans (NPLs).

---

institutions (Newman, Milgate, and Eatwell 1992b: 156).

[15] After the crisis, banks have been required to have compulsory examinations by credit ratings institutions.

Table 4.3 Credit Rating: Domestic Agencies' and S & Ps' Compared

Domestic Agencies' Average				Standard & Poors	
Rating	1997	1996	1995	Rating	1995
A1	8.4%	8.2%	6.4%	AAA	1.2%
A2	17.9%	22.0%	21.1%	AA	5.4%
A3	31.1%	33.8%	32.5%	A	16.2%
B	40.6%	35.9%	40.0%	BBB	19.5%
C	0.4%	0.2%	0	BB	26.1%
D	1.3%	0	0	B	28.6%
No Action	0.3%	0	0	CCC	1.1%

Source: Cho, Y-J (1999: 16)

In-house surveillance and consultations with senior management

Internal controls of financial institutions were ineffective. For example, in relation to foreign exchange business there was no internal regulation required for new entrants to merchant banking during the mid-1990s. In the wake of the crisis, it was revealed that some merchant banks had even issued 'fraudulent' commercial paper. Merchant banks intermediated commercial paper between issuers and investors. Some merchant banks, however, sold to investors more than had been issued by good companies; merchant banks themselves collected the difference (Fund Department of the Bank of Korea 1997).

On-site examinations

On-site examinations are required in order for information to be obtained *in situ* on the financial condition of an institution, and its compliance with the law (Lastra 1996: 115). Examinations were strictly confined to the checking of whether financial institutions had conformed to the related regulations. The problem was that the prudential elements of regulation were too lax and not even strictly imposed.[16]

4.4.3 Sanctioning

Sanctioning includes the power to revoke a bank's licence which rests with the licensing or chartering authority (Lastra 1996). In order for this element of prudential regulation to work, banks should be allowed to fail. Some argue that early closure should be required in case of serious undercapitalization when a bank reaches the point of technical insolvency. The Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 in the US, establishes five capital tiers: well-capitalized, adequately capitalized, undercapitalised, significantly undercapitalised, and critically undercapitalised – and requires prompt corrective action in the last three cases.[17]

In Korea before the crisis, it was difficult for even small financial institutions to fail. In a situation where closure of financial institutions was not allowed, the excessive issues of banking licences and the encouragement of over-competition caused problems.

[16] Details are examined in the Section 4.5.

[17] However, Lastra (1996) mentions that the concept of early resolution (e.g., closure at positive levels of capital) can be politically costly, constitutionally dubious and practically difficult.

4.4.4 Crisis Management and Government Implicit Guarantees

Crisis management comes under the last stage of bank supervision, according to the classification of Lastra. It refers to the official protection by the authorities of banks in a 'crisis situation,' which is the situation of "either illiquidity or insolvency that may threaten the continuation of the activities of a particular bank or banks on a temporary of permanent basis." (Lastra 1996: 124-5) Three ways have been indicated as to the action which the authorities can take in a crisis situation: the central bank acting as lender-of-last-resort, deposit insurance and bank insolvency proceedings (Lastra 1996).

Protection is likely to exacerbate the moral hazard problem of banks. In relation to deposit insurance, McKinnon and Pill (1996, 1998) have shown that the existence of government protection leads to risky behaviour and the problem of overborrowing, leading to a crisis. Thus, protection for banks should be designed to reduce uncertainly and to deter banks from taking undue risks in anticipation of government's protection, thus minimizing moral hazard problems (Newman, Milgate, and Eatwell 1992b).

In Korea, however, the lender-of-last-resort function of the BoK was distorted. It was used as a means of industrial policy and even encouraged banks to make risky investments. Moreover, the resources to support the lender-of-last-resort function in a crisis situation, i.e., international reserves, were used for promoting growth, which reflected private sector interest. Foreign currency assets of the BoK were deposited with domestic banks and lent to industrial firms.

In the wake of the crisis, it was revealed that overseas borrowing by industrial enterprises, mainly overseas subsidiaries of the *chaebol,* totalled US$ 18 billion as at February 1994 when the limit on the amount of such borrowing was still in force. After the limit was abolished in 1994, overseas funding by overseas subsidiaries of the *chaebol* surged to US$ 53 billion as at the end of 1997. The source of such overseas borrowing was largely Korean financial institutions, which borrowed from international financial institutions and lent to overseas affiliates of Korean industrial enterprises.

Deposit Insurance and Bank Insolvency Proceedings

Deposit insurance was not introduced in Korea until 1995. This does not mean that the moral hazard resulting from deposit insurance was not in evidence before 1995. This was because the authorities did not feel it necessary to introduce such a scheme because in Korea banks had never gone bankrupt. There were no insolvency proceedings specific to banks as distinct from that for other businesses.

Lender-of-Last-Resort Role of the Central Bank

Lender-of-last-resort (LLR) is defined as "the central bank's responsibility to accommodate demands for high-powered money in times of crisis, thus preventing panic-induced contractions of the money shock. The central bank discharges this duty either through open-market purchases or by making emergency loans through the discount window to solvent but temporarily illiquid banks at penalty rates on good collateral" (Newman, Milgate, and Eatwell 1992b: 571). [18]

---

[18] The idea of LLR was developed by Henry Thornton and Walter Bagehot, who clarified it in the form of a set of rules for hindering bank panics and crises. These rules

What is important is LLR support should include restraint measures to prevent banks from taking immoderate risks. However, this was not consistent with the case of Korea. The Finance Ministry even argued that the LLR function was also the responsibility of the government. In accordance with the order of the Finance Ministry, a special section of the BoK, supporting the LLR function, did not disclose information about insolvent banks to the Monetary Management Board or to other parts of the BoK. The information was kept secure by the Finance Ministry, which decided on special loans and then asked the Monetary Management Board to issue them. Such special loans were made without the knowledge of the market and they carried no penalty charge; thus banks even sought to get LLR special loans from the BoK, in particular between 1985 and 1988. Some BoK staff members sarcastically referred to the lender-of-last-resort function of the central bank as "the lender of first resort function."[19]

There were several lender-of-last-resort measures in the 1980s and 1990s, which diverged substantially from the ideal concept of LLR. In the 1980s, the measures were aimed at preventing industrial firms from going bankrupt. After banks, in accordance with government policy, extended special loans on favourable conditions to certain enterprises, the BoK supported those banks by making special loans to them at low interest rates. Between February 1985 and February 1988, the Korean government (the

---

emphasized the LLR's responsibility as follows:

> (1) To protect the aggregate money stock, not individual institutions; (2) to support central bank objectives of gold convertibility and long-run stable money growth; (3) to let insolvent institutions fail; (4) to accommodate creditworthy institutions only; (5) to charge penalty rates; (6) to require good collateral, and (7) to preannounce its policy well in advance of crises to minimize the chances of a panic (Newman, Milgate, and Eatwell 1992b: 571).

Finance Ministry) named 78 firms as requiring industrial rationalization. Faced with a slowdown in the international economy and the resultant slow turnover in certain industries, such as the shipping and construction industries to which banks had made loans which could not be repaid, the Korean government took action to improve the situation. Eighteen of 78 companies recovered through their own efforts, and four were liquidated, while the other 56 were sold to third parties.

In relation to the 56 companies which changed ownership, if their assets exceeded their liabilities, then the ownership of the companies was transferred to the third parties without any additional compensation. However, when the value of the assets of the companies was less than their liabilities, the banks extended special loans to the buyers on preferential terms. For example, the ownership of Kyungnam (a construction company) was transferred to Daewoo (a trading company at that time). As the liabilities of Kyungnam were bigger than its assets by 450 billion Won, the government compensated Daewoo for this deficiency in the way of extending special loans by a Korean bank with a favourable interest rate (Kim 1995).

As a result of making special loans to the third parties with favourable conditions, losses of the banks increased. The banks were compensated for these losses by receiving special loans made to them by the BoK. Relying on its money-issuing power, the BoK supplied the banks with special loans to the total of 1722.2 billion won between 1986 and

---

[19] Based on an interview with an anonymous BoK staff member in August 2000.

1988. The rate of interest on the special loans was only 3%, compared to the then interbank rate of 8%.

In the 1990s, special loans by the BoK were made directly to financial institutions. There were five cases of this prior to the crisis. The first was to support three investment trust corporations (ITCs) in 1992, which had been asked to buoy the stock market by buying stocks in spite of the market's slow-down. As a result, all the funds managed by the ITCs recorded huge deficits. Because most investors were withdrawing their money from the ITCs, the ITCs were on the verge of bankruptcy. This was bad not only for the ITCs and investors but also for the stock market; in order for the ITCs to repay investment in their funds, they had to sell stocks and this pushed the stock market down further. The BoK made special loans of 2900 billion won (US$ 3.7 billion) to seven deposit money banks.[20] The banks then lent these funds to the investment trust corporations at an interest rate of 3%, which was far below the then market interest rate, with the collateral being commercial paper issued by the ITCs themselves (BoK 1998).

The second case was the support of the Korea First Bank (KFB) in September 1997, when the economy was on the brink of the crisis. The amount of special loans made to the KFB totalled 1000 billion Won (US$ 1.1 billion) with a market interest rate of 8%.[21] The third case in October 1997 was in respect of merchant banks with non-performing loans caused by the 'bankruptcy protection agreement,' which exceeded half

[20] On the basis of the won-dollar exchange rate at end of the year

[21] This is on the basis of the won-dollar exchange rate as at the end of September 1997.

the banks' equity capital. Again, the amount of the special loans extended by the BoK was 1000 billion won at an interest rate of 8% per annum. In the second and third cases, the KFB and merchant banks had special loans with a market interest rate, which was much lower than they could actually get in the interbank market. The fourth case was the support of the Korea Asset Management Corporation (KAMCO), which bought the bad assets of Korean financial institutions. The special loans to the KAMCO at the end of November 1997 totalled 2000 billion (equivalent to US$ 1.7 billion on the basis of the won-dollar exchange rate as at end of November 1997) and the interest rate was 5% per annum (BoK 1998).

4.5 Examination of Key Prudential Regulations

4.5.1 Capital Adequacy Requirements

Capital adequacy requirements require banks to set aside funds to provide for possible non-repayment of loans made by them in order to protect depositors and creditors. Because banking regulation aims at protecting the banks' payment systems and bank depositors, these requirements are one of the most crucial measures to achieve that goal.

Along with the introduction of obligations imposed on banks to ensure soundness in accordance with the 1991 revision of the General Banking Act, the OBS in July 1992 introduced BIS capital adequacy requirements as one of its management guidance standards. However, the regulation applied only to banking accounts in deposit money banks. The requirements were neither applied to non-bank financial institutions including merchant banks nor to trust accounts in deposit money banks; they were not the subjects of the application of the Act. The new management guidance asked the relevant banks to maintain the ratio at over 7.25 % from 1994 and at over 8% from 1995.

Capital includes both core capital (tier I) and supplementary capital (tier II) and assets are weighted by category to reflect credit risks. In Korea, Tier II capital was composed of revaluation reserves, gains on securities valuation, general provisions for loan losses and subordinated term liabilities (Shim 2000: 108).

However, the standard for loan classification and provisions was much laxer in Korea, compared to that of the major OECD countries and even to some developing countries. The Korean authorities defined non-performing loans as loans that had been in arrears for six months or more, the Japanese standard, while the US standard definition was arrears of three months or more. In addition, bad loans were defined as the loans which were non-performing and not covered by collateral (much of which was in risky real estate assets).

The rules requiring provisions to be made against the value of securities holdings had a detrimental effect on the soundness of banks. Since 45% of unrealized profits were recognized as Tier II capital, the rules encouraged bank portfolio investment in listed stocks. Because the stock market in Korea performed badly after 1995, losses on investments increased. In this situation, the regulatory authorities relaxed regulations requiring provisions to cover unrealised losses resulting from the market value of securities deteriorating in 1995 (Board of Audit and Inspection 1998). The requirements for provisions to cover doubtful loans were brought down from 100 per cent to 75 per cent and for securities losses from 100 per cent to 30 per cent (Baliño et al. 1999: 28). The grace period until the full implementation was extended to the end of1998 for doubtful loans, and to the end of June 1999 for securities losses. This was to enable banks to maintain a capital adequacy ratio of more than 8%. Although official capital adequacy ratios of Korean banks remained over 10% in 1993 and 1994, if stricter rules had been applied, five out of six of the major deposit money banks would have failed to meet the minimum 8% ratio as at the end of 1993 (Shim 2000: 109).[22]

The 'Memorandum on Economic Program' on July 24 1998, agreed between the IMF and Korean authorities, reveals that the Korean authorities had allowed some loan loss provisions in part of Tier II capital before the crisis. It also shows that capital adequacy requirements did not apply to the assets in trust accounts in deposit money banks. [23]

---

[22] The argument is that most Korean banks' general provisions for loan losses related to their non-performing loans. The provisions for losses and doubtful loans and part of substandard loans were calculated as provisions created against an identified deterioration in the value of particular assets. The provisions for loan losses as provided by the Korean standard could not appropriately be regarded as supplementary capital if international standards were applied; therefore, if these provisions were excluded, the real adequacy ratios of Korean banks would have been substantially lower, not to mention if collateral was correctly valued (Shim 2000: 109).

[23] The relevant part of the "Memorandum" was as follows:

> "The FSC will issue an implementation plan by August 15 to bring Korea's prudential regulations closer to international best practice as expressed in the Basle Committee's Core Principles. Such a plan will cover ... Deduction from Tier 2 Capital of all provisions except those in respect of all assets classified as 'normal' and 'precautionary' ... All trust accounts

4.5.2 Large Exposures

Apart from capital adequacy requirements, other regulations directly addressing banking prudence were also less rigorous than required by international standards. A representative example is the large exposure limit. This restricts large exposure to single borrowers or groups within a specified limit; it was first introduced at the end of 1994. If financial institutions were exposed too much to single borrowers or groups, the soundness of the institutions would come to rely on the viability or performance of such borrowers; limits over large exposures is thus one of the crucial prudential regulations. When exposure to such borrowers exceeded 15% of the equity capital of certain financial institutions, the authorities regarded the whole exposure as 'large exposure', and the regulations required all such exposure not to exceed a certain aggregate limit. The aggregate limit was determined by the Monetary Management Board, which specified it to be 500% of the bank's equity capital.

There had been similar regulations before that, such as single exposure and the 'basket system.' However, because a single exposure limit applied only to single companies, the limit could not prevent financial institutions from becoming over-exposed to several companies owned by a *chaebol*. Although exposure to each company was

with guarantees will be regarded as on balance sheet for all supervisory and accounting purposes. For capital adequacy purposes, assets in such accounts will be weighted at 50 percent from January 1, 1999, and 100 percent from January 1, 2000. (Letter of Intent of the Government of Korea, July 24, 1998).

below the single exposure limit, the total exposure to several companies consisting of a *chaebol* could be excessive.

The regulation on large exposure was based on the ideas set out in the January 1991 Basel paper on 'measuring and controlling large exposure'. This policy took the form of strict limits in a number of countries, notably in the European Union (EU) through the "Large Exposures Directive" (Bank for International Settlements 1999: 26). The EU asked its member countries to reflect this directive in their legislation.

However, 'exposure' was narrowly defined in Korea (Office of Bank Supervision 1995: 23). Loans plus bank guarantees shown in balance sheets was the definition of exposure in Korea, whereas the definition of exposure in the EU was broader, including exposure to off-balance-sheet items, such as forward interest rate and currency contracts and swaps. A single group, according to the EU regulation, includes companies cooperating with each other, and subcontractor companies. Table 4.4 below compares the regulations on single and large exposure in Korea and some developed countries.

Moreover, certain forms of 'exposure' were not calculated as part of large exposure. Guarantees were not calculated as part of 'exposure,' when those guarantees had already been guaranteed by the government or other financial institutions, including not only other banks but also short-term finance or insurance companies. In addition, guarantees for opening Letters of Credit (L/C), offshore loans and borrowings from overseas branches of domestic banks were also excluded. This is also a clear case of strong influence by private interest over regulatory outcomes. These exceptions led to serious consequences during the crisis period.

Table 4.4 Regulations on Single and Large Exposure in some Developed Countries and Korea Compared

	Korea	Japan	USA	UK	Germany	France
Limit to individual borrower	15% (loans) 30% (guarantees)	30% (20% in loans)	15%	25%	50%	40%
Limit to individual group	-	40%	15%	25%	50%	40%
Limit on all large exposures	500%	-	-	800%	800%	800%
Criterion on large exposure	Exposure exceeding 15%	-	-	Exposure exceeding 10%	Exposure exceeding 10%	Exposure exceeding 15%

* Percentage is against financial institution's equity capital.
Source: Office of Bank Supervision 1995: 20

At the meetings prior to the crisis, the Basel Core Principles Liaison Group, which consisted of the regulatory authorities of 14 emerging market countries, the Korean representatives took the position that the 25% exposure limit to single or related counterparties would disturb the economy and thus the specific limit should be determined in the light of the particular situation in each country.[24]

[24] This is based on the information given by the FSS in response to the 'questions for Financial Supervisory Service (FSS)', posed by Dr. Andrew Walter in September 2000. In fact, the Core Principles did not specify the ratio of 'large exposure'.

In addition, the Monetary Management Board allowed a 5-year grace period to enable the banks to reduce excessively large exposures. This means that the large exposures limit was in fact never enforced before the crisis. In addition, if it proved difficult to reduce the exposure to within the limit due to the financial market situation, the Governor of the OBS was able to extend the grace period further. Furthermore, when banks exceeded the large exposure limit because they were required to comply with the industrial policy of the government (including M&A because of changes in exchange rates, or a reduction of paid-in capital in banks), they were able to request an exemption from the OBS Governor. The Governor could provide a 3-year grace period, while in other cases the grace period was 1 year (Office of Bank Supervision 1995: 28). In other words, the authorities had a lot of room for regulatory forbearance.

Furthermore, regulations on large exposures only applied to deposit money banks and foreign banks' branches in Korea. Development banks were not subject to the General Banking Act. In order to ensure the effectiveness of the regulation, however, this regulation was made to apply to development banks in a somewhat different form, by order of the Finance Minister. The large exposure limit applied to the Korea Development Bank (KDB) and The Export-Import Bank of Korea (Koex-im) were 1500% and 1000% of equity, respectively, in view of their development function (Office of Bank Supervision 1995: 27; Presidential Committee for Financial Reform 1997a: 142). These limits were two to three-times larger than that of the DMBs. Given that those development banks largely supplied credits to the big corporations, such as the affiliates of *chaebol*, those lax limits can be argued to reflect strong industry pressure.

4.5.3 Foreign Currency Exposure (1): foreign currency loans and short- term borrowing

Financial institutions intermediated foreign funds to domestic industrial firms. The major form of intermediation was by means of foreign currency loans. The loans were denominated in foreign currencies and had only been allowed for limited usage, such as facility investments before 1993 when the Kim Young-Sam government took office. The loans had a long-term maturity, say of three years or longer, though usually they were for over 5 years. Since direct borrowing of foreign funds by *chaebol* was limited, foreign currency loans from financial institutions in Korea were the major way for c*haebol* to raise funds for investment. From the Korean financial institutions' perspective, on the other hand, the loans to the industrial firms represented the financial institutions' assets.

There was substantial liberalization of the rules relating to borrowing and lending of foreign currencies during the Kim Young-Sam government period. In April 1993, just after the new President took office, the incumbent government relaxed the compulsory ratio of long-term foreign currency borrowings to foreign currency loans from 70% to 50%. Following the relaxation in January 1994 of other regulations on the eligibility for the use of foreign currency borrowings, the demand for foreign funds jumped and this was met by short-term borrowing by the banks.

In June 1992, the Engineering Committee for the Relaxation of Financial Regulation in the Korean government indicated that it was very difficult to maintain the compulsory ratio of 70% in a situation where the government controlled the amount of long-term financing. The Committee therefore suggested a relaxation of the ratio. Following that suggestion, another committee, the Committee for Economic Regulatory Relaxation of 1993 decided to reduce it to 50%. Moreover, considering that another confidential BoK document in September 1996 stated, "in order to stem the increase in foreign currency loans their ratio to long term funds should be adhered to", even the ratio of 50% appears not to have been strictly observed (International Department of the Bank of Korea 1996).

Teaching material for foreign exchange business staff, published by the Korea Exchange Bank (KEB), indicated that many foreign exchange business institutions financed their foreign currency requirements by borrowing with short-term redemption periods.[25]

> "A foreign currency loan usually has an over 5 years maturity. There are two sources for the loan: foreign currency funds deposited by the Bank of Korea, and those raised by the Korea Exchange Bank (KEB) itself. The loans for which the source was financed by the KEB itself are called

[25] Foreign Exchange Business Institutions mean financial institutions with a licence for foreign exchange business. In Korea, the business was strictly limited to the BoK and the Foreign Exchange Bank until the latter half of 1980s. After that, most deposit money banks were given foreign exchange business. The merchant banks originally got their licences when they were set up at their inception in the latter half of the 1970s, when the Korean government licensed merchant bank business for the first time in order to overcome a possible foreign currency crisis. Six merchant banks collaborating with foreign financial institutions were licensed between 1976 and 1979

general foreign currency loans, while the others are called special foreign currency loans. The source of general foreign currency loans should be long-term borrowing. However, if a loan were financed by funds whose redemption period was long-term, it would not have been profitable though it may have had stability. Thus, source of general foreign currency loans was short-term borrowing from international banks" (Training Department of Korea Exchange Bank 1995 #186: 18).

The Board of Audit and Inspection (BAI) indicated that the lowering of the ratio in 1993 contributed to the rapid increase in short-term borrowings by foreign exchange business institutions. Between 1993 and 1996, short-term borrowings were US$ 51.8 billion out of a total of US$ 79.6 billion of the aggregate foreign funds borrowed by domestic financial institutions during the period.

Both the short-term foreign borrowings required to fund foreign currency loans and the substantial liberalization of trade-related credits contributed to the increase in the country's short-term foreign currency exposure. The Finance Ministry relaxed trade credits for imports and encouraged DMBs to buy foreign exchange bills from exporting firms.

International banks, rather than domestic banks, mainly supplied trade credits for imports, though overseas branches of Korean financial institutions supplied substantial amounts of trade credits to domestic firms. In order to facilitate the buying of foreign exchange bills by financial institutions from exporting firms, the Finance Ministry asked the BoK to deposit its foreign currency assets with domestic banks. In addition to the

---

(Ministry of Finance and Economy 1998a: 494).

foreign currency deposits from the BoK, the domestic banks also borrowed short-term funds from international banks and increased the quantity of foreign exchange bills purchased from exporting firms.

Trade credits were liberalized throughout the 1990s. The International Department of the BoK argued in 1996 that "The vulnerability of a debt structure, where short-term liabilities represented 60% of total liabilities, resulted from the fact that banks were prohibited from procuring long-term foreign currency funds, while the rules on trade credits for deferred payments relaxed." It stated that "following the relaxation of the deferred period by a further 30 days at end-1995, an increase in trade credits with deferred payment was estimated to amount to US$ 5 billion during the first eight months of 1996" (International Department in the Bank of Korea 1996). A relaxation of the limits on trade credit was what the FKI had continuously demanded for the international competitiveness of Korean corporates (FKI 1992).

The relaxation of the regulations on trade credits therefore appears to have contributed to the deterioration in the balance of payments. From 1993, the eligible term-period for deferred payments was continuously getting longer, and thus the financial burden for imports was reduced from a firm's point of view. Since the interest rate for the credits was low, e.g. Libor + 0.5% (6% per annum) in 1996, importers could profit from the gap between the interest rates for international and domestic financing.

The scale of the trade credits was extraordinary.[26] In 1995, deferred payment inflows reached US$ 50.9 billion, which was almost 38% of total imports of US$ 135.1 billion.[27] Outflows were US$ 47.7 billion in 1995. Due to the increase in the eligible term-period at the end of 1995, during the first three quarters of 1996, the inflows increased by 25.5% and the ratio to aggregate imports jumped to 42.1%. The amount of the inflows was expected to reach almost US$ 63.8 billion in 1996 (International Department of the Bank of Korea 1996). The increase in the deferred payment inflows led to an increase in foreign exchange bills issued by trading firms since the major part of the imports, financed by deferred payment, were goods used for exports.

With regard to the relaxation of trade-related credits, Nam Sang-Woo has commented that the policy-makers were not concerned with the increase in the credits since they were transaction-based capital flows; there was no significant effect on monetary growth in the long run.[28] At the National Assembly, Lee Kyu-Sung, the Finance Minister in 1989 stated, "Increased short-term borrowings of financial institutions are due to foreign currency management funds which are required for regular

[26] This demonstrates the economy's heavy dependence on trade, and the poor financial structure of Korean business. Moreover, the reduction of trade financing from the end of 1980s contributed to the dependence of Korean business on these trade credits during the 1990s.

[27] The deferred payments scheme was introduced in January 1975. It had been strictly managed in order to serve foreign exchange and monetary policy objectives although the allowable term-period for the payment of goods had been flexibly coordinated according to the balance of payments position. However, during the 1990s, following foreign exchange and capital account liberalization, regulation governing the term-period had been continuously relaxed.

[28] Based on an interview with Dr. Nam Sang-Woo, senior research fellow at the Korea Development Institute. He was the senior advisor to Deputy Premier for Economic Affairs during the first half of the 1980s and was involved in making many important

international financing transactions. These short-term borrowings would not be a cause of monetary growth nor be used as funds like hot-money. In terms of external liabilities, the borrowings would accompany the same amount of increase in foreign currency assets." (Minutes of the Committee of Finance at the National Assembly, 6th meeting in the 146th Congress on May 23rd 1989)

In fact, Table 4.5 shows that US$ 27 billion (3 months' financing between January 1997 and March 1997) to US$ 55 billion (6 months' financing between January 1997 and June 1997) of funds of Korean banks were used for supporting current account transactions. The source of the funds was short-term borrowings from international banks.

---

policy decisions during the last two decades.

Table 4.5 Trend of Trade Related Financing, such as Foreign Exchange Bills, of Foreign Exchange Financial Institutions (Unit, US$ million)

Period	Amount	Period	Amount
January 1997	8,670	January 1998	7,120
February 1997	7,903	February 1998	8,811
March 1997	9,779	March 1998	10,274
April 1997	10,505	April 1998	9,967
May 1997	10,632	May 1998	8,730
June 1997	11,273	June 1998	9,585
July 1997	11,092		
August 1997	9,491		
September 1997	9,783		
October 1997	10,544		
November 1997	8,163		
December 1997	6,905		

Source: Bank of Korea, *Data for Members of the Committee on Political Affairs at the National Assembly*, the 198th Congress on October 1998.

4.5.4 Foreign Currency Exposure (2): offshore and overseas financing[29]

Another regulatory policy, which brought about the increase in the magnitude of external liabilities in the DMBs, was the regulatory forbearance given to offshore banking and overseas financing. In addition to the fact that this was what the private sector strongly demanded, the government believed that offshore banking and overseas branch operation did not affect domestic macroeconomic indicators, such as monetary growth and exchange rates. The BAI report on the crisis clearly indicated this as follows:

> "Offshore banking and financial institutions' overseas branch operation were not appropriately supervised by the authorities *since they did not affect domestic macroeconomic indicators, such as monetary growth, and exchange rates.* However, offshore/ overseas branch borrowing was

[29] Overseas financing refers to foreign currency financing by firms' overseas branches. The amount of funding had not been the subject of regulation since 1994. The

> part of the country's external liabilities, and thus pressure from international banks to demand repayment of the borrowing was applied as the country's external credibility decreased. (...) *For foreign creditors, overseas branch operations were no different from those of Korean banks operating in Korea since foreign currency assets of overseas branches were closely linked with overseas Korean companies.* As external credibility of Korean financial institutions was downgraded, *pressure for repayment by not only main offices but also overseas subsidiaries came from international investors at the same time*" (*emphasis added*) (Board of Audit and Inspection 1998).

As prescribed in the Foreign Exchange Management Act, offshore banking was where foreign exchange business institutions borrowed foreign currency funds from "non-residents" and managed them for "non-residents." It was divided into two categories in the statistics of external liabilities; offshore banking by the main offices and offshore banking by the overseas branches of Korean banks. In the analysis of external liabilities, the former was categorised as offshore banking debt, while the latter was overseas branch debt. Offshore borrowing had not been included as part of external liabilities according to the debt compilation of the World Bank and the Korean authorities also adopted this way of categorization until just before the late 1997 crisis.

Offshore banking by the main offices of the banks started in January 1988. It was accounted for separately; offshore banking was only shown in accounts for offshore operations and separated from the onshore accounts.[30] Businesses allowed to conduct

---

authorities however limited the scale of guarantees by the main offices in Korea.

[30] This is the same system as that adopted by the US, Japan and Singapore. There are two other types of offshore banking. One is an integrated system of onshore and offshore accounts. All financial transactions are freely conducted, without any limitation.

offshore banking were restricted. Offshore banking business was getting bigger due to some regulatory relaxation over tax and operations, though the scope of such business was limited to traditional commercial banking businesses such as deposits and loans, plus issuing and purchasing foreign currency securities. Moreover, offshore banking by the DMBs was not subject to this compulsory ratio regulation. This was to give Korean banks the same opportunity as foreign banks of managing assets, according to Lee Kyu-Sung, the Finance Minister in 1989 (Minutes of the Committee of Finance at the National Assembly, the 3rd meeting in the 147th Congress on October 19 1989).

Since 1988, the amount of offshore borrowing has increased. As of the end of 1995, offshore assets in the main offices of Korean financial institutions amounted to 16.1 % of the total foreign currency assets of Korean financial institutions in Korea (Table 4.6). The ratio of offshore assets among the total foreign currency assets rapidly increased (Chart 4.6).

Table 4.6 Offshore Banking Transactions in Main Offices (As of end-period)

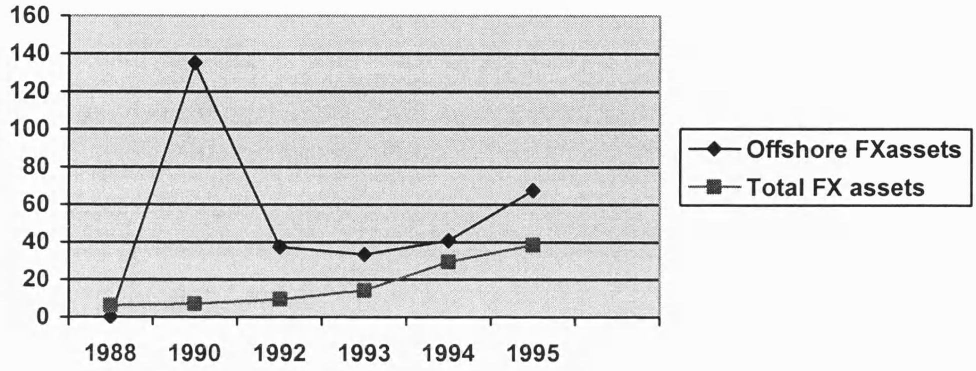
(US$ Billion)

	1988	1990	1992	1993	1994	1995	1996
Offshore foreign currency assets (A)	0.0 (-)	3.1 (135.1)	5.4 (37.4)	7.2 (33.4)	10.1 (40.9)	16.9 (67.6)	26.3 (55.6)
Total foreign currency assets (B)	27.9 <6.2>	39.0 <7.1>	51.1 <9.5>	58.4 <14.3>	75.6 <29.5>	104.8 <38.6>	n.a.
Component ratio (A/B, %)	-	7.9	10.5	12.2	13.3	16.1	n.a.

( ): Incremental ratio compared to that in the same period of the last year
< >: Constituent percentage.
Source: (Presidential Committee for Financial Reform 1997b: 171)

There are no restrictions on the type of financed transactions being conducted. This is the system adopted by the UK and Hong Kong. Another is a tax-haven system; transactions are initiated in some main international financial markets, but accounting is dealt with in tax-haven areas such as Bahama, Cayman Islands.

Chart 4.6 Change in Offshore Banking Transactions in Main Offices (Incremental Ratio of Offshore Foreign Exchange(FX) Assets and Total FX Assets Compared)(%)



Source: Presidential Committee for Financial Reform (1997b: 171)

As for overseas affiliates' local financing, the limit on the amount of such financing by corporates was repealed on February 24 1994. In testimony before the Special Investigation Committee on the Foreign Exchange Crisis in the National Assembly in January 1999, the Assistant Minister for Finance and Economy, Um Nak-Yong stated that the relaxation of the rules on offshore banking was not related to the country's entry into OECD, nor was there any pressure from the US. Liberalization of offshore financing for financial institutions and local financing for industrial firms was allowed because of the demand from within Korea.[31] Beneficiaries of such regulatory relaxation were overseas construction companies (in many cases, general trading companies having licences for construction and trading, such as Daewoo Corporation, Samsung Corporation), foreign direct investors (such as *chaebol*'s general trading

[31] Testimony of Um Nak-Yong before the Special Investigation Committee on the Foreign Exchange Crisis in the National Assembly, 11th meeting held in January 1999.

companies), and vessel transportation companies, most of them being affiliates of *chaebol*.

Table 4.7 Outstanding Balance of Overseas Local Funding by Non-Financial Companies (As of end-period)
(US$ Billion)

	Mar. 1995	Dec. 1995	Mar. 1996	Dec. 1996	Dec. 1997	Aug.1998
Outstanding balance	24.4	32.5	33.8	46.2	53.2	46.8
(By 30 biggest *chaebol*)	n.a.	28.1	n.a.	39.1	45.0	39.1
Trading	12.1	16.2	16.7	n.a.	n.a.	n.a.
Construction	3.4	3.7	3.9	n.a.	n.a.	n.a.
Overseas Investment	4.0	5.5	6.0	n.a.	n.a.	n.a.
Others	5.0	7.1	7.2	n.a.	n.a.	n.a.
Guarantees of Main Offices in Korea	16.9	24.0	24.7	n.a.	n.a.	n.a.

Source: Derived from Ministry of Finance and Economy (1998b: 272), Ministry of Finance and Economy (1996: 78).

As Table 4.7 shows, the amount of such financing was enormous. Borrowing of foreign funds was not only the province of the overseas branches of Korean banks and the offshore banking of Korean banks' main offices in Seoul but also of Korean overseas affiliates of foreign banks. Borrowings were made on a secured and unsecured basis.

When the Daewoo group filed for court protection, the group's foreign currency liabilities had reached US$ 9.9 billion as at the end of June 1999. Of this total, US$ 7.6 was financed through overseas local financing; 62% of this had a maturity of less than 6 months (Financial Supervisory Commission 1999) (Tables 4.8 and 4.9). As at the end of

1996, the amount of overseas local financing by the Daewoo group was said to be close to US$ 10 billion.[32]

Table 4.8 Maturity of Daewoo's Foreign Currency Debts (end of period, US$ billion)

		Aug. 1998	Dec. 1998	Mar.1999	Jun. 1999
Aggregate of foreign currency debts	Main office, Overseas branches	3.27	3.34	3.20	3.10
	Overseas registered affiliates	6.35	5.89	6.34	6.84
	Total	9.62	9.23	9.54	9.94
Overseas local financing	Overseas branches	0.97	1.87	0.86	0.80
	Overseas registered affiliates	6.35	5.89	6.34	6.84
	Total	7.32	7.76	7.20	7.64

Source: Financial Supervisory Commission (1999) *Dae-ugeulub-ui gujojojeong chujinsanghwangkkg* [Situation of Thrust in Restructuring Daewoo Group] August 11th 1999. p14.

Jin Young-Wook, then Director for International Finance in the Finance Ministry, stated in his testimony before the National Assembly:

> "There was no appropriate regulatory measure governing overseas operations between non-residents and non-residents. It was difficult to make new prudential regulation at that time when fervour of deregulation was so strong. In addition, it was difficult to distinguish prudential regulation from regulation restricting competition. Because people who examined the efficacy of regulations were not those with special expertise on finance, but entrepreneurs or officials in secretariats of the Premier's office, it was an uphill task to try and impose new regulations."[33]

---

[32] Interview with Lee Dong-Won in December 2001. Mr Lee was responsible for an organization called the 'British Finance Centre' of the Daewoo group, which managed secret accounts. Kim Woo-Joong, the chancellor of the group controlled Daewoo and initiated a so-called 'Global Management' of Daewoo by controlling the secret accounts on his own. The major source of capital flows into those accounts was overseas financing of overseas registered affiliates. See Kim (2000).

[33] Testimony of Jin Young-Wook before the Special Investigation Committee on

Table 4.9 Structure of the Maturity of Daewoo's Foreign Currency Debts

(end of period, US$ billion)

	By end-1999 (less than 6 months)	After 2000 (more than 6 months)	Total
Main office, Overseas branches	0.74	2.36	3.10
Overseas registered affiliates	4.74	2.10	6.84
Total	5.48	4.46	9.94

Source: Financial Supervisory Commission (1999) *Dae-ugeulub-ui gujojojeong chujinsanghwangkkg* [Situation of Thrust in Restructuring Daewoo Group] August 11th 1999. p14.

4.6 Use of International Reserves of the BoK as Implicit Guarantees for Korean Banks

Insofar as the liabilities of banks and other borrowers are denominated in foreign currency (as they are in many emerging markets), this has limited the ability to undertake the lender-of-last-resort operations necessary for those debtors to make good on their obligations.[34] In this regard, foreign exchange reserves should be regarded as a means of financing lender-of-last-resort operations in emerging economies. Prior to the crisis, however, the Finance Ministry used the BoK's foreign currency assets, which were previously part of the country's international reserves to support the private sector.

---

the Foreign Currency Crisis in the National Assembly, 17th meeting of the 200th Congress on 3rd February 1999.

[34] IMF Transcript: Capital Account Liberalization: What's the Best Stance? October 2, 1998.

Foreign currency reserves are "the stock of official assets denominated in foreign currencies, held primarily to make foreign payments without the need to sell domestic currency in the market – for example, to enable the authorities to intervene in foreign exchange markets, either to counter disorderly conditions or to support their currency in a more systematic way while other policies are taking effect" (Newman, Milgate, and Eatwell 1992b: 161).

Foreign currency reserves management policy prior to the crisis, however, explicitly fostered moral hazard in deposit money banks. On the surface, as it is in other countries, the responsibility for management of the reserves appeared to lie with the cental bank, in this case, the BoK. The BoK managed its foreign currency assets in two ways; one was just in the ordinary way that most central banks managed their international reserves. But another was quite unique, i.e. some of the foreign currency assets of the BoK were deposited with domestic commercial and development banks. This started from the end of the 1980s. The deposits were used by the banks as a major source of their funding for foreign currency loans to businesses. There were two types of foreign currency deposits made by the BoK with Korean banks. Type A deposits were calculated as part of official reserves but Type B deposits were not so included. Type A deposits were with the overseas branches of domestic banks, while Type B deposits were with domestic branches of domestic banks. Until the end of October 1997, the amount of Type A deposits was around $ 8 billion, while Type B deposits were over $ 30 billion.

What should be noted is not only the way the BoK's foreign currency assets were used but also the total amount of the deposits, which was almost the same as the amount of the official foreign exchange reserves of Korea as at the end of 1996, i.e., over US$ 30 billion. If these foreign currency assets of the BoK had not been deposited with domestic banks, the amount of usable official international reserves in Korea would have been over US$ 60 billion as at the end of 1996.

As for the use of such foreign currency assets, there had been a dispute between the Finance Ministry and the BoK but the view of the Ministry, with its orientation of growth, prevailed. The deposit of foreign currency assets of the BoK with domestic banks can be regarded as evidence that the authorities were in effect guaranteeing the viability of the foreign exchange business of the domestic banks. Normally, crisis management measures, such as the provision of funds as a LLR should be conducted in such a way as to restrain moral hazard. In reality quite the contrary occurred in Korea.

The BoK explained that the deposit of public foreign currency assets with domestic banks was introduced to promote the internationalisation of financial institutions, to expedite facility investment by industrial firms and to discourage an increase in foreign debt (Bank of Korea, 1999). The assets were shown as an internal account in the BoK's balance sheet and accordingly were not included as part of the official foreign currency reserves of the BoK. It is unlikely that foreign investors were informed of this, but this prompted the Korean banks to take more risks in their foreign currency asset management than would otherwise have been the case. In addition, this use of Korea's foreign currency assets made foreign investors confused as to the exact amount of Korea's available foreign currency reserves and thus contributed to the run by foreign investors.

This use of public foreign currency assets of the BoK is thus one of most striking aspects in explaining the crisis, but the literature on the crisis pays hardly any attention to it. The use of the assets also reveals how far the Finance Ministry dominated the other regulatory authorities. Only a few works (e.g. Adams 1998; Balino 1999), written by some IMF researchers who were involved in the IMF's dealings with the Korean crisis, mention this, but even they do not notice its significance. Moreover, even in those works, this issue is examined only as an information flow problem, not in relation to other crucial issues, such as the government giving implicit guarantees in the context of the developmental state.

In most countries, the public foreign currency assets of central banks are the official foreign exchange reserves. These assets enable the authorities to intervene in foreign exchange markets, either to counter disorderly conditions or to support their currency in a crisis situation. From the perspective of prudential regulation/ supervision, the assets should be available to support the LLR function of the central bank. In Korea, however, almost half of the public foreign currency assets of the BoK were deposited with domestic banks and thus could not be used in the crisis period since the banks could not repay the foreign currency deposited with them by the BoK.

This is a unique case, which has not occurred in other countries. In terms of achieving the highest possible return, managers of the foreign currency reserves of some countries such as Japan have deposited the reserves with domestic banks, but there has not been any reported case other than that of Korea where the reserves were no longer liquid and accordingly could not be used in a crisis period.[35]

The IMF's Description of the Use of Public Foreign Currency Assets

A member of IMF staff briefly describes such a characteristic use of foreign currency assets under the title 'the liquidity of measured reserves and usable reserves' in an IMF survey on international capital markets (Adams 1998: 20). As regards Type A deposits, the relevant section of the IMF article describes them in detail as follows:

> "As the crisis in Korea unfolded, official reserves of the Bank of Korea fell from a reported $31 billion at end-October 1997 to $ 24 billion by early December. "Usable" reserves, however, were reported to be some $6 billion. This discrepancy between measured and usable reserves arose as a result of *foreign currency deposits placed by the Bank of Korea with foreign branches of domestic banks* that became illiquid. That is in light of the liquidity pressures faced by these institutions, these deposits could not be withdrawn. The practice of the Bank of Korea placing deposits with foreign branches of domestic banks was begun in the late 1980s with the purpose of encouraging globalization of domestic banks, and their offshore branches used these deposits to fund loans primarily to Korean entities, both off- and onshore. The practice remained relatively small, with some 10 percent of official reserves placed in such deposits, and by end-1996 amounted to $ 3.5 billion. However, in January 1997, as the overseas blanches of Korean banks suffered liquidity problems in the wake of the Hanbo affair, the Bank of Korea extended liquidity

[35] Interviews with some staff members in the department in charge of the management of the international reserves in Bank of Korea., August 2000.

support to them, and by the end of March the amount of such deposits had grown to $ 8 billion. Finally as pressures grew in November, by early December such deposits had risen to above $ 10 billion." (Adams 1998: 20)

The description of Type B deposits in the IMF article, however, is somewhat insufficient, as follows:

"In addition to measured official reserves of $ 30 billion prior to the crisis, the Bank of Korea had deposits of $ *30 billion with banks onshore*. As the BoK sought to draw on these deposits, it discovered that these deposits too could not be accessed as they had either been on lent to Korean corporate or invested in – primarily emerging market – assets that the commercial banks were either unable or unwilling to liquidate in prevailing market conditions."*(emphasis added)* (Adams 1998: 20)

Detail of Type B Deposits

Some confidential BoK documents, submitted to the National Assembly in the wake of the crisis, detail the use of Type B deposits. According to those documents, Type B deposits were made for particular objectives, mainly to support exports and investment by corporations. Of the US$ 33.8 billion Type B deposits at the end of July 1996, US$12 billion went to deposit money banks to enable them to buy foreign exchange bills from exporting firms. US$ 8.9 billion went to deposit money banks as well as development banks to enable them to make loans to finance imports by corporations. US$ 8.2 billion went to development banks to enable repayment of their foreign debts. In addition to these three major uses of Type B deposits, another US$ 4.7 billion was used for various purposes: early repayment of foreign debts by deposit money banks (US $ 3.2 billion), overseas portfolio investments for mainly development banks (US$ 1.0 billion), factory automation of SMEs' (US$ 0.2 billion) and for financing merchant banks through deposit money banks (US$ 0.3 billion) (International Department of the Bank of Korea 1996b).

In most cases, the authorities specified not only the use of the deposits, but also the interest rates if the deposits funded foreign currency loans to industrial firms. The BoK, in accordance with the policy of the Finance Ministry, deposited its foreign currency assets at lower interest rates than Libor. Financial institutions did not bid for deposits from the BoK by offering higher interest rates. Moreover, rollover of the deposits was the norm, rather than the exception, until the beginning of 1997, although the deposits were basically made on a short-term basis, e.g. for 6 months. Interest rates on the deposits that the banks had to pay to the BoK were around Libor or less.

In return, the authorities required the banks to charge interest at rates within Libor plus 0.5 % - 1.0 % on foreign currency loans (Type B deposits). If the lending had been funded from the banks own resources, they would charge the borrower Libor plus 0.5 – 1.5% (Bank of Korea 1995a). As regards Type B deposits, banks did not take serious responsibility for the viability of borrowers although the banks would eventually be responsible for the credit risks related to the loans. Furthermore, the reliance by Korean banks on the availability of the BoK assets at low interest rates for repaying their external debts on which high interest rates were payable, may have inevitably led to moral hazard in the banks' foreign exchange operations.

From the perspective of the Finance Ministry, the making of Type B deposits was a good source of power and leverage over the banks to ensure that they fulfilled the authority's policy. Thus, at least up to the mid-1990s, Type B deposits appeared to be a kind of win-win game for all parties in Korea, i.e., the government, banks and corporations. But after mid-1996, when the Korean balance of payments moved into the red, the authorities felt the need to increase the level of the country's official reserves. Table 4.10 shows that the amount of Type B deposits was exceeding US$ 33 billion at the end of 1995. Table 4.11 implies that the rapid increase in foreign currency loans by the DMBs to corporates was ignited by such BoK deposits.

Table 4.10 BoK's Foreign Currency Deposits with Domestic Banks

(US$ Billion)

Classification	92.12	93.12	94.12	95.12	96.12	97.12
Public foreign currency assets	36.8	45.8	55.7	66.2	65.4	60.3
Type B deposits *1)	19.6	25.5	30.0	33.5	32.2	39.9
Official FX reserves	17.2	20.3	25.7	32.7	33.2	20.4
Type A deposits *2)	2.8	2.3	3.3	3.3	3.8	11.5
Usable reserves *3)	15.4	18.0	22.4	29.4	29.4	8.9

*1) Type B deposits: BoK's foreign currency assets deposited with domestic banks onshore. This was not calculated as a part of international reserves of the BoK.

*2) Type A deposits: BoK's foreign currency assets deposited with domestic banks' overseas branches or subsidiaries

*3) Usable reserves: Official FX reserves minus deposits in overseas branches of domestic banks (Type A deposits).

Source: Derived from Board of Audit and Inspection (1998)

Table 4.11 Outstanding Balance of Foreign Currency Loans (as at end-period)

(US$ Billion)

	1990	1991	1992	1993	1994	1995	1996
Outstanding Balance	16.3	19.8	19.5	19.4	23.3	29.1	33.5
Based on the BoK's foreign currency assets	9.6	11.2	10.2	9.8	12.9	12.8	11.6

Source: Presidential Committee for Financial Reform 1997a): 171.

Conflict between the MoFE and the BoK on the Use of Public Foreign Currency Assets

The BoK managed public foreign currency assets, which were mainly obtained by intervention in the country's foreign exchange market. However, in accordance with Clause No. 2-66 in the Foreign Exchange Management Ordinance (regulation on foreign currency funding and the use of the proceeds), the Finance Ministry exercised its supervisory authority over this area. The ordinance reads, "The finance minister can regulate funding, investment of the proceeds, amount, qualifications to be required for the funding of foreign exchange banks, and others, if needed." As the BoK was regarded as one of the foreign exchange banks and subject to the above regulation, according to an additional clause of the Foreign Exchange Management Act, the BoK therefore managed its public foreign currency assets in accordance with the policy of the Finance Ministry.

On the basis of the above regulation, at the beginning of each year the Finance Ministry established a yearly plan for the use of the public foreign currency assets of the BoK and decided "how much" and "for what purpose" the assets should be deposited with domestic banks. The Finance Ministry also decided the ways in which the BoK should manage the assets, the amount for each particular use and the interest rates, and the BoK had to comply.

It was argued that Type B deposits were used for maintaining macroeconomic stability. Dr Oum, then senior counsellor to the Finance Minister in 1994, mentioned that "(in order to limit capital inflows) we urge domestic companies, instead of bringing in additional capital from abroad, to utilize foreign currency loans provided out of the foreign assets of domestic banks and, *even out of the foreign reserves held by the Bank of*

Korea."(Emphasis added) (Dornbusch *et al.* 1995: 479) However, such deposits reflected business interest and resulted in macroeconomic instability nonetheless.

Source of Public Foreign Currency Assets

Public foreign currency assets came from the BoK's intervention in the foreign exchange market. When the supply of foreign currencies exceeded demand, the central bank would buy foreign currencies in the foreign exchange markets, if it wished to restrain appreciation in the value of its own currency. The consequence was monetary growth in the Korean economy. The BoK could then issue monetary stability bonds in the capital market to stem such monetary growth but the ability to issue the bonds would be limited because of the burden of interest on such bonds. Since Korea had recorded surpluses in its balance of payments from the latter half of the 1980s to mid-1996, there had been strong pressure either for monetary growth (when the BoK would intervene) or for the won to appreciate.

The surpluses in the balance of payments derived from trade account surpluses between 1986 and 1989 and capital account surpluses exceeded trade account deficits during the 1990s. After the Korean stock market opened to foreign investors in a limited way after 1992, the amount of foreign capital inflows caused monetary concern to the Korean government. The response of the government was the use of the international reserves of the BoK which it deposited with domestic banks. These deposits were used to fund foreign currency loans by Korean banks to businesses in such a way as not to cause any monetary growth, e.g. for payment for imports of foreign capital goods. As a consequence, the authorities believed that such use of foreign currency assets could restrain increases in external liabilities and monetary growth. However, this was only viable while Korea's balance of payments remained in surplus.

As at the end of 1996, the level of public foreign currency assets was over US$ 65 billion and half of those assets had been deposited with the main offices of Korean banks. If the assets had been kept by the BoK, thus enabling the BoK to maintain its international reserves at the level of US$ 65 billion as at the end of 1996, the situation at the end of 1997 might have been different. The confidence of foreign creditors might not have been adversely affected during the period and the roll-over ratio for short-term borrowing might have been much higher than it was. Among groups of financial institutions, domestic DMBs were the main beneficiary of the BoK's deposits in foreign currency. Non-bank financial institutions received almost none of the assets being distributed. In spite of the magnitude of the foreign currency assets and the distribution of such assets not being replicated in other countries, the BoK's policy of making deposits in domestic banks has not been fully investigated until now.

*Table 4.12 Foreign Portfolio Equity Investment; inward/outward flows and transactions**

	1992	93	94	95	96	97.1-10
Balance of net inflows[1]	2.1 <0.7>	7.8 <2.3>	9.7 <2.5>	12.0 <2.6>	16.5 <3.4>	17.2 <n.a>
Ratio of total equity ownership limits for foreigners (Ceiling, %)	10	10	12	15	20	23

* End of Period

1) US$ billion, < > is outstanding balance/ GDP

2) Ceiling refers to the ratio of total equities in each company, within which foreign investors could buy; End of period

Source: Oh, H-I 1997.

Between 1992 and 1996, US$ 48.1 billion worth of foreign portfolio investment flowed into the Korean stock market (Table 4.12). During the same time, the amount of increase in foreign currency assets of the BoK was US$ 28.64 billion: the increase in international reserves was US$ 14.0 billion and the increase in Type B deposits was US$ 14.6 billion.

Explanation of the Deposit of Public Foreign Currency Assets with Domestic Banks

The reason why public foreign currency assets were deposited with domestic banks resulted from the regulatory institutional structure: the subordination of the BoK to the Finance Ministry and the growing influence of the private sector. After 1995, the BoK argued that public foreign currency assets, obtained from the foreign exchange markets, should be added to the official international reserves. However, in accordance with the Finance Ministry's policy, more of the assets were used to fund Type B deposits. When the capital flows started to reverse, increases in Type B deposits stopped. Although the BoK wanted to withdraw some of the Type B deposits in order to increase the level of official reserves, this was difficult since the banks in which the deposits had been made would have had great difficulty in obtaining funding elsewhere.

Banks, such as development banks and some of the DMBs, which were in a relatively better position, were asked to repay some Type B deposits to the BoK from the latter half of 1996. Between January and October1997, a net value of US$ 2.5 billion was repaid. US$ 7.77 billion was calculated to have been returned to the BoK, mainly by development banks. This led to mixed policy effects for foreign investors. During the first half of 1997, official international reserves increased, thus making foreign investors more comfortable. They fell in the second half of 1997 along with Type A deposits, confusing foreigners and increasing their worries about the exact level of official reserves.

In sum, the Type B deposits and some Type A deposits meant that the Finance Ministry de facto gave explicit guarantees to Korean banks on their foreign exchange business, encouraging the moral hazard of those banks. The significance of the deposits, in particular the Type B deposits, was not fully disclosed to foreign investors. However, this certainly caused uncertainty as to the level of official reserves and therefore contributed to the panic of foreign investors. Because financial institutions have close links to each other, the financial distress of some can spread contagiously to others and potentially endanger the entire system. If banks' creditors are less than fully informed about the quality of their loans, a run on one bank may be taken as a signal of potential problems elsewhere in the system.

Table 4.13 Change in the Amount of Type B Deposits in the Wake of the Crisis

(US$ Billion)

	1997	1998	1999	July 2000	Sep. 2002
Outstanding Balance	39.88	24.38	17.47	11.32	0.8
Change (repayment)	Δ7.7*	15.5	6.91	6.15	10.5

* Δ means that the deposits had increased over the previous year.
Source: Bank of Korea, *Data requested by the Committee for Finance and Economy in the National Assembly*, Korea. October 2000.

In the wake of the crisis, Korea is said to have recovered quickly from the crisis. The rapid increase in the level of its international reserves has been a major sign of recovery (e.g. Rodrik 2000). However, the rapid increase in international reserves, such as from US$ 8.9 billion as at the end of 1997 to US$ 116.7 as at 15 October 2002, largely originated from the repayment of the Type A and B deposits to the BoK. At the end of 1997, Type B deposits were US$ 39.88 billion (See Table 4.13). Deposits with Korean banks were US$ 53 billion in total.[36] The remaining deposits at the end of September 2002 were less than US$ 1 billion (BoK 2002b: 22). This means that US $ 52 billion deposits were repaid to the BoK during the five years following the crisis. Moreover, unlike an ordinary increase in reserves, the increase absorbed monetary growth, rather than increasing it.[37] As the literature on the crisis missed the significance of the Type B deposits in explaining the crisis, the literature on the recovery from the crisis has not fully understood this significant aspect of the deposits.

4.7 Conclusion

This chapter has investigated the lax prudential regulatory policy prior to the crisis from the perspective of the strong influence of the private sector. The question of how various areas of prudential supervision including key prudential measures, i.e. capital adequacy reqirements and rules on large exposures and foreign currency exposures, were distorted in favour of special interests was examined.

This chapter has revealed a unique relationship between the Finance Ministry-BoK-financial sector regarding the use of the foreign currency assets of the BoK, which has not arisen in other countries. Such a relationship was certainly a reflection of the

---

[36] Interview with Cho Moon-Ki, Deputy general director for International Department, the BoK, 12 November 2002.

[37] Interview with Chung Tae-Yon, Deputy Director for Monetary Policy, the BoK,

country's close government-burearcracy-industry (*chaebol*) relations. In the name of the efficient use of international reserves and preventing further increases in external liabilities, the Finance Ministry asked the BoK to deposit its foreign currency assets with domestic banks. The policy-makers argued that the banks would be able to use such foreign currency assets in order to lend foreign currency-denominated loans to industrial firms without further borrowing in international capital markets. In addition to causing monetary growth, it encouraged risky behaviour by banks in particular with regard to their foreign exchange business. Accordingly, this characteristic use of the central bank's foreign currency assets gave birth to various problems - encouraging moral hazard of domestic financial institutions, monetary growth, confusion by foreign investors about the level of international reserves of the BoK, and the loss of usable international reserves for the Korean authorities.

Such a moral hazard problem, resulting from these solid government-bureaucracy-industry relations, led to a financial crisis for proper prudential measures were not initiated. This chapter has shown that regulatory forbearance was pervasive because the political influence of the private sector was strong.

---

on 13 November 2002.

Chapter 5 Regulatory Policy and Deposit Money Banks

5.1 Introduction

Explaining the regulatory policy applied to deposit money banks ("DMBs") is particularly interesting because DMBs were the only financial sector which was supervised by the Monetary Management Board of the Bank of Korea ("BoK") with strict stabilization objectives. To what extent did such objectives endure? If such objectives were distorted in the introduction and enforcement of the regulatory process, how was such distortion related to the then growing private influence and the regulatory centralization?

Although they were still lax by international standards, relatively strict prudential regulatory measures such as BIS (Bank of International Settlement) capital adequacy requirements were imposed on DMBs; while did not apply to other financial sectors, i.e. development and merchant banks.[1] In addition, another key prudential measure, the limits to large exposures of 500 % of each bank's equity capital, was introduced in 1995. But the limits imposed upon development banks were much lax, being 1500% (for the Korean Development Bank) and 1000 % (for the Export-Import Bank of Korea). There were no

[1] In accordance with the 1991 revision of the General Banking Act, the Office of Bank Supervision ("OBS") introduced in July 1992 the BIS capital adequacy requirements as one of their "management guidance" standards. Such requirements were not imposed on development banks or on merchant banks. However, this was a regulation, its status among regulations was the lowest, being subordinated to Act and Ordinance.

such limits applied to merchant banks though there was a single exposure limit regulation which was 25% of each merchant bank's equity capital.[2]

On the surface, therefore, one might think that the application of such relatively strict regulations to DMBs by the BoK seems inconsistent with the argument in this thesis for regulatory failure in Korea, i.e. regulatory capture by private interest and regulatory centralization. If so, was the regulatory outcomes to deposit money banking sector consistent with the strong state argument that the government policy was autonomous of private interest? This chapter argues, however, that the regulatory policy applied to the DMBs is consistent with the argument of this thesis, i.e. regulatory capture by private interests being facilitated by the regulatory centralization or, to put it another way, the subordination of the BoK and the OBS to the Finance Ministry.

The chapter consists of six sections. Section 5.2 describes the change in government-DMBs-industry relations with regard to ownership and governance of the DMBs and the control of credits by the DMBs to *chaebol*. Section 5.3 focuses on the fact that the regulatory policy imposed on the DMBs was complicated due to the growing influence of the private sector. Although the BoK, with substantial supervisory authority, had adopted monetary targetting in its operation of monetary and credit policy and had conducted a relatively strict regulatory policy, the authority of the BoK was limited to the

[2] As mentioned in Chapter 4, if financial institutions were exposed too much to single borrowers or groups (whose individual borrowings were below the single exposure limit), the soundness of the institutions would come to rely on the viability or performance of such borrowers; in this regard, the large exposure limit, which restricts the aggregate exposure to a group of single borrowers, is distinguished from single

banking accounts of the DMBs only.[3] As the Finance Ministry allowed the DMBs to do trust account business which was subject to relatively lax regulation by the Finance Ministry, the size of the trust accounts business of the DMBs increased to almost the same level as that of bank accounts. The trust accounts of the DMBs were a major source of corporate finance because the banks managed the assets in the account largely by buying securities, such as commercial paper (CP) and equities in listed companies.

Section 5.4 examines the external and internal explanatory factors which increased the vulnerability of the DMBs against systemic risks. As regards external factors, the depressed stock market in Tokyo deteriorated the ratio of capital adequacy requirements of Japanese banks which had to accumulate provisions for the unrealized capital losses due to a drop in the price of the securities they held. Thus, Japanese banks have reduced their exposure to Asian banks, including Korean DMBs in particular, every quarter since the end of March 1997, thus decreasing the roll-over ratios of short-term liabilities in the Korean DMBs. Also, overseas regulatory authorities in Hong Kong and Tokyo consolidated their regulatory supervision of liquidity in the overseas branches of Korean financial institutions. Accordingly, the main offices of the Korean DMBs had to supply long-term foreign currency assets to their overseas branches. As regards internal factors, regulatory liberalization such as a relaxation in entry barriers to non-bank financial institutions as well as the DMBs in the 1980s and 1990s led to over-competition

---

exposure limits and is a key prudential measure.

[3] M2 as the monetary aggregate had been the core monetary index for that targetting; customers' savings and time and demand deposits with DMBs were the major components of M2.

among financial institutions, thus decreasing the value of the licence to conduct banking business.

Section 5.5 investigates the BoK's foreign currency assets which were deposited with the DMBs. In particular, the questions of "how did the deposits foster the moral hazard problem of the banks?" and "how was the lender of the last resort function of the central bank distorted from its original *raison d'etre?*", are raised and addressed. Section 5.6 describes two rounds of banking crises which occurred in Korea in 1997 before the foreign exchange crisis at the end of that year and the crisis management policy of the government. During the crisis periods, conflicts among the regulatory authorities, in particular between top officials in the Finance Ministry and the BoK, suggested that the state was far from strong. Section 5.7 concludes this chapter.

5.2 Change in Government-Bank-Chaebol Relations and Regulatory Relaxation

When the DMBs were privatised in the 1950s, the banks were controlled by a few *chaebol*. After 1960, the voting rights of the shares of the banks were forced to be handed over to the government "in order to nationalize corruptively accumulated wealth" (the Provisional Act on Financial Institutions of 1961). The influence of the government over financial institutions was therefore substantially strengthened; as a consequence of the transfer of voting rights along with other measures, including the revision of the Bank of

Korea Act, the financial system in Korea changed into a growth-oriented one to support the government's plan for economic growth. The DMBs came to focus on their public functions rather than on their own profitability.

As for the role of the banks in Korea, Joseph Stiglitz puts it as follows:

> A number of East Asian governments played a large role both in helping create financial institutions and in maintaining their capacity to lend. Historically, financial institutions in most countries have lent largely for trade credit and collateralised real estate. Development lending (long-term investment lending) by banks in limited. But in countries such as Korea, the government helped create a number of banks and encouraged them (through a variety of mechanisms) to go beyond these traditional lending avenues (Stiglitz 2001:514).

What is interesting is that the development lending practice came to be adopted not only by development and specialist banks but also by the DMBs. The Monetary Management Board in the BoK and the OBS tightly controlled the DMBs and in return the viability of the banks was guaranteed in various ways, such as the BoK frequently supplying special loans to the DMBs. Throughout the 1980s and 1990s, when the DMBs had formally been privatised, the DMBs were still a means of enabling the government to further its economic policy to help corporate financing.

Regulations on Ownership and Governance of DMBs

The regulations for ownership and governance of the DMBs did not allow them to be privately controlled. In other words, no dominant shareholder was allowed to control the operations of a DMB, whereas the Korean government had various methods of exerting a strong influence on the DMBs, for example, by proposing the appointment of presidents and directors of the DMBs in accordance with the special provisional act of 1961, which was in effect until 1982.

The regulatory authorities imposed the limit of ownership of the DMBs. The maximum percentage of a DMB's equity owned by a non-government shareholder was restricted by the General Banking Act. The rationale for this limit was to prevent industrial capitalists (*chaebol*) from manipulating DMBs for private gain (Bank of Korea 1999: 73). Until 1982, the maximum equities that any single person could have were 10%. Moreover, in accordance with the Special Provisional Act, introduced in 1961, private shareholders had no voting rights. When the DMBs started to be privatised in 1982, the limit was reduced to 8%; the 8% limit for ownership remained for the following 10 years. In May 1992, regulation over ownership was further tightened by extending the definition of any "single person" who could own the stocks of a DMB.

In order to prevent any single person from controlling a substantial number of shares, the definition of a "single person" who was able to own 8% of the equities was tightened. Before 1992, a person and spouse, relatives by blood within "the eighth degree" and those by marriage within "the fourth degree," were defined as a single person. But thereafter, a company owned by a *chaebol* and officers of that company were also defined as a single person. In December 1994, the limit was lowered further from

8% to 4%.[4] However, institutional investors such as investment trust companies were allowed to own within 8%. As at the end of 1999, the maximum percentage of the equity of a DMB that any single stockholder or person could own or actually control still remained at 4%.[5]

In May 1993, the Office of Bank Supervision (OBS) introduced a new scheme "the Committee for the Recommendation of Bank's Presidential Candidates." Details of this scheme were embodied in a revised version of the General Banking Act at the end of 1994. The Committee consisted of nine members, of which three were former bank presidents, the Directors' Committee choosing the other six members. However, this Committee did not have a checks-and-balances function which could have enabled it to evaluate and check on the president's management performance. The Committee therefore came to be responsible only for recommending presidential candidates. Accordingly, governance of the DMBs lay with the presidents of the banks rather than with the Directors' Committee. Due to the fact that the presidents of the banks were habitually chosen by the authorities, western commentators have often indicated that the governance system was the main reason why Korean banks could not establish their own responsible management system; important decisions, such as large loans, were entirely

---

[4] In the 1994 revision, the Korean government introduced a financial specialist corporation scheme which allowed such corporations to own 12% of a bank's equity. However, no financial specialist corporation qualified under the scheme. In the wake of the crisis, the scheme was repealed.

[5] There were exceptions for local, foreign-invested banks, and for two newly-established small nationwide DMBs. The limit for local banks was 15%, while a foreign-invested bank, KorAm Bank, was able to allow for nationals to own as much as was allowed for foreigners. In this case, it was 18.56 %. Lastly, two small nationwide DMBs, Hana and Boram, were transformed from merchant banks and had single shareholder

determined by the presidents of the banks. This governance system, they argued, ultimately led to huge bad debts.

Since January 1997, following the revision of the General Banking Act, the Directors' Committee has been empowered to recommend presidential candidates and the auditor. Non-executive directors numbered more than half the aggregate number of directors. However, even after this the Directors' Committee remained dominated by the incumbent president; the functions of decision-making and day-to-day operations were not separated.

To What Extent Did Chabol Own Shares of the DMBs

Regardless of the regulation on ownership, which was 4% for a single person, the *chaebol* owned a substantial amount of the DMB equities. For example, the Samsung group was a shareholder of all the big DMBs (except for Kookmin Bank, of which the major shareholder was the Korean government), from 2.81% (Choheng Bank) through 7.03% (Commercial Bank) to 18.56% (Koram Bank, a foreign invested bank). Table 5.1 shows that the Stock Market Stabilization Fund, non-bank financial institutions (in particular: Investment Trust and Insurance companies), and the *chaebol* were the major shareholders of the DMBs as at the end of 1996. The Stock Market Stabilization Fund was established in May 1990 when the stock market was seriously depressed. In order to maintain the market's stability, securities companies, banks, insurance companies and listed firms invested in the Fund.

---

equity limits of 8%. These two new nationwide DMBs merged into Hana Bank in 1999.

*Table 5.1 Large Shareholders' Lists of 10 Biggest DMBs**

Bank	Shareholders (Ratio of shares)
Choheng	Citibank N.A (11.69)** Stock Market Stabilization Fund (6.55) Tae-Kwang Group (5.47), Daehan Life Insurance (4.48), Korea Investment Trust (4.18), Daehan Investment Trust (3.84), Samsung (2.81), Kyobo Life Insurance (2.43), Ssangyong (1.98), QE Int'l Ltd. (1.19)***, Kookmin Investment Trust Company (1.11)
Commercial	Stock Market Stabilization Fund (7.25), Samsung (7.03), Korea Investment Trust (5.01), Kyobo Life Insurance (4.06), QE Int'l Ltd. (4.00), Daehan Investment Trust (3.07), Kookmin Investment Trust (1.36), Bangrim (1.26), Lee Sang-Soon (1.03), Daehan Life Insurance (1.03)
Korea First	Stock Market Stabilization Fund (7.00), Daehan Life Insurance (5.48), Samsung Life Insurance (3.96), LG Fire Insurance (3.03), Korea Investment Trust (2.95), Kyobo Life Insurance (2.50), Daehan Investment Trust (2.33), Hyundai Marine & Fire Insurance (2.20), QE Int'l Ltd (1.72), CMB-Euro (1.23), CMB-CAP (1.13), SG Warburg (1.07), Kia Auto (1.04)
Hanil	Stock Market Stabilization Fund (6.96), Korea Investment Fund (4.86), Samsung (4.76), Daehan Investment Fund (4.18), Kyobo Life Insurance (2.50), Daelim Corp. (3.57), Yoon Byung-Kang (3.03), CMB-CAP (3.00), CMB-EURO (2.51), LG group (2.47), Hyundai Group (2.00), FTCI (1.98), Kookmin Investment Trust (1.26), Korea First Bank (1.14)
Seoul	Stock Market Stabilization Fund (7.47), Daehan Life Insurance (4.57), Samsung Life Insurance (3.77), Kyobo Life Insurance (2.44), BEAR STERNS Co. (2.09), Asan Trust (1.99), Korea Investment Trust (1.92), Donga Construction Co. (1.50), Lee Sang-Soon (1.46), DongKuk Steel (1.27), First Life Insurance (1.07), Korea Investment Trust (1.01)
Korea Exchange	Bank of Korea (47.88), Korea Investment Trust (2.02), QE Int'l Ltd. (1.94), Daehan Investment Trust (1.51), Gartmore (1.27), Kim Tae-Jin (1.21), Kookmin Investment Trust (1.09), Samsung Life Insurance (1.05), Ssangyong Investment Securities (1.04)
Kookmin	Government (17.08), Bank of New York (13.86)**, Korea Investment Trust (6.24), Daehan Investment Trust (3.80), Kookmin Investment Trust (2.41), Ssangyong (1.96), Kyobo Life Insurance (1.09), Hannam Investment Trust (1.04), Shinhan Bank (1.00)
Shinhan	Daehan Investment Trust (3.92), Korea Investment Trust (3.58), Samsung (3.36), Stock Market Trust Fund (3.29), Kookmin Investment Trust (1.13), Shinhanil Electrics (1.09)
KorAm	Bank of America (18.56), Daewoo Corp. (18.56), Samsung (18.56), Stock Market Stabilization Fund (4.74), Daehan Electrics (4.00), HanGlass (1.72), Dongil Corp. (1.72), QE Int'l Ltd. (1.48), Dongsuh Food Co. (1.05)
Hanna	Kyobo Life Insurance (6.79), Long-term Credit Bank (6.57), Dongwon Securities (5.80), Cho Seok-Rae (Hyosung Group) (5.16), Stock Market Stabilization Fund (4.17), Woojeon Oil (Jinro Group) (3.51), Samsung Life Insurance (3.42), Incheo Saekwang Hospital (3.40), Nomura Securities (3.12), Woo Sang-Ki (2.65), E.M. Warburg (2.50), Daehan Investment Trust (2.09), Ssangyong Cement (1.53), Barings Securities (1.47), CMB-TEMP EM (1.37), Hong Young-Chul (Koryo Steel) (1.28), QE Int'l Ltd. (1.15), Kyobo Life Insurance (1.12), CMB-TEMIT (1.04)

* Underlined entities are affiliates of *chaebol*. **Deposit Receipts
***Run by George Soros' Quantum Fund.

Source: Presidential Committee for Financial Reform (1997b: 28-29)

The reason why some *chaebol* owned more than 4% was that Article 2-1 of the supplementary provision of the General Banking Act allowed a grace period until 28 May 1998 before the 4% regulation came into effect for the *chaebol* (Bank of Korea 1995c).[6] However, the Presidential Committee for Financial Reform of 1997 indicated that the *chaebol's* actual shares were higher than the official figures given in Table 5.1. This was because the staff of the *chaebol*'s affiliates possessed additional shares. However, due to the regulation of the authorities and the difficulty of collusive action among the *chaebol*, they did not try to control the management of the DMBs (Presidential Committee for Financial Reform 1997b: 14).

Basket System and Government-DMBs-Chaebol Relations

Korea was one of the few countries in which large 'commercial banks (deposit money banks in Korea)' have been a tool of government policy rather than governing in their own right. *The Financial Times* once argued that the DMBs served two main purposes - aggressively financing the country's rapid industrial expansion and keeping a watchful eye on behalf of the Government on the big conglomerates, the *chaebol*. "If, along the way, these purposes have meant that the banks could earn only low returns or became saddled with huge non-performing debts, then that was the price that had to be paid" (Financial Times, 14 May 1987). The role of supporting rapid industrial expansion has been examined, while the other aspect of containing the concentrated power of the *chaebol* has not been well illuminated in the literature on regulatory failure.

---

[6] However, the revision did not allow the voting right of the private shareholders

At the same time, however, the Korean government tried to limit the amount of the financial resources that the DMBs and development banks extended to the *chaebol.* What is interesting is that this was to restrain the concentrated power of the *chaebol* rather than to promote the soundness of the banks. The Loans Limit System (the so-called Basket system) evolved of such considerations. Credits to the 30 biggest *chaebol* (the 10 biggest *chaebol* after 1996) extended by the DMBs and development banks were subject to regulation from 1984 (Presidential Committee for Financial Reform 1997a: 127-129).

The Monetary Management Board introduced "Financial Institutions' Loan Management Regulation" which was followed by the OBS's "Enforcement Regulation on Loan Management to Conglomerates". According to the regulation, the OBS Governor imposed a limit (called Basket), within which each DMB (or development bank) was free to extend loans to the *chaebol.* In the initial period, the limit was not fixed and was at the discretion of the OBS Governor. After 1987, however, the Governor imposed ratios (loans to the *chaebol* / loans in total made by the DMBs) and the effectiveness of the Basket system appeared to be strengthened. As Table 5.2 shows, credits by banks to the *chaebol* which were subject to the Basket system had continuously decreased.

Regulatory Relaxation

However, not all loans made to the *chaebol* were subject to this regulation. First of all, loans from the overseas branches of Korean financial institutions and deferred export credits were excluded from the Basket for the reason of promoting the

---

to exceed 4% (Bank of Korea 1995c).

international competitiveness of Korean corporates and financial institutions (Testimony of the Finance Minister, Lee Joon-Sung, in 1989 at the National Assembly). Moreover, for the reason of "strengthening the manufacturing sector's competitiveness," the number of exceptions to the application of the Basket system increased. In 1991, each *chaebol* could choose three major companies which became exceptional to the Basket system. In addition, a certain group of listed firms of the *chaebol* could be free from the regulation when over 50% of their shares were held by members of the public who were not related to the *chaebol* (so-called equity-ownership-well-distributed-companies).

Table 5.2 Basket Ratios and Real Shares

	5 biggest *chaebol*		30 biggest *chaebol*	
	Regulatory ratios	Shares	Regulatory ratios	Shares
1987	18.6	15.3	30.4	26.5
1988	15.2	12.7	25.7	22.0
1989	8.6	7.2	16.8	14.7
1990	7.2	6.6	14.7	13.5
1991	5.8	5.8	10.8	10.9
1992	5.6	5.2	10.4	9.3
1993	6.2	4.9	10.9	8.4
1994	5.7	4.4	10.6	7.6
1995	5.3	3.6	9.9	6.3
1996	4.9	3.6	6.6*	4.5*

*10 biggest *chaebol* only
Source: Presidential Committee for Financial Reform (1997a: 130)

Regulatory relaxation expanded. Again, to strengthen corporate competitiveness, three main industries (rather than main companies) for each *chaebol* came to be excluded from the application of the Basket system in January 1994. Thus, the number of companies which were not subject to regulation increased because the *chaebol* usually had multiple affiliates in certain industries which were, they thought, important. In 1996, smaller *chaebol*, i.e. between 11th and 30th in terms of size, came to be free of regulation:

only the 10 biggest *chaebol* remained the subject of regulation. Due to the exceptions made for main industries and equity-ownership-well-distributed companies, as Table 5.3 shows, only 36.5% of aggregate loans made to the 10 biggest *chaebol* by the DMBs were within the Basket (Lee Y-H 1999: 438-439).

Table 5.3 Loans to the 10 Biggest Chaebol (as at end-March 1997)

(unit: billion won, %)

	Subject of the Basket system	Exceptions to the Basket			Loans in total
			Loans to main companies doing particular industries	Loans to equity-ownership-well-distributed companies	
Loans	13333	23100	17900	5200	36400
Ratio	36.5%	63.5%	49.2%	14.3%	100.0%

Source: Lee Y-H (1999)

In sum, seemingly strict regulatory policies of ownership, governance and loans management system were imposed on the DMBs but the real effectiveness of such regulations was doubtful. In particular, the Basket system came to be only nominal due to continuous regulatory relaxation as the Kim Young-Sam government continuously increased the number of exceptions in the name of promoting corporate competitiveness. Moreover, as will be seen in Chapter 7, the *chaebol* could borrow more loans from non-bank financial institutions, such as merchant banks, than ever before during this period. In addition, they tap directly into international capital markets by issuing securities. Opportunities for corporate finance and the amount of financial resources that the *chaebol* could attract increased dramatically.

5.3 Regulatory Complexity: Growth with Monetary Targetting

Regulatory policy towards the DMBs became complicated and the regulatory authority of the BoK over the DMBs shrank due to the growing influence of special interests.[7] The regulatory policy applied to deposit money banks was originally formulated to achieve the policy objectives of the regulatory authorities, i.e. growth (for the Finance Ministry) with stabilization (for the BoK). The regulatory institutional structure over the DMBs also reflected these dual objectives. Before the outbreak of the crisis in November 1997, the BoK had adopted monetary targetting in its operation of monetary and credit policy. Under that system, the objective of price stability and economic growth had been pursued through the establishment of intermediate targets for the M2 and MCT monetary aggregates and strict management of those variables (Bank of Korea 2002).[8] The size of M2 was tightly controlled by the Monetary Management Board and the BoK. However, such targetting was only applied to DMB banking accounts while DMB trust accounts were free from such regulatory policy.

[7] This is consistent with the argument of Olson (1982).

[8] M2 is defined as M1 plus customers' savings and time deposits in banks plus residents' foreign currency deposits. Although customers' savings and time deposits are held to increase wealth and to cover future expenditure, it was assumed that they were not very different from demand deposits which are an element of M1 because, if customers incurred a small penalty, deposits could be easily withdrawn. MCT is M2 plus certificates of deposit and customers' trust money held with banks. Lastly, M3 is MCT plus customers' deposits with non-bank financial institutions, bonds and commercial papers issued by financial institutions, repurchase agreements ("RP") etc. M3 is the monetary index which is brcader than any other indices.

During most of the time between 1979 and 1997 the Korean authorities used M2 as the monetary index because increases in M2, more than in any other monetary indices, had parallelled economic growth and inflation rates in Korea. M2 consisted of M1 (the sum of legal tender notes and coins held by the public plus customers' demand deposits placed with banks) plus customers' savings and time deposits with banks plus residents' foreign currency deposits. Because deposits in the DMBs were directly related to the size of M2, the businesses of the DMBs were strictly controlled by the regulatory authorities. The DMBs were the only financial institutions able to create credit. However, after the considerable liberalization of trust business was introduced in May 1996, MCT became as significant a central monetary index as M2.[9]

The policy of monetary targetting partly affected the precise form of regulatory policy including domestic financial liberalization and capital account liberalization policy. The authorities, in particular the BoK, wanted monetary growth to remain within a certain limit[10]; thus, regulatory relaxation which would increase monetary growth in terms of M2 was carefully examined. However, this objective was hampered by the growth-oriented policy of the Finance Ministry which reflected private sector interests. As a consequence, regulatory outcomes as applied to the DMBs became complicated.

[9] As a result of changes in trust business on 1 May in 1996, liquidity moved from trust money in financial institutions to savings accounts in deposit money banks. Thus, the effectiveness of the MCT index increased since the effects of such movement would have been offset under the index system.

[10] The limits were arranged on the basis of a target for growth and the inflation rate.

On the one hand, the business of the DMBs was relatively less liberalized than that of other types of financial institutions. On the other hand, in order to promote growth, the Finance Ministry actively liberalised the business areas of non-bank financial institutions, which included operation of the trust accounts of the DMBs. Moreover, various business areas of the DMBs, such as asset management of DMBs overseas branches, were not subject to the monetary targetting policy objective of the BoK. Such a regulatory institutional environment resulted in the unintended consequence of regulatory arbitrage by the DMBs.

According to the policy objectives of the authorities, for example, foreign currency funding of the DMBs had to be used mainly to finance the source of foreign currency loans rather than for domestic currency loans.[11] Regulations on the use of foreign currency loans were carefully formulated in order not to cause monetary growth in terms of M2. No foreign currency loan was to be used for the working capital of the borrowers: the loans could be used only to pay for import facilities and overseas investment by firms or for high technology and services for Small and Medium Enterprises (SMEs).[12] However, to promote corporate competitiveness, US$ 2.5 billion of foreign currency loans were allowed for banks to lend corporates for purchasing machinery made by domestic companies in 1996. This certainly caused an increase in the monetary aggregate.

[11] As will be described in Chapter 6, development banks were allowed to undertake foreign currency funding as a resource for domestic currency loans.

[12] See Chapter 3 regarding the use of foreign currency loans.

5.4 Explaining the Vulnerability of DMBs

It should be emphasized that Korean banks did not suddenly get into trouble at the end of 1997. During February and August 1997, there were two rounds of banking crises. But even well before 1997, Korean banks had suffered from structural vulnerability. According to an inside BoK report, an unprecedented phenomenon attracted the attention of a section of the Bank, the Monitoring Team in the International Department, which was responsible for monitoring the foreign exchange business of the DMBs. The report indicated that "the phenomenon originates from the structural vulnerability of Korean banks, rather than from temporary problems in the international capital markets, and has deteriorated; thus a proper corrective measure is required." (Monitoring Team in International Department of Bank of Korea 1996) [13]

The unprecedented phenomenon referred to the fact that the DMBs were having difficulty in securing foreign currency term loans with a maturity of 3 or 6 months despite their willingness to pay high interest rates. Thus, the banks had to rely on extremely short-term loans, such as call-money, which resulted in their foreign currency funding structure becoming unstable. The report indicated four areas as being particularly worrisome:

---

[13] This report belongs to the documents submitted to the Special Investigation Ccommittee on the foreign currency crisis in the National Assembly in January 1999. The title of the report is "The Recent Situation of Domestic Banks' Deepening Instability in Financing Foreign Funds and a Suggestion." This was made by the Monitoring Team of

Accordingly, first, the "Korean premium" for short-term funding in April 1996 suddenly jumped in April 1996 and remained high, exceeding the interest rates payable on long-term foreign currency funding (see Table 5.5 and Chart 5.5). Second, from 1996 the DMBs were increasingly dependent on extremely short-term loans, i.e. over-night and call money. The amount of Euro time-deposits (international money market loans having a maturity of 3 months and 6 months), was stationary, while extremely short-term borrowing, i.e. over-night and call money, was increasing throughout the period. The major DMBs were borrowing approximately US$ 0.4 – 0.5 billion in over-night loans. Third, short-term foreign borrowings were continuously increasing as the DMBs relied on short-term borrowings for long-term investments such as foreign currency loans, overseas securities investment, and foreign currency leasing. Due to the restrictions by the authorities on long-term borrowings and because foreign banks would not lend long-term loans to Korean banks, the long-term assets (investment) of the DMBs could not be funded by long-term borrowings. Also, as the DMBs purchased foreign currency securities, issued by financial institutions, such as merchant banks that were set up after the DMBs, the 'dual foreign currency funding structure' clearly appeared.[14] Fourth, the overall availability of foreign currency funding for Korean banks' overseas branches deteriorated. In support of their overseas branches, the main offices of the DMBs had to borrow foreign currency and transfer the funds to their overseas branches.

---

the BoK's International Department in June 1996.

[14] Dual structure means that a Korean bank would borrow foreign funds from another Korean bank which itself borrowed the funds from international banks or markets.

This situation was extraordinary because it was at a time when Korea was in its final stage of obtaining entry to the OECD; conventional wisdom would have indicated that the premium for borrowing foreign funds would have decreased in the expectation of entry. This does not mean that all banks had to pay more for short-term funding than for long-term funding. Foreign banks were in fact unwilling to lend long-term funds to some Korean banks and only short-term borrowings at high interest rates were available to those banks.

*Table 5.4 Trend of Short-term and Long-term Spread over Libor for DMBs*1)*

	1/95	3/95	6/95	9/95	12/95	1/96	2/96	3/96	4/96	5/96	6/96
Long-term	0.30-0.35	0.30-0.35	0.30-0.35	0.35-0.40	0.40 – 0.45	N/A	0.32-0.37	0.32-0.36	0.32-0.36	0.36-0.43	0.35-0.40
Euro T/D*2)	0.14	0.15	0.17	0.29	0.33	0.26	0.26	0.30	0.32	0.32	0.35
Over-night	0.06-0.13	0.06-0.13	0.06-0.13	0.38-0.50	0.25-0.50	0.13-0.38	0.13-0.25	0.13-0.50	0.35-0.60	0.35-0.60	0.40-0.90

* 1) Figures are spreads over Libor for eight main DMBs; unit is percentage.
* 2) Euro Time-Deposit refers to short-term funds with a maturity of 1-6 months, which were financed by banks in international money markets.
Source: Monitoring Team of International Department of the Bank of Korea (1996)

*Table 5.5 Structure of Short-term Borrowing in DMBs*1)* (US$ billion)

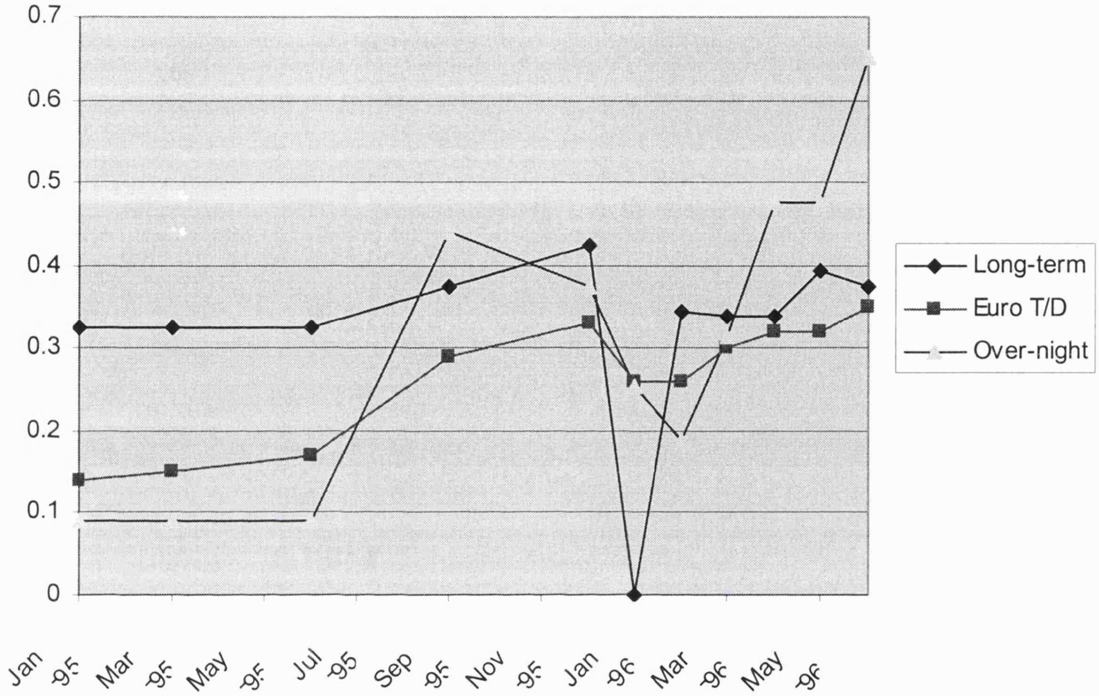
	1/95	3	6	9	12	1/96	2	3	4	5	20/6
Euro T/D	6.8	7.9 (1.0)	9.5 (0.5)	10.4 (0)	11.4 (-0.3)	11.9 (0.5)	11.8 (-0.1)	11.6 (-0.2)	11.2 (-0.4)	12.0 (0.8)	12.2 (0.2)
Call-money (including over-night)	0.8	0.9 (-0.5)	1.6 (0.1)	1.7 (-0.4)	1.6 (-0.1)	1.3 (-0.3)	2.8 (1.5)	1.8 (-1.0)	2.5 (0.7)	1.7 (-0.8)	1.9 (0.3)

*1) Figures of this table are an aggregate of four major DMBs.[15]
Source: Monitoring Team of International Department of the Bank of Korea (1996)

[15] In the confidential document on which this table is based, there was no specific reference to the number of DMBs used for this statistical research. However, considering that the main banks were renewing over-night loans each of US$ 0.4 - 0.5 bn, there is no doubt that the number was four out of the eight main banks.

*Chart 5.4 Trend of Short-Term and Long-Term Spread over Libor for DMBs*1)*

(Units: %)



*1) Long-term and over-night spread over Libor is (maximum + minimum spread)/2.
Source: the Monitoring Team of the International Department of the Bank of Korea (1996)

External and Internal Factors

As regards the cause of the problems, on the surface the jump in the premium was related to Japanese banks. At the end of every three months, Japanese banks, the major lender to Korean banks at that time, had to withdraw their loans to comply with BIS capital adequacy requirements. This appears to have increased the Korean premium because Japanese banks provided funds for 30-40% of international borrowings by Korean banks. The reality, however, was that the premium for funding jumped at the end of March 1996 and remained high even after the period for settlement of the accounts of the Japanese banks. At the end of June 1996 spread-over Libor for over-night borrowing by Korean banks reached almost 1%.

The BoK report showed that this was caused by an increase in demand for foreign funds caused by regulatory liberalization, in particular the sudden lowering of the barrier to foreign exchange business, rather than for external reasons. Eleven leasing companies were authorised to do foreign exchange business in July 1994 and a further nine in July 1995. Nine merchant banks were authorized to do this business in November 1994 and a further nine in July 1996. Consequently, there was over-competition for foreign funds among Korean financial institutions, along with an increase in demand for foreign funds corresponding to an increase in the size of the economy. In particular, as new merchant banks with low international credibility were created from investment and finance companies, they tapped into the international capital market and borrowed regardless of the level of interest rates in order to extend their foreign exchange business. The overall credibility of Korean financial institutions declined and this led to raised interest rates for borrowings (the Monitoring Team in the International Department of the Bank of Korea 1996).

Overseas branches of DMBs were having particular difficulty in attracting foreign funds. The BoK report indicated that the authorities in the United Kingdom and Japan had strengthened their supervision over term mismatch ratios. The UK and Japanese authorities applied the same terms of mismatch regulation as imposed upon their countries' financial institutions to Korean branches within their territories. As overseas branches had tended to rely on short-term loans for long-term investment in order to increase their profitability (see Table 5.6), the enforcement of these regulations by the British and Japanese authorities came to be a serious problem to Korean overseas branches.

As at the end of 1995, the mismatch ratio of overseas branches was 83.9%, which was twice as much as that of their main offices. From 1996, the Bank of England started to enforce regulation on liquidity mismatch ratio in respect of Korean banks' branches in London and Hong Kong. At the same time, the Bank of Japan also expressed its concern over the Korean banks' excessive dependence on over-night loans and indicated its intention to regulate the liquidity ratio of Korean banks. Thus, on 29th of January 1996 the OBS in Korea asked the Korean financial institutions to prepare a plan to reduce the size of call money loans (the Monitoring Team in the International Department of the Bank of Korea 1996). It was not known whether the authorities specified a certain level or not.

Table 5.6 Foreign Currency Asset Management of Overseas Branches of DMBs

	1993	1994	1995	April 1996
FX assets	41.4 (4.3)***	52.4 (11.0)	64.4 (12.0)	n.a.
Mismatch ratio*				
Main offices	38.6 %	43.5 %	36.9 %	32.2 %
Overseas branches	83.6 %	88.1 %	83.9 %	n.a.
Local branches**	70.5 %	62.3 %	58.3 %	n.a.

*Main offices: 100 – (long-term borrowings/ foreign currency loans x 100)
Overseas branches, Local branches: 100 – [(long-term deposits with the branches + long-term borrowings/ (long-term loans + long-term deposits with other financial institutions) x 100]
** Local branches refer to financial institutions independently registered in accordance with local legislations.
*** Inside the parentheses is the amount of the increase over previous balance.

Source: the Monitoring Team in the International Department of the Bank of Korea (1996)

Enthusiasm for Deregulation

According to published research by the BoK in June 1996, the market value of DMBs compared to their book value deteriorated due to competition from new entrants to the business (Monetary Economy Research Institute 1997). As the report of the Monitoring Team at the BoK points to over-competition for foreign funds, this BoK research also indicates that over-competition occurred in the domestic currency business area as a result of the authorization of new entrants to the deposit money banking business.

Four points were made on this subject. First, competition between banks intensified; second, the gap between interest rates for deposits and for loans decreased; third, new entry by six deposit money banks negatively affected the profitability of all the banks; lastly, the vulnerability of the banks increased as the ratio of portfolio equity investment by the DMBs to deposits in the banks increased. As a consequence, the probability that a bank could go bankrupt increased, and the market value of the banks compared to their book value continued to decline. The research concludes that the relaxation of entry barriers has reduced the value of a licence to conduct banking business (Monetary Economy Research Institute 1997).

The BoK research did not blame the relaxation of entry barriers itself for causing the problems. It argued that the relaxation was implemented in a non-market friendly manner, which meant that the decision to admit new entrants was influenced by the enthusiasm for financial liberalization, while other regulations on interest rates remained unchanged and financial institutions were not allowed to fail. This indicates that the financial liberalization adopted was asymmetrical.

Financial liberalization, promoted by the new leadership of the Finance Ministry (formerly EPB officials) focussed on the substantial reduction of entry barriers to the financial industry. Permission granted for new deposit money banks in 1982 and 1983 coincided with the emergence in the Finance Ministry of the new leadership under Kang Kyung-Sik.[16] Two new deposit money banks were established: Shinhan Bank in July 1982 and KorAm Bank in March 1983. Between 1989 and 1992, six more deposit money banks were allowed. Four of those banks were founded to increase the electoral chances of the then ruling party (reflecting business interests in regional areas) and two of them were originally investment and finance companies which were allowed to become DMBs under the Act Concerning Mergers and Conversion of Financial Institutions.

In relation to foreign currency business, the enthusiasm for deregulation together with the policy objective of growth led to a relaxation in the enforcement of key restrictions such as the compulsory long-term funding ratio for foreign currency loans. The compulsory ratio, 70%, for long-term funding for foreign currency loans was a key prudential regulation because the loans were the major foreign currency assets of the

[16] Kang Kyung-Sik became Finance Minister again in 1997.

DMBs and demand for the loans from firms rapidly increased as a result of the easing of the restrictions on the use of the loans.

Relaxation of the ratio to 50% was a kind of symbol of the incumbent government of Kim Young-Sam, who took office in April 1993. The government started its term with the 'New Economy 100 days' Plan' which was very growth-oriented. Having relaxed the ratio in April 1993, the government eased restrictions on the eligibility for firms to be able to use foreign currency loans with a generally long maturity of over 5 years. Because the loans were given at very cheap interest rates, such as Libor plus 1%, demand jumped. Due to the relaxation of the ratio, much of the new demand was funded by short-term borrowings by the DMBs. Moreover, offshore banking of DMBs was not subject to the application of the compulsory ratio of 50%.

In the wake of the crisis, the Board of Audit and Inspection (BAI) indicated that short-term borrowings represented 65% of aggregate foreign currency borrowings of Korean financial institutions between 1993 and 1996. Since development banks continued to borrow long-term funds as their major funding sources, the ratio of short-term borrowings by the DMBs must have greatly exceeded 65%. As described in Chapter 4, the term period for trade credits was substantially eased during the Kim Young-Sam presidency. Due to the economy's high dependence on trade, the scale of trade credits was large. Although trade credits for imports contributed to an increase in exports, those credits are partly to blame for the rapid increase in trade deficits in the mid-1990s. Also, a rapid increase in exports meant a corresponding increase in foreign exchange bills, which were included in the foreign currency assets of the DMBs. The bills were bought from trading firms which were the major affiliates of the major *chaebol*. When capital flows reversed on the eve of the crisis, the foreign exchange bills possessed by the DMBs were illiquid for at least a 3 to 6 month term. The DMBs were the only group of financial institutions which bought foreign exchange bills from trading firms. There were about 10 trading firms before the crisis, the firms all being affiliates of the *chaebol*.

Regulatory Forbearance by the Finance Ministry

The debt structure of the DMBs was short-term oriented and over half the short-term liabilities were incurred through offshore/overseas branch borrowing. This was a consequence of regulatory liberalization. As explained, the Monetary Management Board within the BoK was the major supervisory authority over the DMBs and the authority imposed relatively stricter rules over the DMBs than other groups of financial institutions. As also indicated, the strict rules were prompted by the BoK's concern with monetary targetting.

However, not all the regulatory policy imposed upon the DMBs was made by the Monetary Management Board of the BoK. As is well-known, only part of the business of the DMBs was supervised by the Board. Regulatory authority over the trust accounts of the DMBs was under the jurisdiction of the Finance Ministry. The trust business, which had been restricted to the Bank of Seoul, was opened to local banks in May 1983 and to the nationwide DMBs in February 1984. Thereafter, foreign bank branches (in September 1985) and specialist banks (in January 1989) were also allowed to transact trust business (Money and Banking Division in Research Department 1994: 11).

This resulted from the Finance Ministry's concern to raise the competitiveness of the DMBs vis-à-vis non-bank financial institutions which, since the 1970s, were enjoying relative freedom over their business.[17] In addition to the concern to maintain the competitiveness of the DMBs and non-bank financial institutions, the ability of the DMBs to meet the growing and diversified demand for financial services was also taken into account. Authorization by the Finance Ministry enabling DMBs to transact trust business was facilitated by the fact that the increase in trust account deposits with the banks did not affect monetary growth as measured by M2 and also the regulatory authorities over banking and trust accounts were different.

The rapid growth of trust accounts held by the DMBs during the 1980s and 1990s, however, certainly weakened the application of prudential regulatory policy to deposit money banks. As the prudential regulatory measures imposed over the DMBs by the Monetary Management Board, such as the capital adequacy requirements and the single and large exposure limits, were not applied to the trust accounts of the DMBs, the prudential measures applied to the banking accounts of the banks would not be effective in restraining the banks from activities which made them vulnerable to taking systemic risks. This is strongly suggestive of the influence of special interests which seem to dominate when not in overt conflict with the narrowly-interpreted monetary objectives of the BoK.

---

[17] As we will see in Chapter 7, the establishment of non-bank financial institutions

In the wake of the crisis, it was revealed that, if the exposure to the *chaebol* arising from the trust accounts of related banks were included, the exposure to Hanbo Steel by related banks exceeded the single and large exposure limits, which were set by the regulatory authorities. When loans arising from trust accounts to the *chaebol* were included, for example, those to Hanbo Steel and Kia Motors of the KFB would be more than the single exposure regulatory limit, i.e. 15% of equity capital. However, when loans from banking accounts only were calculated, those of the KFB to Hanbo Steel and Kia Motors were below the limit, i.e. 14.1% and 9.3%, respectively. On 1 October 1997, the Finance Ministry imposed a new single exposure limit applied to trust account of the DMBs which was 5% of the balance of the aggregate loans arising from trust accounts (Statement of the OBS Governor, Lee Hyun-Jae, at the National Assembly).[18]

Offshore loans by the DMBs to non-residents, i.e. overseas branches or affiliates of firms, were not calculated as part of single or large exposures. Lee Kyu-Sung, Finance Minister at the end of the 1980s, stated at a hearing of the National Assembly that, as offshore banking was competing with foreign financial institutions, any substantial regulation over the asset management of Korean banks would restrict their competitiveness (the Minutes of the Committee of Finance at the National Assembly, 6th meeting in the 146th Congress on 23 May 1989).

---

was originally prompted by the growth-oriented policy of the government.

[18] Minutes of the Special Investigation Committee on the Foreign Currency Crisis, the 7th Meeting of the 200th Congress on 21 January 1999).

5.5 Bank of Korea's Foreign Currency Deposits with the DMBs

It is now known that the BoK deposited some of its international reserves at overseas branches of Korean banks prior to the 1997 crisis (Baliño et al.1999; Fischer 2002). Before the crisis, international reserves were defined by the Korean authorities as foreign currency assets in the central bank's external account; thus assets deposited at overseas financial institutions, which included not only foreign banks abroad, such as Citibank in New York, but also Korean banks' overseas branches, such as Korea First Bank in London, were calculated as part of international reserves.[19] Foreign currency deposits with overseas branches of Korean banks have been classified as Type A deposits in this research and described in Chapter 4. As at the end of 1996, the amount of Type A deposits with overseas branches of Korean financial institutions was US$ 3.82 billion. The deposits increased to US$ 8.01 billion as at the end of October 1997. Most of the Type A deposits (US$ 3.5 billion as at the end of January 1997) were deposited with overseas branches of the DMBs and used as resources for establishing overseas branches of the DMBs and their business (the International Department of the Bank of Korea 1997e).

[19] In the wake of the crisis in 1997, international reserves of the BoK came to exclude foreign currency deposits held by overseas branches of Korean banks. Also, almost all the foreign currency assets of the BoK previously deposited at the main offices of the Korean banks, i.e. over US$ 40 billion as of end-July 2000, has been returned to the BoK to form part of the international reserves of the central bank. Without understanding this complex mechanism regarding the BoK's foreign currency assets, it would be difficult to understand the rapid increase in the international reserves of the BoK in the wake of the crisis.

As Korean DMBs suffered from a foreign currency liquidity problem during the course of 1997, however, Type A deposits were no longer usable international reserves of the BoK, but the deposits were still defined as part of the Bank's international reserves. International creditors blamed this inaccurate classification for causing uncertainty during the crisis period.

It has however never been revealed in the literature on the crisis in Korea that there were huge amounts of foreign currency assets deposited with the main offices of domestic banks including the DMBs. The deposits have been classified in this research as Type B deposits and briefly described in Chapter 4. The amount of the Type B deposits was large; as at the end of 1996 the deposits were US$ 32.2 billion. What is remarkable is that the BoK put Type B deposits in its internal account, thus the deposits were not regarded as part of the international reserves. Out of the total Type B deposits, US$ 11.5 billion (36%) was deposited with the main offices of the DMBs in Seoul, Korea (International Department in the Bank of Korea 1997e). Type B deposits were used to fund Korean banks to enable them to conduct foreign exchange business.

Regulation on Domestic Operations of Foreign Currency Assets by the BoK

Type B as well as Type A deposits were handled by the order of the Finance Ministry. The making of the foreign currency deposits by the BoK with domestic banks was in accordance with "Regulation on Domestic Operation of Foreign Currency Assets" which fell under the jurisdiction of the BoK.[20] The objective of the regulation in Article 1

[20] It was established on 29 December 1984.

reads, "This regulation is to prescribe relevant particulars regarding domestic utilisation of foreign currency assets, such as buying and selling of foreign funds, deposits of foreign funds with domestic foreign exchange business banks, call-loans of foreign funds." Article 8 of the regulation ordains three different kinds of deposits: (1) deposits to support short-term foreign currency loans for businesses; (2) deposits to support early repayment of foreign debts; and (3) deposits to support foreign currency loans by Korean banks, which are specially approved by the BoK Governor.

Article 9 of the regulation prescribes where the deposits should be placed. Deposits to support short-term foreign currency borrowings by businesses were to be placed with domestic foreign currency business banks (excluding foreign banks' branches in Korea and development banks, i.e., Korea Development Bank, Export-Import Bank of Korea, Long-term Credit Bank and merchant banks). Thus, in effect, the regulation clearly prescribes that the deposits to support short-term foreign currency borrowings by businesses should be placed only with the DMBs, whereas deposits to support early repayment funds of foreign debts were to be placed with foreign exchange business banks, excluding foreign banks' branches. Thus, not only the DMBs but also the development banks were authorised to receive the deposits. The specific approval by the BoK Governor of deposits to support foreign currency borrowings was entirely at the Governor's discretion. However, as indicated in Chapter 4, the ultimate authority over the deposits was with the Finance Ministry.

The management by the BoK of Korea's international reserves did not conform to the normal management of most central banks of their international reserves, which focus on security and liquidity with profitability. "Deposits by the BoK with domestic banks were made taking into account the situation of demand and supply of foreign funds and demand by foreign exchange business banks for foreign funds" (Article 10 of the regulation). Term periods were within 1 year (Article 10) and the interest rates of the deposits were to be based on Libor.

It is not clear when the practice of making these Type B Deposits started. Although the regulation was made at the end of 1984, a supplementary provision of the regulation prescribed "previous regulations on different kinds of deposits would be repealed when the 1984 regulation was enforced". This means that such deposits had been made before the regulation was introduced. One of the previous regulations authorised deposits by the BoK to support the funding of a new subway; in this case, the deposits were placed with some of the DMBs which then lent the funds to local governments to finance the construction of the subway systems.

Type A deposits were placed with the overseas branches of the DMBs in the latter half of the 1980s. In order to sterilize large capital inflows, which resulted from Korea's huge trade surpluses between 1986 and 1989, the authorities prompted the DMBs to establish overseas branches. The deposits were used as the equity capital of such branches as well as for operating funds for foreign currency business. The number of overseas branches of the DMBs was 123 as at the end of 1996 (Bank of Korea 1997).

Overseas branches including overseas local affiliates of Korean financial institutions borrowed over US$ 31.7 billion as at the end of 1996, representing 20% of their aggregate external liabilities, i.e. US$ 157.5 billion at that time. US$ 26.4 billion out of the US$ 31.7 billion was short-term borrowings (Ministry of Finance and Economy 1998). In this regard, Type A deposits were partly a consequence of capital account liberalization (authorisation of overseas branches to promote capital outflows) and stabilization policy. International operations of the DMBs without adequate preparation were encouraged by the regulatory authorities and this must have aggravated the moral hazard problem of the DMBs.

Type B deposits also exacerbated the DMBs' moral hazard problem. The central bank's Type B deposits with the DMBs were introduced to support them in making foreign currency loans and in buying the export bills of trading firms. Although foreign currency loans usually had a maturity of more than five years, the term period of the deposits to support the loans was less than one year; therefore, renewal of the deposits was the norm rather than the exception. Thus, Type B deposits meant that the authorities (the BoK and the Finance Ministry) encouraged DMBs to make long-term loans sourced by short-term borrowings. The DMBs' liquidity problem was, therefore, aggravated by the regulatory authorities.

The rationale for such deposits was, as mentioned, to promote economic growth without damaging macroeconomic stability. In order to reduce the demand by Korean banks for foreign currency funds and maintain the macroeconomic stability of the economy, the BoK deposited its foreign currency assets acquired by its intervention in the foreign exchange market with domestic financial institutions. This meant that demand for foreign funds could be met without increasing Korea's external liabilities. By reducing the demand by the DMBs for foreign currency funds, the authorities tried to manage foreign exchange rates and to ensure stable monetary growth. Since the interest rates on the BoK's foreign currencies deposited with the domestic financial institutions were Libid (London Inter-bank Bid Rates), those institutions preferred such deposits to borrowing funds directly. Accordingly, the central bank was effectively subsidising Korean banks including the DMBs.

5.6 Banking Crises and Crisis Management Policy in 1997

This section examines the banking crises of February and August 1997 and the foreign currency crisis at the end of 1997. The collapse of some *chaebol*, starting with the insolvency of Hanbo Steel, had raised significant questions regarding the viability of some banks. Overall, the DMBs were revealed as having a poor assets and liabilities structure, for example, having too large an exposure to those *chaebol*, a foreign currency liquidity mismatch and risky investments. When foreign investors started to reduce their exposure to Korean banks following the collapse of Hanbo Steel and Kia Motors, this reduction immediately led to a banking crisis which could only be alleviated by the BoK making additional foreign currency deposits with the banks.

The crisis management policy of the Korean government during the course of these crises merits scrutiny because it reflects the change in the developmental state, i.e. the strong emergence of proponents for "market discipline." In the wake of the crisis, Kim Young-Sup, Senior Advisor to the President on Economic Affairs between November 1997 and February 1998, referred to Kang Kyung-Sik, Deputy Premier, and Kim In-Ho, Senior Advisor to the President on Economic Affairs, between March – November 1997 when he said, "they did not appropriately harmonize market discipline with the role of the government."[21]

Significance of DMBs in Foreign Currency Funding

The DMBs were the major constituent of Korean financial institutions. No other constituents of the Korean financial sector were more significant than the DMBs in terms of the magnitude of their external liabilities and assets. The difficulties of the DMBs led directly to the outbreak of the foreign exchange crisis in late 1997. The crisis broke when some major DMBs were no longer able to obtain foreign currency funds from other sources, i.e., the BoK and development banks and some other solvent DMBs. In other words, the crisis occurred because some DMBs could not settle payments for imports by industrial firms which were guaranteed by the DMBs nor repay their borrowings from international banks on maturity.

---

[21] Statement of Kim Young-Sup, former Senior Advisor to the President on Economic Affairs, before a public prosecutor in 22 April 1988. Refer to separate volume supplement of Monthly Chosun (a magazine), October 1999 issue.

Table 5.7 shows that the foreign funds borrowed by the DMBs were much bigger than those borrowed by other segments of the financial sector, i.e., the development and merchant banks. It also indicates that short-term funding in 1997 dropped by over US$ 32.6 billion compared with 1996, while short-term assets reduced by only US$ 15.7 billion. This implies that the DMBs had difficulty in renewing their short-term external liabilities. In Table 5.7 the liquidity ratio of the DMBs of 78% as at the end of 1996 was the ratio of assets to liabilities both with less than 1 year's maturity. As at the end of June 1997, the liquidity ratio of assets to liabilities (with less than 3 months maturity) was 63% for the nationwide DMBs (Board of Audit and Inspection 1998).

Table 5.7 Foreign Currency Liabilities and Assets by Different Financial Institutional Group (End of Period, Unit: US$ billion)

			1992	1993	1994	1995	1996	1997
DMBs	Liabilities	Long-term	16.3	19.7	23.4	29.1	35.1	51.2
		Short-term (A)	40.4	43.9	58.7	76.3	92.8	60.4
		Total	56.7	63.6	82.1	105.4	127.9	111.6
	Assets Management	Long-term	23.1	25.0	34.8	46.2	55.8	55.2
		Short-term (B)	33.6	38.6	47.3	59.2	72.1	56.4
		Total	56.7	63.6	82.1	105.4	127.9	111.6
	Liquidity ratio (B/A)		83%	88%	81%	78%	78%	93%
Development Banks	Liabilities	Long-term	15.4	17.6	21.1	26.0	30.0	31.1
		Short-term (A)	4.0	5.0	7.0	9.4	13.2	17.5
		Total	19.4	22.6	28.1	35.4	43.2	48.6
	Assets Management	Long-term	18.1*	21.0	25.8	31.7	37.5	37.8
		Short-term (B)	1.2*	1.6	2.3	3.7	5.7	10.8
		Total	19.4*	22.6	28.1	35.4	43.2	48.6
	Liquidity ratio (B/A)		31%	33%	33%	40%	43%	62%
Merchant Banks	Liabilities	Long-term	1.3	2.0*	2.2	4.6	6.0	5.4
		Short-term (A)	3.3	3.6*	5.1	7.1	12.6	13.7
		Total	4.6	5.5*	7.3	11.7	18.6	19.1
	Assets Management	Long-term	4.4	5.4	7.1	11.4	17.8	17.1
		Short-term (B)	0.1	0.1	0.2	0.2	0.8	2.0
		Total	4.5	5.5	7.3	11.7	18.6	19.1
	Liquidity ratio (B/A)		4%	4%	3%	3%	6%	15%

* Figures are rounded off to the first decimal place; therefore, the total of long-term and short-term ones may have an error of 0.1.
Source: Board of Audit and Inspection (1998)

Poor Foreign Currency Assets and Liabilities Structure of DMBs and the First Banking Crises

Some of the DMBs had difficulty in repaying their foreign currency liabilities in February and March 1997 and many of them could not settle their liabilities in August 1997. These crises occurred when international banks reduced credit lines to those DMBs which had difficulty in renewing their commercial paper.

During the first quarter of 1997, the only way in which the banks could avoid default on their foreign currency debts was by obtaining support from the authorities. The BoK was therefore obliged to deposit its foreign currency assets with the banks. After the collapse of Hanbo Steel in January and Kia Motors in July, some international banks reduced their credit lines to Korean banks (Table 5.8). Other international banks, which still maintained their lines to the Korean banks, shortened the redemption period of the remaining credits. During the two months following the collapse of Hanbo Steel, the credit lines of international banks to seven major DMBs were reduced by US$ 9.1 billion (International Department in the Bank of Korea 1997c) (Table 5.8).

Table 5.8 Reduction in Credit Lines after the Collapse of Hanbo Steel and Kia Motors

(Unit: US$ billion)

	Choheng	Commercial	Korea First	Hanil	Seoul	Foreign Exchange	Shinhan	Total
After Hanbo [1]	1.1	1.6	2.6	1.1	1.5	0.4	0.9	9.1
After Kia [2]	1.1	1.3	1.4	1.6	0.6	0.8	0.4	7.1
Total	2.1	2.9	3.9	2.7	2.1	1.2	1.3	16.2

1) Between Feb. 1997 and Mar. 1997
2) Between 16 Jul. 1997 and 30 Sep. 1997

Source: International Department in the Bank of Korea (1997c)

This difficulty derived not only from an increase in bad debts due to the collapse of several *chaebol* during the course of 1997 but also in part from a reduction of credit lines supplied by Japanese financial institutions at the end of March 1997 when the period for settlement of accounts of the Japanese banks was near (Table 5.9).

Table 5.9 Short-term Liabilities to Japanese Banks, which Matured during March 1997
(Unit: US$ billion)

	Choheng	Commercial	Korea First	Hanil	Seoul	Foreign Exchange	Shinhan	Total
Matured (A)	0.24	0.79	1.20	0.67	0.56	0.38	0.20	4.03
Renewal or switch to other sources (B)	0.03	0.25	0.58	0.24	-	0.12	0.05	1.27
A – B	0.21	0.54	0.62	0.43	0.56	0.26	0.15	2.76

Source: International Department in the Bank of Korea (1997c)

Amid the instability caused by the collapse of Hanbo Steel, the statement at the end of January 1997 by the Senior Advisor to the President on Economic Affairs that "Banks could go bankrupt" aggravated the situation. As briefly mentioned in Chapter 4, the senior advisor's statement made foreign fund-holders nervous and hesitant to lend money to Korean banks, and therefore the Governor of the BoK, Mr Lee Kyung-Sik, asserted at a press conference on 1 February 1997 that the BoK would not let Korean banks fail.

In relation to the press conference of the BoK Governor, Jin Young-Wook, the Director of the Department of International Finance in the Finance Ministry revealed that, "Following the statement of Lee Seok-Chae (Senior Advisor to the President), Korean banks, in particular Korean banks' branches in Japan, had difficulty in revolving their over-night loans from Japanese financial institutions. Thus, I asked then finance minister, Han Seung-Soo, that he requests that the BoK Governor hold a press conference aimed at correcting the statement of the senior advisor to the President for economic affairs" (The Minutes of the Special Investigation Committee on the Foreign Currency Crisis at the National Assembly, 17th meeting of the 200th Congress on 3 February 1999).

After the BoK Governor's news conference, the Bank of Japan (BoJ) expressed its gratitude for the BoK's swift action in holding the conference, which contributed to capital market stability in Japan and helped resolve the difficulty of the funding of Korean banks in Japan. In addition, the BoJ stated its intention that it would inform Japanese banks and short-term finance companies of the BoK Governor's message (Report of the Tokyo office of the BoK to the Director of Planning Department of the BoK on 3 February 1997). Nihon Kezai (a Japanese Economic Newspaper) reported, "BoK Governor stated that the supervisory responsibility over the ability of settlement of Korean overseas banks' branches lies with the BoK." The newspaper interpreted the message as "the BoK's expression of support to Korean banks", and wrote that "the BoJ also has a view that the situation has been calmed down." (Nihon Kezai on February 2nd "Korean Banks Difficulty in Funding towards Normalization: The Central Bank in Korea Expressed its Support for Korean Banks")

During the first quarter, not only were credit lines being reduced but also commercial paper (CP) issued by the banks was also difficult to renew. According to the BAI's investigation report on the crisis, in the course of 1997 over 90% of the CP in 13

Korean banks (including major DMBs, special and development banks) was not renewed. The amount of CP issued by the banks as at the end of 1996 was US$ 7.4 billion but only US$ 0.7 billion worth of CP was outstanding as at the end of 1997 (Board of Audit and Inspection 1998).

There is no doubt that the reduction in credit lines by US$ 9 billion was a significant blow to the DMBs. However, considering the fact that the DMBs possessed foreign currency assets of US$ 31 billion with less than 1 year's maturity as at the end of 1996, the detrimental effect of the reduced credit lines could be balanced by a realisation of part of their short-term assets. The reality was that immediate realisation of the assets was difficult. In relation to that situation, the BoK indicated, "the underlying reason originated from the weakness of foreign currency funding and asset management structure, which could not cope with change in international capital markets" (International Department in the Bank of Korea 1997c).

In relation to asset management of the DMBs, over 65% of the assets (US$ 20.2 billion worth) were discounted foreign exchange bills which the banks had bought from trading companies. US$ 5.0 billion of the assets were deposits with other financial institutions (Table 5.10). Among the deposits, US$ 2.5 billion was deposited with Korean merchant banks as at the end of February 1997. Since the merchant banks had started to suffer from a liquidity problem earlier than the DMBs, they could not meet the DMBs' demands for repayment of foreign currency deposits. Furthermore, seven major banks possessed US$ 2.2 billion of international securities, of which only US$ 0.4 billion had an 'A' rating. The rest of the securities were issued by Korea and developing countries (the International Department of the Bank of Korea 1997c).

Table 5.10 Foreign Currency Assets Portfolio of DMBs (Units: US$ billion)*

	93	94	95	96	97.2
1. Long-term assets	11.9	17.1	23.3	26.6	26.0
	<42.6>**	<46.5>	<47.4>	<46.2>	<46.5>
(Foreign currency loans)	9.7	13.5	18.5	21.0	21.1
2. Short-term assets	16.1	19.8	25.8	31.0	29.9
	<57.4>	<53.5>	<52.6>	<53.8>	<53.5>
(Foreign exchange bills)	9.1	12.3	16.5	20.2	19.0
(Deposits)	2.8	3.2	3.9	5.0	5.1
Total (1 + 2)	28.0	36.9	49.1	57.6	55.9

* Outstanding balance
**< > is %.
Source: International Department in the Bank of Korea (1997c)

Table 5.11 Foreign Currency Liabilities of DMBs (US$ billion)

	93	94	95	96	97.2
1. Long-term	2.2	2.1	4.2	7.3	7.1
	<7.7>	<5.7>	<8.6>	<12.9>	<12.9>
2. Short-term	9.5	14.9	22.3	28.3	30.3
	<33.9>	<40.5>	<46.0>	<50.1>	<54.8>
3. Foreign Currency assets of	16.4	19.7	22.0	21.0	17.9*
BoK deposited at the DMBs	<58.4>	<53.8>	<45.4>	<37.0>	<32.3>
Total	28.1	36.7	48.5	56.6	55.4

*This does not mean that the BoK withdrew their assets in foreign currency from the DMBs. The BoK moved the assets deposited at main offices of DMBs (Type A deposits) to overseas branches of DMBs (Type B deposits). By doing this, the BoK could increase the official figure of international reserves of the BoK. In fact, in the course of Feb. 1997, BoK's deposit at DMBs including both those at main offices and at overseas branches increased by US$ 1 billions.
Source: International Department in the Bank of Korea (1997c)

Table 5.12 Assets and Liabilities Ratios by Maturing Terms in 7 Major DMBs (%)*

Within 7 days	Within a month	Within 6 months	Within a year	More than 1 year
61.9	61.4	69.9	75.9	171.3

* Ratio = Assets by maturing terms/ Liabilities by maturing terms x 100
Source: International Department in the Bank of Korea (1997c)

The poor portfolio structure derived from the nature of regulatory policies in Korea. Liberalization of trade credits increased the short-term liabilities and the assets of the DMBs but the assets could not be easily liquidated in case of emergency. The difficulty could only be resolved by the BoK providing support to the DMBs. The BoK increased its foreign currency deposits at the overseas branches of the DMBs by US$ 1 billion during the last week of March 1997. Table 5.13 shows that the branches of the DMBs in Tokyo were having the most serious liquidity problems. By making these deposits, the BoK could support the DMBs without apparently reducing the figure of international reserves, though the level of usable international reserves inevitably decreased.

Table 5.13 BoK's Additional Deposits at Overseas Branches of DMBs by Region as at the End of March 1997

(US$ bn)

Tokyo	Singapore	Hong Kong	New York	London	Total
0.59	0.03	0.09	0.19	0.05	0.95*

* The remaining US$ 50 million was expected to be deposited at those banks, which would have difficulty in settling their liabilities on the last day of March 1997.

Source: International Department in the Bank of Korea (1997d)

In addition, BoK asked the DMBs to dispose of their foreign currency securities in order to obtain liquidity. Securities held offshore were also to be disposed of in order to supply overseas branches with liquidity. For seven major banks, less than half of the securities held (US$ 1 billion out of US$ 2.2 billion) could be realised. In addition, the BoK suggested an increase in the ceiling from 20% to 23% for foreign direct investment in the Korean stock markets earlier than expected.

It also decided to establish country funds earlier than expected and recommended that the Finance Ministry remove the restriction on long-term funding by financial institutions.[22] In the regulatory area, the BoK introduced the same prudential measure over the mismatch gap as the Bank of England had done. The BoK established the guideline that the mismatch gap between assets and liabilities having less than one month's maturity should be under 10% whereas the main DMBs had a mismatch gap of on average 13.5%. As this mismatch gap was based on aggregate foreign currency assets, a 10% mismatch was not an insignificant problem. For example, if a bank had assets of US$ 10 billion, a 10% mismatch gap meant that the bank had to attract at least US$ 1 billion within a month.

Table 5.14 Mismatch Gap between Assets and Liabilities Having Less Than a Month Maturity (as at end-Feb. 1997)*

(unit: %)

Choheng	Commercial	Korea First	Hanil	Seoul	Foreign Exchange	Shinhan	Average
12.1	12.2	18.5	18.4	7.7	12.1	11.2	13.5

*Mismatch gap (%) = |(Assets by maturing terms – Liabilities by maturing terms)/ (Aggregate foreign currency assets) | x 100
Source: International Department in the Bank of Korea (1997c)

These measures appeared to have been successful in enabling some of the DMBs to survive the banking crisis. Withdrawals by Japanese banks of US$ 2.8 billion were balanced by the BoK's deposit (US$ 1 billion) and the DMBs' disposal of their securities.

[22] Establishing country funds, which were particularly aimed at the stock market in Korea, had been strictly limited since it would cause capital inflows and disrupt the policy objective of stabilization by increasing the monetary aggregate and strengthening the exchange rate of the Korean won.

For example, Korea First Bank, which had the most serious liquidity problem, raised almost US$ 1 billion by the end of March 1997 by disposing of international securities (US$ 0.5 billion) and receiving deposits of part of the BoK's foreign currency assets (US$ 0.3 billion). According to a BoK report, once the BoK had allocated its international reserves to the DMBs' overseas branches, their ability to borrow from international banks appeared to get better, according to a BoK report (International Department in the Bank of Korea 1997c). For some banks, spreads for borrowing declined: Spread over Libor for O/N (overnight) money borrowed by the Seoul bank decreased from 0.50% to 0.40%, and that for the Foreign Exchange Bank and the Hanil Bank also decreased by 0.05% - 0.10 %.[23] Therefore, the Korean DMBs survived beyond March 1997 which was a period expected by international capital markets to be very difficult, because of the effects of the settlement of year-end accounts by Japanese banks and the aftermath of the Hanbo Steel's collapse.

The Second Banking Crisis

The borrowing of foreign funds again became difficult after the end of July 1997, soon after Kia Motors became the subject of the bankruptcy protection agreement (Table 5.15). Major damage came from international credit rating agencies which placed 11 Korean banks (not only the major DMBs but also special and development banks) on a watch list. Spread-over Libor for short-term funding by the DMBs increased to Libor plus 67 bp. Interest levels for overnight (O/N) borrowing also jumped. After 11 August 1997, some Korean financial institutions got into trouble: a couple of the overseas branches of

[23] These DMBs were the main creditors of Hanbo Steel.

the DMBs such as the Los Angeles branch of the Korea First Bank and the Chicago branch of the Commercial Bank were all recorded as being overdrawn (O/D). On 14 August 1997, the Dongnam Bank was only able to settle its liabilities with emergency support, i.e. additional deposits of foreign currency assets from the BoK. During this time, the liquidity problems of merchant banks were much more serious than those of the DMBs.[24] Japanese banks again reduced their exposure to Korean banks, in order to prepare their accounts for the half year.

Table 5.15 First and Second Banking Crisis Compared

	First	Second
Period	23 Jan – end March	15 July – 20 November
Stock market index	677 → 617	755.05 → 488.41
Won/Dollar FX rate	853.60 → 897	891.40 → 1035.50
Usable international reserves	US$ 27.2 bn (end Jan)→ 21.1 (end March)	US$ 25.7 bn (end July) → 7.3 (end Nov.)
Spread over Libor in funding Overnight Term loans	 17 bp (Jan.) → 27 (Mar.) 25 bp (Jan.) → 36 (Mar.)	 63 bp (Jul.) → 178 (Nov.) 55 bp (Jul.) → 124 (Nov.)
Reduction in credit lines	US$ 9.1 billion (between Feb. and Mar.)	US$ 9.0 billion (between 16 Jul. and Oct.)
Roll-over ratio (%)	115.4 (Jan.) → 109.0 (Mar.)	90.9 (Jul.) → 58.8 (Nov.)
Trade deficits (US$ billion)	7.4 (first quarter)	2.1 (third quarter)

Source: Derived from Board of Audit and Inspection (1998)

It is interesting to note that the situation was not so adverse just after Kia Motors collapsed but it deteriorated soon afterwards because the position of the government was not clear as to how it would deal with the Kia problem and whether it would help the company to repay its foreign currency liabilities. The credit lines of international banks to Korean financial institutions decreased rapidly, as Table 5.15 shows. Within a week of the Kia Motors collapse, credit lines had been reduced by US$ 0.51 billion; however, within the following two weeks, this reduction increased to US$ 1.45 billion, which was

[24] Details will be dealt with in Chapter 7.

believed to be the consequence of the government's obscure position (International Department in the Bank of Korea 1997e).

In contrast to the early 1997 period, development banks also had some difficulty in issuing CP and attracting further foreign funds; thus, the development banks could not fully support the DMBs and non-bank financial institutions. Moreover, the BoK's support for the DMBs by way of depositing its foreign currency assets with the overseas DMB branches was difficult since usable international reserve levels were rapidly decreasing. During the period of the first banking crisis, the BoK could increase its usable international reserve level by getting its foreign currency assets back from the development banks. Furthermore, September 1997 was the closing month of the first half of the fiscal year for Japanese banks. The further reduction of credit lines to Korean banks by Japanese banks worsened the situation.

The BoK was only able to allocate US$ 1 billion of its international reserves to seven of the major DMBs. It suggested that the government should announce clear and concrete measures to help foreign creditor banks owed money by Kia Motors before international rating agencies downgraded the ratings of Korean financial institutions. The BoK also tried to encourage the DMBs as well as development banks to attract foreign funds, by paying high interest rates, and asked them to re-lend those funds to other financial institutions which were experiencing a liquidity problem. The BoK argued that the high interest rates could be recovered from the secondary borrowers and that the primary borrowers would not suffer a loss. In view of the urgent situation, the BoK recommended the DMBs to obtain finance by short-term rather than long-term borrowings which would take longer to set up (International Department in the Bank of Korea 1997e).

In order to attract more foreign portfolio funds, the BoK encouraged investment trust companies to set up overseas funds enabling foreigners to invest in Korean securities and increased the ceiling on aggregate and individual portfolio investment by foreigners in the Korean stock market. As in the previous crisis of early 1997, the BoK also asked the DMBs to liquidate their foreign currency portfolio assets.

As the DMBs were having liquidity problems and had thus to withdraw their deposits with merchant banks, the liquidity of the merchant banks was seriously threatened. A regional DMB and seven regional merchant banks became virtually bankrupt. Without the support of the BoK by way of depositing its international reserves with the DMBs and the lending by the DMBs to the merchant banks, those banks would not have been able to settle their liabilities. As the DMBs had difficulty financing time deposits, the level of extremely short-term borrowings surged from US$ 4.3 billion as at the end of 1996 to US$ 7.3 billion as at 10 August 1997. Euro time deposits had terms of one, three and six-months but one-month term borrowings became the norm.

The Foreign Exchange Crisis in the Late 1997

The last 1997 crisis commenced late in that year after international credit rating agencies, such as Moody's and S&P, had at the end of October downgraded the credit rating of development banks. The banking crisis developed into a foreign currency crisis. Sovereign rating as well as ratings of special and commercial banks were lowered at the same time. During the latter part of October 1997, credit lines to the relatively healthy DMBs were further reduced by US$ 2 billion. The downgrade of the credit ratings might have been affected by the Hong Kong stock market crisis on 23 October 1997 but the continuous collapse of *chaebol*, uncertainty over the Korean government policy and the low level of international reserves in the BoK appeared also to have been critical.

As the placing of additional foreign currency deposits by the BoK with the DMBs and the making of call loans by relatively healthy banks to troubled banks became extremely difficult, the troubled DMBs and non-bank financial institutions rushed to buy foreign currency in the foreign exchange market and this made the market extremely volatile. Because international reserves in the BoK had almost dried up, the BoK could not supply the market with sufficient foreign currency. Usable international reserves were only US$ 13.7 billion as at 8 November 1997.

It was very clear that without emergency measures there would be a default within a month. The level of usable international reserves could only settle 1.1 month's import payments and was almost the same as the amount of foreign money invested in the Korean stock market. Both short-term borrowings and also matured long-term bank loans had to be repaid. Most financial institutions relied on the BoK's support for their settlement of foreign exchange transactions. The Finance Ministry decided to extend the foreign exchange rate band from ± 2.25 % to ±10% and asked for support from international financial institutions such as the IMF.

This late 1997 crisis was the final banking crisis during that period. From early 1997, some of the DMBs could not meet the demands for repayment of foreign funds by the international banks. By early November 1997, any further assistance from other banks, i.e. some of the strong DMBs and development banks, was not available. Most of the DMBs fell into de facto default. Without the foreign currency deposits allocated to the banks by the BoK on a day-to-day basis, most of the DMBs could not meet the repayment demands by international creditors in late November and December 1997.

Table 5.16 Credit Ratings of DMBs by Moody's *1)

(as at end of the period)

Bank	end-1995	Jan. 1997	end-1997	Apr. 1998
Choheng	A3	A3	Ba1	Ba1
Commercial	Baa2	Baa2	B1	B1
Korea First	A3	Baa1	B1	B1
Hanil	A3	A3	Ba1	Ba1
Seoul	Baa2	Baa2	B1	B1
Korea Exchange	A3	A3	B1	B1
Shinhan	A2	A2	Ba1	Ba1
Kookmin	A3	A3	Ba1	Ba1
Housing and Commercial	A1	A1	Ba1	Ba1
Hanna	-	Baa1	Ba1	Ba1
Boram	-	Baa1	Ba1	Ba3
KorAm		Baa1	Ba1	Ba1

*1) Long-term credit rating
* The top six banks were called 'six major banks.' The top seven banks were called 'seven major banks.'
Source: Ministry of Finance and Economy, *Data for Members of the Committee of Finance and Economy at the National Assembly,* October 1998.

Conflict within the Government over Crisis Management Policy

According to a BoK proposal on 25 August 1997, the most urgent task of the government was to remove doubts held by Korean and overseas investors on the viability of the domestic banks. Therefore, it felt that the government should put in place both emergency support measures for the financial institutions which faced serious financial difficulties and also measures to eliminate the bad debts owing to financial institutions. In this connection, the BoK recommended that the government authorise the central bank immediately to extend special loans to the Korea First Bank (KFB). Although there were many other banks including the Seoul Bank which were suffering from an increase in bad debts, support to the KFB had to take first priority because the bank was in the most serious situation and evaluation by S&P of the bank was pending. An immediate measure suggested by the BoK was that the BoK provide the KFB with Korean Won 2,500 billion at an interest rate of 3% per annum (Bank of Korea 1997b). What is remarkable was that this suggestion was rejected by the then Finance Minister, Kang Kyung-Sik, though the Department of Financial Policy in the Finance Ministry was sympathetic to the BoK's recommendation (Monthly Chosun 1999).

Throughout 1997 there had been conflict among the authorities as to how to deal with the *chaebol* and their creditor banks and this had delayed the introduction of the measures. This conflict and the resultant delay had a detrimental impact on foreigners' confidence in the Korean financial system. This by and large reflected the strong emergence of the 'market discipline' idea among senior officials such as the Finance Minister and Senior Advisor to the President on Economic Affairs.

Emphasis on 'market discipline' by those senior officials led to controversy not only among the Korean authorities but also among the domestic banks and foreign investors. It started with the statement of Senior Advisor to the President, Lee Seok-Chae, "Banks can go bankrupt" in January 1997, referring to those banks which were exposed to large loans to Hanbo Steel, which collapsed on 23 January 1997. The statement diminished the confidence of foreign investors in the Korean financial system, which was already fragile. In the wake of the collapse of Hanbo Steel, BoK indicated: "Due to the uncertainty as to how the government would deal with the company and its creditor banks, funding offers by international banks to Korean banks reduced to US$ 0.2–0.5 bn from 1.0–1.5 bn per day." (the International Department of the Bank of Korea 1997a)

In another report, the BoK also indicated that "The obscure position of the Korean government as to whether it would support the country's financial institutions exacerbated the foreign investors' worry about the institutions' ability to repay their external liabilities." (International Department in the Bank of Korea 1997e) As mentioned, the instability caused by the statement by Lee Seok-Chae had been redressed by a strong statement from the Governor of the BoK that the central bank would be responsible for the external liabilities of Korean financial institutions followed by additional foreign currency deposits in the DMBs by the BoK.

Senior Advisor to the President for Economic Affairs, Kim In-Ho, who was the successor to Lee Seok-Chae, stated: "The question of whether some companies would be bankrupt or not is to be judged by financial institutions." This was understood as a sea-change in dealing with insolvent companies; previously, the government had determined the answer to that question and had usually asked financial institutions to extend additional loans to those firms to ensure their solvency. Thus, financial institutions not only became unwilling to extend additional loans to companies whose financial structures appeared problematic, they also rushed to withdraw the loans they had previously made to the companies (Lee 1997).

Lee Seok-Chae established the Presidential Committee for Financial Reform on 11 January 1997, most members of which came from the private sector. Officials of the Financial Policy Department in the Finance Ministry were excluded from being members of that Committee. In the wake of the crisis, the Director of the Department stated in the Prosecutor's Office: "The committee was initiated by Lee Seok-Chae, consisted of people from private companies and banks and excluded officials of the Finance Ministry. Therefore, in many respects, there was a conflict between the presidential office and the Finance Ministry. Officials in the department of financial policy were angry about the establishment of the committee. It was set up when the term of the government had almost ended. The Finance Ministry was formulating various financial reform policies. We thought it was not acceptable because, all of sudden, the presidential office bypassed the ministry in relation to the establishment of the committee and constituted it with people who were not experts on finance." (Monthly Chosun 1999)

There was a conflict within the government on the issue of whether it would declare that it would guarantee the foreign debts of Korean financial institutions. The delay in supplying the KFB with special loans by the BoK in September 1997 was a result of the Deputy Premier, Kang Kyung-Sik's idea of 'market discipline' without regard to the stability of the financial market. The BoK suggested in relation to this issue: "Although the recent deterioration of foreign currency funding by Korean banks is basically blamed for the collapse of Kia Motors, it is also substantially traced to the uncertainty of the direction as to how the government would deal with Kia Motors and its creditor banks. Therefore, in order for the creditor banks to ease their difficulty in obtaining funding and to prevent the further downgrading of credit ratings, clear and concrete measures on the issues by the government is required as soon as possible (in especially for the KFB). In particular, the government measures including special loans and support of foreign currency funding by using international reserves of the central bank should be in place before international credit rating agencies adjust the credit ratings of Korean banks. S&P and Moddy's are expected to publish credit ratings of Korean banks between 21 and 31 August and between September and October 1997, respectively." (Bank of Korea 1997b)

Kang Kyung-Sik, however, opposed the proposed special loans to the Korea First Bank by the BoK. "Kang Kyung-Sik thought the bank, the KFB, should be responsible for the bad debts, caused by the collapse of the *chaebol* (Hanbo Steel, Sammi Steel, and Kia Motors etc) because the bank had made the loans to the *chaebol*. Accordingly, Mr Kang speculated that the suggested special loans to the KFB by the BoK at such a low interest rate of 3% were not consistent with the 'market discipline.' Initially, the officials in the department of financial policy had approved the suggestion." (Statement of Yoon

Jeng-Hyun, the Director of the Department of Financial Policy in the Finance Ministry). Eventually, the special loans were made but the amount of the loans was reduced to Korean Won 1000 billion from the original BoK suggestion of Korean Won 2500 billion, and the interest rate was increased from 3% to 8%.

In November 1997, there was confusion within the Finance Ministry over the authority for the management of foreign exchange, i.e. whether the Ministry (the Department of Financial Policy) should intervene in the foreign exchange market or completely delegate this to the BoK. This confusion and conflict within the government further undermined investors' confidence in the government's ability to protect the Korean financial system which had been already become unstable due to continued bankruptcies in Korea and the instability of the international financial markets.

5.7 Conclusion

This chapter has raised an important question, namely why relatively strict regulatory policy was applied to the DMBs compared to that over other types of financial institutions, i.e., development banks and merchant banks? Monetary targetting based on M2, which originated from a major policy objective of the BoK, stabilization, has been suggested as the explanatory factor for this regulatory policy. The precise form of capital account liberalization policy in relation to the operations of the DMBs was also partly affected by the BoK's concern that monetary growth should remain within a certain limit.

This chapter has argued, however, that such a regulatory policy objective was not implemented effectively in reality. Growth concern, reflecting private sector interests, interferred with the original regulatory objective applied to the DMBs in a number of areas and created regulatory complexity. Also, deregulation, in particular in the area of the issue of licences to conduct foreign exchange business, created structural weakness in the DMBs. The weakness was revealed well before 1997 by a jump in the Korean premium for foreign funding. Relatively strict prudential regulation of the DMBs by the BoK was often negated by the regulatory forbearance shown by the Finance Ministry during the mid-1990s.

In relation to the BoK's foreign currency deposits with Korean banks, the majority of the deposits (Type A deposits) were made in accordance with the wishes of the Finance Ministry, in order to achieve growth. When the deposits were due for repayment, the DMBs not only had to comply with the renewal of the deposits but required additional deposits from the central bank in order for them to settle their outstanding foreign currency liabilities. As previously indicated, prudential regulation/ supervision is crucial to restrain the moral hazard problem that banks inherently tend to have. In particular, where domestic banks intermediate foreign funds, they are exposed to greater risks than banks who do not; thus, there is a greater necessity for a prudential regulatory policy to stem this moral hazard problem (McKinnon and Pill 1998). This chapter has shown that the regulatory authorities in Korea, in particular the Finance Ministry, aggravated the moral hazard problem rather than restraining it, by extending special loans in won currency to the DMBs and depositing foreign currency assets with the banks.

Finally, this chapter has shown that during the course of the crisis the authorities failed to produce an effective and coherent crisis management policy. Such regulatory features certainly undermine the strong state arguments.

Ch 6 Development Banks in the Developmental State

6.1 Introduction

The existing literature on the crisis and the regulatory failure in Korea largely overlooks the role of the development banks in the developmental state. Haggard (2000) may be an exception but his interest in the development banks is also limited. He indicates the role of the Korea Development Bank (KDB), one of two wholly-owned government development banks in Korea, in relation to both the government's ownership of banks and the moral hazard problem. He explains that "Although the government's ownership of banks was not as extensive in Indonesia, neither was it trivial ... During the 1994-96 period, the Korean Development Bank increased credit for facility investment at a rapid pace. This lending signalled the government's commitment to larger projects, again raising moral hazard questions" (Haggard 2000: 29).[1] In other words, lending by the KDB to *chaebol* is criticized because it implied that the Korean government was committed to large projects, thus for encouraging Korean deposit money banks (DMBs) to extend credit for such projects.

Beyond those points indicated by Haggard (2000), this chapter illuminates the role of development banks in the government-financial sector-industry triangle. If

[1] The moral hazard problem raised by Haggard is one concerning domestic banks and the government. Other moral hazard problems arose between international investors and their governments and also between investors' governments and the governments of countries in which the investments were made.

authorities-DMBs-industry relations which were examined in Chapter 5 included strain and collusion at the same time (at least on the surface), the proximity of the Finance Ministry to industry brought about unlimited support for industry by the development banks. The Development banks were supervised by the Finance Ministry and the regulatory policy applied to them were much laxer than that applied to the DMBs. The business of the development banks frequently interferred with the stabilization objective of the Monetary Management Board of the Bank of Korea (BoK).

Section 6.2 examines the emergence, governance and objectives of the development banks. It describes the emergence in the 1960s of the KDB as a key financial institution for the enhancement of the country's economic development. Since their inception the development banks had supported the special interests of certain industries. The banks were owned by the government and behaved as if they were part of the Finance Ministry. Section 6.3 shows that the Finance Ministry imposed lax regulatory policy on the development banks. It also indicates that, due to the "full faith and credit" provision and the long-term oriented funding structure, the development banks could enjoy good credit ratings on a par with Korean sovereign ratings by international credit ratings agencies.

Section 6.4 reveals the conflict between the regulatory authorities' policy objectives in connection with the business of the development banks, i.e. growth (the Finance Ministry) and strict stabilization (the BoK). Evidence shows that the growth-oriented objective of the Finance Ministry, reflecting the special interests of the *chaebol*, interfered with the strict stabilization objective of the BoK. Section 6.5 reveals that the KDB and the Export-Import Bank of Korea (Ko-exim Bank), among other financial institutions, were the first and second biggest beneficiaries of the BoK's foreign currency deposits. The banks, however, repaid most of the deposits during the crisis period, thus postponing the onset of the impending crisis on the one hand and obscuring the level of international reserves of the country on the other.

Section 6.6 reviews the development banks' *chaebol*-oriented lending structure and the downgrading of the credit ratings of the development banks. As the development banks found it difficult to attract foreign funds and in view of the depletion of the international reserves, there was no option left for the government but to ask the IMF for help. Section 6.7 concludes this chapter and sets out the implication for the thesis.

6.2 Emergence, Governance and Objectives

The development banks were specialized banks, established to supply sufficient credit to special business areas. The biggest development bank, the KDB, was established in the early 1950s. Due to the lack of funding resources and professional expertise of the DMBs and the uncertain profitability of special business which was perceived necessary for economic development, the Korean government took the view that the DMBs could not supply such business areas with sufficient and necessary credits. Thus, between the

1950s and 1970s, the government founded several specialized banks including the development banks which had particular objectives (Bank of Korea 1999a).

The specialized banks were to promote the "balanced development" of the national economy in accordance with the legislation which established them, such as the Korea Development Bank Act of 1953. Development banks were distinct from other specialized banks in that the former concentrated on very large-scale industries, such as heavy and chemical industries, where long-term and large fixed capital is required, while the latter specialised in such areas as private accounts, house purchase loans and banking for Small- and Medium- sized Enterprises (SMEs).[2]

Emergence of Development Banks

After World War II, various types of development banks were set up by different countries to promote reconstruction and economic development. Development banks were different from the DMBs (or commercial banks) in that the object of the former was to support certain industries with low profitability where investments had long pay-back periods.

Development banks took different forms in different countries. While the source of funding in the development banks in developed countries was surplus funds from the private sector for long-term economic development projects, the role of the development

[2] The Kookmin bank (for private accounts), the Housing bank (for house purchase loans) and the Industrial bank of Korea (for SMEs) belonged to the latter category. When the special acts setting up these two banks were revoked in 1995 (the Kookmin bank) and 1997 (the Housing bank), they were then converted into ordinary

banks in developing countries was different in some countries. These banks were proxies acting for the government to invest and finance certain projects, or in other countries to supplement industrial financing by way of attracting domestic credit and foreign funds. The banks had the objective of supporting the country's economic development plan over countries (Korea Development Bank 1997). The banks were established either under general company law or special laws. The Industrial Development Bank of Israel was established under general company law, while Kreditanstalt fur Wiederaufbau (KfW) in Germany, Japan Development Bank and the KDB belong to the latter category (Korea Development Bank 1997: 29-30). The KDB was and is wholly owned by the Korean government.

The setting up of the KDB was a consequence of the industrial development-first policy of the government after the Korean War of 1950 to 1953. At the inception of the KDB, there was a controversy between the monetary stability-first policy and the industrial reconstruction-first policy (Korea Development Bank 1997). The former view was well-expressed by a recommendation of A.I. Bloomfield and J.P. Jensen of the New York FRB, who were asked at the beginning of the 1950s by the Korean government to construct a blueprint for the Korean financial system.

The US experts argued that as Korea had an agriculture-oriented economy, lacked spontaneous savings/capital accumulation and faced serious inflation, measures to deal with the inflation were the most important in terms of its monetary policy. Thus,

---

deposit money banks.

long-term credit business had to be carried out within the terms of the then General Banking Act and was required to be funded in such a way as would not cause inflation. The experts advised that establishing development institutions had to be postponed until US counterpart funds, which had been used to cover the Korean government budget deficits, could be used for economic reconstruction and other resources, which would not cause inflation, could also be mobilized. In this regard, the establishment of the KDB in 1954 meant that the government put an end to the controversy on policy and decided that the KDB should follow the industrial reconstruction-first policy. Long-term financial institutions in Japan were modelled on the KDB (Korea Development Bank 1997: 14-15).[3]

The Ko-exim Bank was founded "in order to establish a financial system, based on mid and long-term deferred-payment for exports, and thus enable exports to increase" (The Export-Import Bank of Korea Act). Although the Ko-exim Bank Act was passed in 1969, establishment of the Bank was delayed until 1976. This was because the size of business envisaged by the Act was so small that the government did not feel it necessary to establish an independent bank until then. Instead, the business envisaged by the Act was carried out by another special bank, the Korea Exchange Bank.[4]

[3] Article 1 of the Act of the Japan Development Bank, which served as the model of the KDB, prescribed that, "in order to reconstruct the economy and to promote industrial development, the bank aims at either supplementing or promoting financing of general financial institutions."

[4] When the Korea Exchange Bank Act was revoked, the bank became privatised and an ordinary deposit money bank.

The Korean government decided in 1976 to establish an independent expert credit agency. The Ko-exim Bank was established under the country's slogan of "Constructing a heavy and chemical industry export-oriented country" (The Export-Import Bank of Korea 2000: 614). During the early years after its inception, the Ko-exim Bank mainly supported the shipbuilding industry. Exports by the shipbuilding industry grew rapidly due to the support of the Ko-exim Bank for deferred payments.

Ownership and Governance

Three development banks existed before the crisis, two of which were owned by the government. The KDB was wholly owned by the government, while the major shareholders of the Ko-exim Bank were the Korean government (46.5%) and the Bank of Korea (37.3%) as at the end of August 1997.[5] These two development banks are investigated in this research.[6]

Of the two development banks, the KDB merits particular attention. The Ko-exim Bank was established in 1976 and its asset size was much smaller than that of the KDB. The Governor of the KDB had often been appointed by the former deputy Finance Minister. Also, the KDB Governor was often appointed as a new Finance Minister. The Development banks submitted their budget and business plan to the Finance Minister at

---

[5] The remaining 16.2% share of the Ko-exim Bank was owned by the Korea Exchange Bank which was owned by the Korean government. Thus, the Ko-exim Bank was de facto wholly government owned (Minutes of the Committee for Finance and Economy at the National Assembly, 14 October 1997).

[6] The third development bank was the Long Term Credit Bank of Korea (LTCB). Since this was a private bank, and its foreign currency liabilities and assets were much smaller than those of the other two development banks, the LTCB, established in 1980, is excluded from this research. The LTCB was merged into the Kookmin Bank in the wake

least one month before, i.e. by the end of November. For example, the KDB did so in accordance with Article 32 of the KDB Act. Presidents of the development banks were nominated by the President of the Korean government, by a prior recommendation of the Finance Minister. In particular, the president of the KDB was called 'Governor,' a title held by only one other bank president, namely, the President of the BoK. The title was intended to imply that the KDB was an important government institution rather than just an ordinary financial institution.[7]

Developmental Objectives of Defending Private Sector Interest

Establishing the KDB had been conceived as one of five pillars of the Korean financial system since the 1940s. According to 'Draft for Overall Financial Legislation' prepared by the then Korean government, the government was to establish five axes of the financial system, i.e. four government banks consisting of the central bank, the KDB, the foreign exchange bank and the people's cooperative bank (for ordinary households). In addition, there were the DMBs, owned and managed by private investors (Korea Development Bank 1997: 14). The Bank of Korea Act and the General Banking Act were approved in 1950 but founding the KDB was delayed until the end of 1953. This was because it was difficult to extract funds from the government to establish the KDB. In the wake of the Korean War, however, the need for the development of financial institutions to speed up the reconstruction of industrial facilities and the economy was strongly held within the government.

---

of the crisis.

[7] Testimony of the KDB Governor, Kim See-Hyung, before the Committee for

The Korea Development Bank Act was therefore approved at the end of 1953 and established at the beginning of 1954. Ko-exim Bank was founded in 1976 almost two decades after the KDB. The Ko-exim Bank aimed, during the latter half of the 1970s, to support the policy of developing the heavy and chemical industries. In this regard, it is clear that the establishment of the Ko-exim Bank itself was related to the special interests of particular industries, such as the shipbuilding industry. All the shipbuilding companies were the main affiliates of the *chaebol.*

Development Function and Targeted Industries

The KDB supported "important industries" which were prescribed in the KDB Act. Since its inception the KDB "aimed at supplying and managing funds for important industries, in accordance with the government policy." (Article 1 of the KDB Act of 1953) The important industries were specified by the government and reflected in the revisions of the KDB Act (in Article 18 until the 11th revision of 1997). At its inception, the KDB focussed on reconstructing the industrial facilities destroyed by the Korean War and on economic development. During the 1950s, it supported industries manufacturing products essential for the people's well-being and basic industries such as electricity and coal.

When the government started putting the First Economic Development 5 Year Plan into effect in 1962, the industries designated 'important' changed into basic industries and export and import substitution industries. The definition of basic industry extended to include the shipbuilding and steel industries in addition to those which had

---

Finance and Economy at the National Assembly of Korea, 1997.

previously been included such as electricity and coal. When the government targeted heavy and chemical industries during the 1970s, loans from the KDB were concentrated on the heavy and chemical industries, mainly the shipbuilding, steel, machine and export industries in order to strengthen Korea's international competitiveness (Korea Development Bank 1997: 28).

In the 1980s, the Korean government paid much attention to economic stabilization and industrial restructuring. Accordingly, the KDB strengthened its support for investment restructuring of the heavy and chemical industries and supplied credit to the electronics, automobile, semiconductor, and parts and material industries. During the 1990s, the focus was moved to the latest technology industry and Social Overhead Capital (SOC). As confidence in investment shrank due to the slump in exports, the KDB provided credits to facilitate exports and investment in equipment and increased its funding of overseas investment and of the latest technology industry. It also supported factory automation, energy-saving and the development of technology. After approval of the Act enabled private capital to fund SOC, the KDB also provided in the 1990s project financing for companies participating in SOC projects (Korea Development Bank 1997: 28). Article 18 of the KDB act divided 'important industries' into two categories: necessary industries and basic industries. Changes in the designation of "important industries" are shown in Table 6.1.

Table 6.1 Changes in Details of 'Important Industries' in the Article 18 of the KDB Act

	Situation	Definition
1953 (inception)	After the Korean War	Necessary industries for the stabilization of people's livelihood: fertilizer, cement and plate glass industries Basic industries: electronic power, coal industry.
Since 1962 (1st revision)	Outward-oriented economic development policy	Extension of 'basic industry' concept: electronic power, coal, shipbuilding and steel industries. Export and import substitution industries.
1970s	Heavy and chemical industry drive	Heavy and chemical industries: shipbuilding, steel, and machine industries. Export industry for strengthening international competitiveness
1980s	Economic stability and industrial adjustment	Industrial financing for industrial structural adjustment. Electronics, car, semiconductor, and parts and material industries
1990s	Encouragement of latest technology industry; Increase in investment confidence; Social Overhead Project	Funding for facilities, overseas investment, and latest technology. In addition, factory automation, energy savings, and technology developments are particularly supported. Project financing for companies participating in SOC

Source: Derived from the Korea Development Bank Act of 1953 and its Revisions.

Unlike those of the KDB, the areas focused on by the Ko-exim Bank were unchanged. According to a revision of the Act at the end of 1986, heavy industry goods were included in the deferred payment export scheme. Also, the revision enabled the Bank to support overseas investment by companies, in particular the locally-registered overseas affiliates of Korean companies.[8] Beneficiaries of such revision were general trading companies which were the main affiliates of the *chaebol.*

[8] In the wake of the crisis, as deposit money banks had difficulty in extending short-term trade credits to non-financial companies, the Ko-exim Bank started in September 1998 to transact short-term trade credit business. Before then, the bank did not

6.3 Regulatory Policy Applied to Development Banks

From their inception, the KDB and the Ko-exim Bank were almost exempt from the application of the BoK Act and the General Banking Act; thus, it was not subject to the regulation of the Monetary Management Board of the BoK. The KDB Act and the Export-Import Bank of Korea Act stated that the BoK Act and the General Banking Act did not apply to these development banks unless there was a certain provision in the KDB Act and the EXIM Bank of Korea Act. For example, Article 53 of the KDB Act prescribed that some provisions of the BoK Act and the General Banking Act would apply to the development banks but in only very limited areas.

These limited areas related mostly to the deposit-taking business. In other words, in relation to just a few areas, the development banks were subject to the regulations of the Monetary Management Board of the Bank of Korea, such as regulations on the maximum interest rates on deposits and on the reserve requirement ratio on deposits. The KDB, however, could only take deposits from limited companies which were the recipients of KDB loans and from local governments. As the value of deposits compared to aggregate assets was quite small, the influence of the BoK over the KDB business was negligible. The same was true for the Ko-exim Bank.

---

transact any discount or lending business with a maturity of less than 6 months.

In relation to prudential regulation/supervision, the regulation of an aggregate large exposure limit only applied to the development banks but in a very loose way. As already described, the limits to the KDB and Ko-exim Bank were 1500% and 1000% of the banks' equity capital, respectively: these were much smaller than that applied to the DMBs, i.e. 500%.[9]

The reasons for the regulatory exemption of the development banks from the Monetary Management Board's supervision were twofold. First, the development banks were non-monetary financial institutions in accordance with the standard of the IMF. Monetary institutions are defined as institutions whose major function is credit creation due to the bulk of the institutions' liabilities being demand deposits.[10] The second and more important reason was that the supervision of the Monetary Management Board over the development banks such as the KDB might disrupt the development banks' functions as the government's financial policy institutions (Korea Development Bank 1997: 30). In this regard, the development function took priority for the government over other policy objectives such as stabilization of the BoK.

Instead, development banks were under the supervision of the Finance Ministry and were controlled in accordance with the government's industrial financial policy. The

---

[9] In the wake of the crisis, the BoK Act and the General Banking Act are still not applied to the KDB. However, according to Article 25 of the MOU (Memorandum of Understanding) between the IMF and Korean Finance Ministry on prudential regulation, the Finance Ministry, the supervisory authority over the KDB, promised to apply the same prudential standards imposed over the DMBs to the development banks.

[10] As mentioned, the relative importance of KDB's demand deposits compared to its total liabilities was negligible.

KDB Act, until its ninth revision in January 1995, clearly stated its main objective in Article 1 of the Act as follows:

> "In accordance with government policy, the KDB finance and manage funds for important industries in order to stabilize the national economy and to promote industrial reconstruction ('development' since 1976 revision of the Act)."[11]

Although the KDB Act was revised twelve times before the crisis, provisions for the government's supervision over the bank remained. These provisions are summarized as follows:

- Business plan of the bank is required to have the prior approval of the government (Article 20 of the KDB Act).
- The government can guarantee the repayment of Industrial Finance Bonds issued by the KDB (Article 28).
- Only the government is able to invest in the bank (Article 47).
- The government appoints and dismisses executives of the bank (Article 48).

Among other provisions, however, the most important might be that the government would make good any losses of the KDB. Article 44 of the KDB Act, which is called the "full faith and credit" provision, reads as follows:

> "Losses of the KDB are to be made good from reserves or by the government if the reserves fall short of the losses." [12]

---

[11] The phrase "In accordance with government policy" was dropped in 1995 because it was thought it might violate the World Trade Organization ("WTO") rule of "prohibition of government subsidy to particular industries" and cause trade conflict with other countries.

[12] 'Full Faith & Credit' is a principle, recognized among states or between the Federal government and states in the United States on the basis of Article 4 of the US

Moreover, the government established the Korea Asset Management Corporation in 1962 which was to buy and dispose of any bad assets of the KDB.

Regulatory policy which was applied to the KDB was also applied to the Ko-exim Bank. The Bank of Korea Act and the General Banking Act did not apply to the KDB (Article 2 of the EXIM Bank of Korea Act). The bank had to submit to the Finance Minister its budget and business plan at least one month before the date it started (Article 32). The Bank was guaranteed by the 'full faith and credit' provision; losses would be made good from reserves and, if these were insufficient, the government would itself make good the deficit (Article 37). The Finance Ministry was required to supervise the business of the Ko-exim Bank (Article 39). Moreover, the Finance Minister could choose or dismiss the President and Directors of the Bank (Article 40).

Stable Funding Structure

As regards foreign currency funding by the development banks, the Finance Ministry favoured the development banks over the DMBs. The Finance Ministry determined the limits on long-term foreign funding by financial institutions for each year and the regulations of the term and the amount of such funding. This was called "Traffic control." During the period between 1992 and 1996, development banks were allocated as much as US$ 12.8 billion out of the total amount decided by the Ministry of US$ 25.2

Federal Act. Each state gives full faith and credit to legislation, documents and legal proceedings of other states and regards them as those of its own. The principle that the US Federal government is responsible for the liabilities of government institutions is accepted both by the US Federal government and other government institutions (Korea billion. The DMBs and non-bank financial institutions were allocated only US$ 7.6 billion and US$ 4.7 billion respectively during the same period (Table 6.2).

Table 6.2 Long-term Foreign Funding Allocated by Finance Ministry

(US$ billion)

	1992	1993	1994	1995	1996
Development banks	1.7	1.8	2.1	3.1	4.1
Deposit money banks	0.5	0.2	0.9	2.5	3.5
Merchant banks and leasing companies	0.3	0.4	0.6	1.4	2.0*
Total	2.5	2.5	3.6	7.0	9.6
Funding by non-financial companies	2.1	4.0	3.5	4.1	n.a.

* Merchant banks and leasing companies in 1996 funded only US$ 1.6 billion in international markets though those banks were allocated a limit of US$ 2.0 billion by the Finance Ministry.

Source: International Department in the Bank of Korea (1996a), International Department in the Bank of Korea (1996c)

The authority to issue financial bonds was another area where the development banks were favoured. The KDB was allowed to issue Industrial Finance Bonds guaranteed by the government. This was the major source of funding of the Bank. It was unusual when compared with the funding methods of other countries' development banks, the ratio of government funding in Korean development banks being relatively small. Also, the ratio of short-term foreign currency bonds to long-term foreign currency bonds had never been much higher than 10% throughout the 1994-97 period (See Table 6.3).

Development Bank 1997: 181).

Table 6.3 Liabilities and Equity Capital of the KDB (Banking Account only)*

(end of period, US$ million)

	1994	1995	1996	1997
Deposits	1446	1919	2091	2523
Deposits made by the BoK	6909	7366	6589	1389
Borrowing	6800	7772	9575	11969
Government	2752	2807	2757	1767
Special-purpose Funds	988	1068	1180	910
Foreign Capital Loan Funds	3060	3896	5638	9291
Industrial Finance Bonds	21567	26844	30865	28256
IFB in Won	14437	17025	18038	12964
IFB in Foreign Currencies (a)	6632	8326	10112	11613
Offshore Foreign Bonds	498	1493	2715	3678
IFB maturing within 1 year	*6876*	*9743*	*9744*	*7799*
IFB in Won	*6550*	*9271*	*8820*	*5721*
IFB in Foreign Currencies(b)	*305*	*323*	*595*	*1372*
<b/a>	*<4.6>*	*<3.9>*	*<5.9>*	*<11.8>*
Offshore Foreign Bonds	*20*	*149*	*329*	*706*
Guarantees	2307	3751	6010	6342
Other Liabilities	2151	2845	3250	3448
Total Liabilities	41180	50476	58367	53918
Total Equity	2051	2242	2460	2061
Total	43231	52718	60827	55979

* Trust Accounts is not included. But, the value of trust accounts was small, approximately one sixth of that of banking account.

Source: Korea Development Bank, *Annual Report of the KDB, 1995, 1996, 1997.*

The Ko-exim Bank also could issue long-term bonds, i.e. Export-Import Financing Debentures. The debentures and the BoK's foreign currency deposits were the Ko-exim Bank's major funding source. Full faith and credit-backing by the government was given to the debentures which were allowed to be issued in foreign as well as domestic currencies. The funding structure of the Ko-exim Bank was stable compared with that of the DMBs which relied on short-term bank loans by international banks. The banks hardly had any short-term borrowings until 1997 when the government asked the development banks to obtain all kinds of foreign currency funding, in order to increase capital inflows. Even in that year, the major source of foreign currency funding was long-term. Although the Korean DMBs did not succeed in attracting virtually any long-term foreign funds, the Ko-exim Bank attracted almost US $ 5 billion in that year by issuing its debentures in international capital markets (see Table 6.4). Issuing bonds was the major funding source for the bank's long-term assets while EXIM banks in other countries relied mainly on government funding (Table 6.5).

Table 6.4 Liabilities and Equity Capital of the Ko-exim Bank by Category
(US$ million)

Liabilities and Equity Capital	1994	1995	1996	1997
Borrowings	2992	3910	4486	3952
Borrowings in local currency	334	520	666	405
Borrowings in foreign currencies	2658	3390	3819	3548
Bank of Korea (National Investment Fund)	48	31	23	14
Bank of Korea Deposits	2040	2627	3209	289
Syndicated Banks	520	512	179	88
Others	50	221	409	3157*3)
Call Money	90	188	270	1825
Export-Import Financing Debentures*1)	1471	1994	2993	4966
Other Liabilities*2)	190	1211	1507	3593
Equity Capital	1283	1306	1236	880
Total	8457	8610	10492	15216

*1) All the Debentures were issued in foreign currencies.
*2) Proceeds from the Sale of Promissory Notes and Acceptances, Guarantees.
*3) Borrowings from international financial institutions such as World Bank, promissory notes sold, and other liabilities are included.
Source: Export-Import Bank of Korea, Annual Report, 1995, 1996, 1997.

Table 6.5 Ratio of Funding of Government Budget against Gross Funding in Exim Banks in Different Countries

(Unit: %)

	1996	1997	1998
US Exim*1)	89.9	91.9	92.4
Japanese Exim*2)	89.7	86.7	84.7
Taiwanese Exim*3)	92.0	82.2	85.9
Korean Exim *4)	20.0	10.1	15.2

Source: Export-Import Bank of Korea (1999), *Data for Members of the Committee for Finance and Economy at National Assembly, October 1999.*

Bank loans which were the main funding source of the deposit money banks were mainly supplied by international commercial banks, while bonds issued in international capital markets were bought not only by international commercial banks but also by investment banks and public and private funds. Thus, funding by way of issuing bonds could attract more foreign funds and had a longer-term maturity than that of bank loans. Moreover, international bond markets had secondary markets which had excellent liquidity. The issuing of bonds incurred lower costs than funding by bank loans.

Continued Capital Injections into Development Banks by the Government

Development banks have continuously mobilized resources from domestic and international capital markets for industrial financing. From the KDB's inception in 1954, most of its revisions of the KDB Act related to increases in the paid-in capital of the Bank. In its first revision in 1961, an intermediate military government regime, which had legislative power in the wake of the military coup d'etat, approved the increase of the KDB's paid-in capital from 40 million won to 20 billion won.[13] The

[13] In terms of the then money measure, the original paid-in capital 0.4 billion whan (the Korean currency unit until 1962) was increased to 200 billion whan. As a result

KDB was allowed by this revision to obtain foreign currency funding and it could also borrow from the BoK. In return, the limit for the issue by the KDB of industrial financing bonds was set at ten times its paid-up capital.

After the First Economic Development 5-Year Plan was successfully accomplished in 1968, the paid-up capital of the KDB was increased in order for the country to pursue continuous economic development in the new economic and financial climate. During the first half of the 1960s, new industrial financial institutions were established. Paid-up capital was increased to 70 billion won (a 3.5 times increase) and the increased capital was injected by the government. When the KDB attracted foreign funds, the government or the Korea Exchange Bank (then a special bank) could guarantee the repayment of the principal and interest on the borrowing. Moreover, the limit for the issue of industrial financing bonds was increased to ten times the paid-up capital and reserves.

In 1969 by its fourth revision, the government increased the KDB's paid-up capital to 150 billion (over two times the previous total) in order to increase the amount of investment by the KDB. Thereafter, as the drive to expand the heavy and chemical industries proceeded, the government strengthened the KDB's ability to borrow foreign funds by increasing its paid-up capital to 300 billion won (double the previous amount) in order to meet the increased demand for investment. The limit for the industrial financing bonds issue was increased again by disregarding the industrial financing

---

of currency reform on 10 June 1962, 10 whan became equivalent to 1 won.

bonds guaranteed by the government. Then, by further revisions of the KDB Act, the paid up capital was increased in 1995 to 500 billion won, in 1977 to 600 billion won, in 1981 to 1000 billion won, and in 1988 to 1500 billion won. In addition, by the revision of the Act in 1995, the limit for industrial financing bonds was increased to 30 times the paid-up capital plus reserves. In sum, the KDB's paid-up capital increased from 20 billion won in 1961 to 5000 billion in 1995, a 250 times increase. The limit for industrial financing bonds increased 750 times (250 x 3) on that in 1961. The balance sheet of the KDB greatly improved due to the increase in the amount of paid-up capital.

Revisions to the EXIM Bank of Korea Act were also aimed at enabling the Ko-exim Bank to increase its paid-up capital. This was initially Korean won 30 billion, all of which was injected by the Korean government. In the first revision of the Act at the end of 1974, the paid-up capital of the Bank was increased to Korean won 150 billion. At the end of 1977, the Ko-exim Bank's capital was further increased to Korean won 500 billion by the second revision of the Act. The capital was then increased at the end of 1986 to Korean won 1000 billion in the Act's third revision. At the beginning of 1998, the capital was further increased to Korean won 2000 billion and it is now Korean won 4000 billion.

In sum, development banks had many regulatory concessions not available to the DMBs. The biggest portion of the annual limit within which Korean financial institutions could attract long-term foreign funds was given to the development banks. Also, the Finance Ministry gave the development banks the exclusive right to issue long-term bonds where the DMBs could not. In addition, it gave explicit guarantees to the development banks represented by the "full faith and credit" provisions of related acts. Moreover, the Korean government had continued to inject additional capital into the development banks from time to time. These measures made the balance sheets of the development banks sounder than those of the DMBs. Accordingly, international credit ratings agencies regarded the credit ratings of the development banks as the most important in Korea (see Table 6.6).

Table 6.6 Changes in Credit Ratings of KDB and Ko-exim Bank by International Credit Ratings Agencies

Moody's			S&P		
Date	LT deposits*	ST deposits**	Date	LT deposits	ST deposits
1996	A1	P-1	1995	AA-	A-1+
5 Aug 1997	On Watch***	On Watch***	6 Aug 1997	(negative)	
28 Oct. 1997	A1(RPD)****	P-2	24 Oct. 1997	A+ (Neg.)	A-1
28 Nov.1997	A3(RPD)	P-3	25 Nov. 1997	A- (Credit Watch, Negative)	A-2
10 Dec. 1997	Baa2(RPD)	NP	10 Dec. 1997	BBB- (Credit Watch, Negative)	A-3
22 Dec. 1997	Ba1(RPD)	NP	22 Dec. 1997	B+ (Credit Watch, Negative)	C

*Long-term deposits ** Short-term deposits *** Possible downgrade announced. **** Review of Possible Downgrade

Source: Moody's, S&P, 2001; Korea Development Bank, 1999; Ko-exim Bank, 1999

Table 6.7 Credit Rating Structure of Credit Ratings Agencies

Grade	**Moody's**	**S&P**	**Grade**	**Moody's**	**S&P**
Eligible to invest			Not desirable to invest (Junk)		
1	Aaa	AAA	11-13	Ba1- Ba3	BB+ - BB-
2-4	Aa1- Aa3	AA+ - AA-	14-16	B1-B3	B+ - B-
5-7	A1- A3	A+ - A-	17	Caa	CCC
8-10	Baa1- Baa3	BBB+ - BBB-	18	Ca	CC
			19	C	C

Source: Moody's, S&P, 2001.

6.4 Conflict between Growth and Stabilization Objectives

The regulatory authorities in Korea restricted the annual amount of long-term foreign currency funding of financial institutions and the use of the proceeds. The restriction aimed at ensuring economic growth with macroeconomic stability. It should be noted, however, that there was significant variation between the authorities' attitude towards the development banks and towards the DMBs.

Evidence shows that the government's concern regarding economic growth (the Finance Ministry) took precedence over the monetary stability objective (the policy priority of the central bank) where they were in conflict. Above all, the KDB was allowed to borrow foreign currency in order to fund its lending in won currency though the central bank complained about it due to its threatening monetary stability.

The authorities restricted the use of the proceeds resulting from foreign currency funding. For example, there were restrictions on the use of the proceeds from issuing securities in overseas capital markets, such as foreign direct investment of Korean corporates. The rationale behind this was that those funds would quickly and heavily inflow unless restricted because there was a significant gap between the interest rates of the domestic and the international financial markets. Such flows into the economy were perceived to bring about a significant appreciation of the exchange rate of the won, the Korean currency, against foreign currencies. The appreciation of the foreign exchange rate for the won was then expected to reduce Korean exports and the inflows would cause a rapid increase in monetary growth thus undermining the stability of the economy.

However, the policy considerations for the stability of monetary growth as well as foreign exchange rates were not strictly applied to the funding of the development banks and the use of the proceeds. The KDB attracted foreign funds as a source for won (Korean currency) loans. After having financed foreign funds, for example by issuing industrial finance bonds abroad, the proceeds were sold on the Korean foreign exchange market. The won currency funds realised were used to fund won currency loans. Since funding costs in international capital markets were much lower than those in the domestic market, the KDB benefitted from a substantial profit compared to the DMBs, although interest rates on the KDB's lending were lower than those of the DMBs.

The effect of this was the same as a big increase in commercial loans which had been strictly prevented until the beginning of 1997 for monetary growth and foreign exchange rate appreciation. The BoK calculated that the foreign funds sold in the foreign exchange market by the KDB to fund its won currency loans were between 12 and 49 per cent of the monetary increase from the foreign sector during 1992–95 periods and 21-59 per cent of the monetary growth (M_2). Also, the foreign currency inflow resulted in the appreciation of the foreign exchange rate. In the period 1992-95, the inflows were calculated to have caused a 0.45-1.24 per cent appreciation in the won (see Table 6.8) (International Department of the Bank of Korea 1996a).

Table 6.8 Won Currency Lending Denominated in Foreign Currencies by the KDB and Monetary Growth

(US$ billion)

	1992	1993	1994	1995
Foreign Funds Financed by the KDB	1.6	1.6	1.7	2.0
Increment in foreign currencies nominated Won currency loans	1.2	1.4	1.3	1.5
The ratio of foreign currencies nominated Won currency loans against Won currency financing (%)	52	54	49	60
Foreign currencies sold in foreign exchange market by the KDB (A)	0.6	1.3	1.6	1.7
Monetary growth caused by Foreign Sector (B)	5.2	6.7	3.3	3.6
Monetary Growth (M_2) (C)	2.3	6.2	2.7	5.3
A/B (%)	11.5	19.4	48.5	47.2
A/C (%)	26.1	21.0	59.3	32.1

Source: International Department of the BoK (1996a)

The interest rate gap between the KDB's borrowings and loans in won currency but denominated in foreign currencies was much higher than the interest gap between the DMBs deposits and loans. During 1992-95, the KDB's margins were 1.6-2.8% for US dollar denominated loans and 1.9-4.4% for Japanese yen denominated loans while the DMBs margins were only 1.4-1.8%. Thus, the development banks made good profits from this business.

6.5 The BoK's Foreign Currency Deposits with the Development Banks

Among the Korean financial institutions, the KDB and the Ko-exim Bank were the first and the second biggest recipients of the BoK's foreign currency deposits (Table 6.9). The outstanding balance of the BoK's foreign currency deposits with the KDB was US$ 4.5 billion as at the end of September 1996. It was 22 per cent of the

BoK's total foreign currency deposits with all Korean financial institutions and more than three times its average deposit with the six main DMBs (International Department in the Bank of Korea 1996b).

Table 6.9 BoK's Foreign Currency Assets with Banks (as of end March1996)

(US$ billion)

	Foreign currency business funds	Foreign currency loans funds[1)]	Overseas portfolio investment funds	Foreign debt's early repayment funds[2)]	Total	
					Amou -nt	%
(1) DMBs	10.4	6.0	0.3	2.2	18.9	56.7
Korea Exchange Bank	1.6	0.5	0.3	1.0	3.3	9.9
Choheng	1.2	0.8	-	0.3	2.3	6.9
Commercial	1.4	0.2	-	0.4	2.0	6.0
Korea First Bank	1.5	0.8	-	0.2	2.5	7.5
Hanil	1.2	0.7	-	0.2	2.1	6.3
Seoul	0.8	0.5	-	0.2	1.5	4.5
Shinhan	1.1	0.3	-	0.2	1.6	4.8
(2) Dev. Banks	7.4	1.6	0.7	1.7	11.4	34.2
KDB	4.5	1.1	0.4	1.3	7.3	21.9
Ko-exim Bank	2.4	-	0.3	0.0	2.7	8.1
LTCB	0.5	0.5	-	0.4	1.4	4.2
(3) Regional banks	1.0	0.7	-	0.0	1.7	5.1
(4) Specialized banks	0.6	0.6	-	0.1	1.3	3.9
(5) Foreign banks	-	-	-	0.03	0.03	0.1
Total((1)-(5))	19.4	8.9	1.0	4.0	33.3	100.0

1) For the use of the import for facility goods and for the automation of SMEs (Small and Medium-Sized Enterprises).
2) No more deposits were to be made.

Source: Foreign Currency Planning Team of the International Department in the Bank of Korea (1996)

This was certainly good for the development banks and a result of regulatory favours by the Finance Ministry. The interest rates on the BoK's deposits were lower than the development banks would have had to pay in international markets and the deposits were almost automatically renewable at least until the end of 1996. A BoK document indicates that the KDB could easily increase the BoK's foreign currency deposits with the KDB by regular consultations with the MoFE. When the KDB was successful in persuading the Finance Ministry to authorise additional deposits from the BoK, the Finance Ministry ordered the BoK to make further deposits with the KDB (Foreign Currency Planning Team of the International Department in the Bank of Korea 1996).

For example, the Finance Ministry was interested in increasing the ability of domestic financial institutions to transact international business and thus it asked the BoK to deposit a portion of its foreign reserves with certain banks. The Development banks rather than the DMBs were chosen to be the recipients. After 1988 when the country had experienced a series of trade surpluses for the first time in its history, the BoK started to make foreign currency deposits to fund the foreign portfolio investments of Korean financial institutions. Only three banks, two of which were development banks and one a specialized bank, were the recipients of the funds: the KDB, the EXIM Bank of Korea, and the Korea Exchange Bank (KEB).[14] In addition to the receipt of these funds, which eased the funding of overseas portfolio investments, the regulations in respect of such investments were relaxed.

The policy of providing funds to support overseas portfolio investment was criticized by the Board of Audit and Inspection (BAI) for violating the original spirit of the foreign currency deposit scheme.[15] Hence, the BAI asked the BoK either to

---

[14] At that time, the KEB was owned by the Korean government. It was privatised at the end of 1989. Most countries did not then levy any tax on public institutions. Now, the exemption from taxation does not apply to public or private institutions except for the treasury securities of Japan.

[15] The argument of the BAI was that as the international business of those three

discontinue the deposit scheme for the three banks or to give the banks which had received the deposits a low priority for further funding (Foreign Currency Planning Team of the International Department in the Bank of Korea 1996). In April 1988 at the inception of the scheme whereby foreign currency deposits were made, US$ 0.2 billion was originally deposited with the KDB and the KEB. In September 1989, the amount increased to US$ 0.4 billion for the KDB and US$ 0.3 billion for the KEB. In August 1990 the Ko-exim Bank joined the group of recipients of the funds and US$ 0.3 billion were deposited with that bank.

Interest rates for the deposits were London Inter-Bank Bid Rates (LIBID) and the maturity was one year. The funds had been almost always automatically renewed. The Finance Ministry requested the BoK in August 1988 to allocate funds to the selected banks within the limit of US$ 1 billion. Since 1994, the BoK was allowed to consider profitability when depositing its foreign currency assets and thus could exert partial autonomy in determining how much of its foreign currency assets it would allocate to the three banks for overseas portfolio investment. The allocation for the KEB increased while that for the other two development banks declined or was static (Table 6.10). The source of the funds was the foreign exchange equilibrium fund of the Finance Ministry.[16]

---

banks had extended together with increased competition among domestic banks, such deposits with those banks would be against the principle of equity and would violate fair competition among banks (Foreign Currency Planning Team of the International Department in the Bank of Korea 1996).

[16] In order to maintain stability in the foreign exchange rate, a fund called the 'foreign exchange equilibrium fund' was established by the Finance Ministry. The fund was entrusted to the BoK which used it to intervene in the foreign exchange market.

Table 6.10 Allocation of Foreign Currency Assets for Overseas Portfolio Investment (a variety of the BoK's foreign currency deposits)

(US$ billion)

	KDB	Ko-exim Bank	KEB	Total
22nd Apr. 1988	0.2	-	0.2	0.4
6th Sep. 1989	0.4	-	0.3	0.7
9th Aug. 1990	0.4	0.3	0.3	1.0
28th Apr. 1994	0.38	0.315	0.305	1.0
28th Apr. 1995	0.38	0.315	0.305	1.0
27th Apr. 1996	0.379	0.31	0.311	1.0

Source: International Department of the BoK (1996b)

6.6 Bad Loans, Crisis and Downgrade of Credit Ratings

It is worth noting that the KDB was used as a means of temporarily averting the failure of some of the DMBs. The KDB repaid most of the BoK's foreign currency deposits during 1997 and supplied foreign currency call loans to the DMBs. In order to fund these loans, the KDB vigorously borrowed substantial foreign funds in international capital markets-more funds than it actually needed. Following the repayment of foreign currency deposits by the KDB, the BoK was able during the first nine months of 1997 to support Korean financial institutions without using a substantial portion of its international reserves. During the course of 1997, the KDB and the Ko-exim Bank repaid part of the BoK's foreign currency deposits held at the end of 1996,

---

Although the foreign currencies obtained as the result of the intervention were managed by BoK, the ultimate decision as to how to use the foreign currencies was taken by Finance Ministry.

i.e. US$ 5.2 billion and US$ 2.9 billion, respectively.[17] However, there was an adverse effect resulting from the active role of the KDB in supporting other banks and repaying the BoK's deposits; the repayment may partly have served to obscure the country's vulnerable financial position in particular in relation to the level of international reserves.

When at the end of October 1997, Moody's downgraded the credit rating of the KDB from A-1 to A-2 for long-term deposits and P-1 to P-2 for short-term deposits, the KDB could no longer borrow substantial foreign funds. The rating agency blamed the rapid growth of short-term external liabilities and the instability of the financial system on the collapse of a number of *chaebol.*

Chaebol- Oriented Business and Increase in Bad Loans

In fact, the large companies-oriented lending structure of the development banks resulted in huge bad loans during the crisis period. As at the end of August 1997 lending to the 30 biggest *chaebol* by the KDB was 15476 billion won, which shared 30.2% of lending in total. Lending to SMEs was only 23.5%. The rest went to large companies which did not belong to the 30 biggest *chaebol.* Accordingly, loans to large companies including *chaebol* reached 77% as at the end of August 1997. This emphasis on large companies was inevitable because the KDB supplied large companies with funds for facilities investment and the ratio of SMEs among the aggregate facilities investment in Korea was under 5%. As a result of the bankruptcy of a couple of

[17] In the case of Ko-exim Bank, however, it repaid US$ 2.2 billion on 23 December 1997 after the Bank received loans from international financial institutions.

chaebol in 1997, bad loans increased from 277 billion to 3027 billion won, which amounted to 5.9% of lending in total of the KDB (Minutes of the Committee of Finance and Economy at the National Assembly, 11 October 1997).

The KDB entrusted the function of loan screening to its subsidiary, Korea Management Consulting and Credit Rating (KMCC), which was one of three credit ratings agencies in Korea. However, the credit ratings of the KMCC were not credible. Commercial paper of 44 companies, which had credit ratings by the KMCC, were liquidated between 1993 and October 1997; none was rated as junk bond.

A representative example was the lending by the KDB to Hanbo Steel. Although the debt against equity ratio of the company was 3200% in January 1997 when it was liquidated, the KDB extended as much as 1245 billion won, which amounted to 8% of the total loans of the KDB and 23% of total borrowing of the Hanbo Steel from financial institutions. What was important is not only the amount of lending to such a bad company, but also the fact that the KDB started to fund Hanbo's facility investment at the end of 1992 when the then presidential election resulted in the victory of Kim Young-Sam, the ruling party's candidate. It was believed that the founder of Hanbo supplied Kim Young-Sam with a large number of donations during the election period (Minutes of the Special Investigation Committee on the Crisis at the National Assembly, 21 January 1999). This shows that the government-wholly-owned bank was particularly volatile to special interest. After that, the KDB and the Korea

---

Only US$ 0.7 billion of this sum was funded from the bank's own resources.

First Bank provided funds for Hanbo Steel's facility investment which resulted in bad debts after all.

Too much attention to the *chaebol* was also observed in the lending structure of the Ko-exim Bank. Lending to the 30 biggest *chaebol* was 9557 billion won, which comprised 73.6% of total lending of the Ko-exim Bank. Eighty-three per cent of this lending went to the five biggest *chaebol* as at the end of August 1997 (Minutes of the Committee of Finance and Economy at the National Assembly, 14 October 1997). However, in the case of the Ko-exim Bank, it did not suffer from the problem of bad loans during the crisis period for the authorities explicitly guaranteed the validity of the five biggest *chaebol* and supported them.

Downgrade of Credit Ratings

It is now very clear that the downgrading by international credit ratings agencies of credit ratings for the development banks as well as the sovereign rating in the fourth quarter of 1997 forced the authorities to prepare for doomsday. In particular, the downgrading in October 1997 was the first time since 1996 that the Korean sovereign rating and that of the development banks (ratings of these banks were the same as that of the sovereign rating) had been downgraded (see Table 6.6). The international rating agencies thus indicated their belief that, in view of the shrunken size in its international reserves and the large number of non-performing assets held by Korean banks, the liabilities of Korean financial institutions could not be met even with support from the Korean government.

A series of downgradings followed thereafter which weakened the position of the Korean government in its negotiations with the IMF. To add to the problems of the Korean economy, the downgraded development banks could no longer fulfil their role after they had been downgraded. During the remainder of 1997, the Ko-exim Bank could not attract any additional long-term foreign funds. The KDB could still borrow foreign funds but the sums available were substantially lower than those in the previous period in 1997. The KDB borrowed US$ 3.85 billion on a long-term basis during the course of 1997 of which US$ 3.33 billion was borrowed between January and September 1997.

Apart from credit ratings for long-term and short-term deposits which are well-known, there was another credit rating category set by Moody's based on the 'financial strength' of financial institutions. Moody's assigned the ratings of 'financial strength' for the first time to four development banks in Asia, including the KDB.

The rating for 'financial strength' for the KDB was E+, an intermediate category between D and E, at the end of July 1997. E was the lowest grade for financial strength. In evaluating 'financial strength', Moody's considered "bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification." It also took into account "other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision."[18] The probability of external support and sovereign actions was excluded in assigning the rating of 'financial strength,' according to Moody's.

However, Moody's credit ratings continued to be high for long-term and short-term deposits with development banks until the end of October 1997. International credit ratings agencies did not downgrade the credit ratings of the KDB and the Ko-exim Bank but Moody's placed them only on a 'Watch' list. Prior to that the ratings for the development banks were A1 (for Long-term deposits) and P1 (for Short-term deposits) for Moody's, and AA- and A-1+ for S&P (Table 6.6). A1 was the fifth highest grade for long-term deposits and A1 was the highest for short-term ones (Table 6.7). AA- was the fourth highest grade for long-term deposits by S&P. This implies that Moody's was sending a mixed but rather positive signal to the market over the credibility of the KDB.

The reason for these high ratings for the development banks was the credibility of the Korean government. With reference to the bailout of Kia Motors in July, Moody's stated in August 1997 that "(it) expects Korea to put the right economic

---

[18] Moody's, *Rating Definitions on Bank Financial Strength Ratings*, http://www.moodys.com. D is assigned to banks, which possess adequate financial strength, but may be limited by one or more of the following factors: a vulnerable or developing business franchise; weak financial fundamentals; or an unstable operating environment. E is assigned to banks which possess very weak intrinsic financial strength, requiring periodic outside support or suggesting an eventual need for outside assistance. Such institutions may be limited by one or more of the following factors: a business franchise of questionable value; financial fundamentals that are seriously deficient in one or more respects; or a highly unstable operating environment.

policies in palace to stem its debt buildup, based on the country's past prudent economic management."

On 25 August, the Korean government announced its 'Comprehensive Measures for the Stability of the Financial Market' contingency plan, which included a government guarantee of the liabilities of banks to foreigners and a guarantee by the KDB of the liabilities of finance companies to foreigners. The measures also included the provision of special liquidity to the KFB (Korea First Bank) whose difficulties were one of the main factors causing the instability of the financial system.

International investors appeared to react positively to the measures. The KDB was very successful in borrowing US$ 1.5 billion in international capital markets in mid-September 1997, two weeks after the measures came into effect. Experts in capital markets took the view that Korea had got over its liquidity problem when they saw the successful launch of Global Bonds by the KDB.[19]

In sum, the downgrading of the development banks' credit ratings arose from doubts as to the capability of the Korean government to honour the country's gross external liabilities in view of the relatively small size of its international reserves.

[19] Interview with Mr Won-Keun Kim at the KDB in January 2001. Mr. Kim has, since 1992, been in charge of issuing bonds of the Bank in international capital markets. He asserted, "when the KDB was successful in launching its global bonds, which was better than expected in terms of the amount and the term, experts in international capital markets came to think that Korea was getting out of the then difficult situation. But when another special bank, Industrial Bank of Korea went to the market to issue bonds at the end of September, the situation suddenly worsened."

6.7 Conclusion

The strong support of the development banks for industry, in particular industries dominated by the *chaebol*, implies the Finance Ministry's proximity to industry. The regulatory authority favoured the development banks over other financial institutions. Some policies, such as the use of the proceeds of foreign currency funding for won currency lending, obstructed the strict stabilization objective of the BoK. Such policies, along with a large portion of the BoK's deposits with the development banks, enabled the development banks to supply large credits to industry.

The business of the development banks was closely related to the special interests of the *chaebol.* The vagueness of the definitions of important industries in the KDB Act may have facilitated the intrusion of political /special interests into the lending processes of the KDB, while the Ko-exim Bank consistently served the special interests of the five biggest *chaebol*, such as the shipbuilding industry. Due to their subordination to the Finance Ministry, the banks were particularly volatile to the special interests of the *chaebol* who were able to mobilize the support of politicians, as shown in the case of Hanbo Steel. In this regard, the development banks were located at the centre in the government-financial sector-industry triangle of the developmental state.

Chapter 7 Regulatory Policy and the Merchant banks

7.1 Introduction

This chapter explains the political economy of the regulatory policy applied to the merchant banks in Korea before the 1997 crisis. The regulatory policy applied to the merchant banks has attracted much attention in the literature on the crisis. In particular, the literature indicating regulatory failure in the Korean financial system has focused on the regulatory policy imposed on merchant banks. Haggard (1999) argues that "The creation of new merchant banks and the liberalization of the CP (Commercial Paper) market was a major factor in the expansion of short-term financing; it is also a case study in how financial reforms can be captured not only in their implementation but in their basic design." It is also claimed that "Leading this rapid build-up of short-term foreign debt were the inexperienced merchant banks (officially called 'merchant banking corporations'), newly licensed by the Kim government in the name of financial liberalization – nine of them in 1994, and fifteen in July 1996, in addition to the six that existed before the 1993 financial liberalization" (Chang, Park, and Yoo 1998: 738).

It should be noted, however, that as Table 5.7 shows in Chapter 5, the size of the external liabilities of the merchant banks was much smaller than those of the deposit money and development banks. This chapter argues that regulatory failure over the merchant banks occurred against the backdrop of the confluence of the developmental financial system during the 1960s and 1970s and the domestic financial liberalization during the 1980s, which allowed the setting up of a large number of Investment Finance Companies (IFCs). Against a backdrop of those factors, the relaxation of entry barriers to merchant banking business for the IFCs during the mid-1990s led to the merchant banks engaging in some risky business which ignited the instability of the foreign exchange market in 1997. Such relaxation of entry barriers goes back to the "New Economy Plan" in the new Kim Young-Sam government in 1993, which was clearly a growth-oriented policy, reflecting private sector interest.[1]

That is, this research confirms the argument that the regulatory failure was largely due to the strong influence of the special interests of *chaebol* and construction companies. This chapter differs from the existing literature by showing the way in which such failure occurred. Changes in micro-level institutional characteristics, such as change of ownership of the merchant banks, the central role of the Finance Ministry in the regulatory policy applied to this sector and the adverse effects of financial liberalization are important in understanding how such regulatory failure occurred.

Section 7.2 reviews the historical background of the IFCs established during the 1970s and 1980s, after which some became deposit money banks (DMBs) and securities companies. On two occasions in 1994 and 1996, twenty-four remaining IFCs were transformed into merchant banks. Two related explanatory factors are emphasized for the emergence of non-bank financial institutions (NBFIs), in particular the IFCs and late-comer merchant banks. The existence of a curb market, which was unavoidable under the

[1] Reduction of entry barriers was included as a policy of the plan.

repressed financial system of the developmental state, and the government's endeavour to legalize the curb market, are described. Section 7.3 investigates the change in ownership of the merchant banks, from foreign investors to Korean *chaebol* and big companies and the preponderance of loans made by merchant banks to *chaebol*.

Section 7.4 describes and explains the regulatory policy imposed over the IFCs and merchant banks. Regulatory liberalization during the 1980s and 1990s provided the banks with serious competition, while the Finance Ministry did not try to impose any prudential regulation over the sector due to the close business-government relations. Section 7.5 compares the asset and liability structure of a group of merchant banks, which existed prior to 1994 (hereafter 'group A'), with another group of merchant banks, which had been converted into merchant banks from IFCs in 1994 and 1996 (hereafter 'group B'). While the merchant banks in group A were relatively stable during the crisis, the ones in group B, which were strongly influenced by the special interests of the *chaebol* and some construction companies, were *de facto* insolvent during that period. Section 7.6 sets out the implications for this thesis.

7.2 Historical Background of the IFCs and Merchant Banks

Repression of the financial system in the 1960s and 1970s brought about a dual structure in the Korean financial market which was divided into a regulated market and an unregulated one. The former was an institutionalized area, characterised by policy loans and low interest rates, while the latter was a curb market where relatively high interest rates, which were close to market interest rates, prevailed. The gap between the interest rates in each market gave investors the opportunity for interest arbitrage (Lee 1985: 217).

The financial situation of non-financial corporations had deteriorated at the beginning of the1970s. Non-financial corporations, which observed rapid economic growth in late the 1960s, continued to attract substantial investments based on the assumption that economic growth and government support for the corporations would continue. The major source of the investments was loans from domestic banks and foreign currency loans from abroad. Insofar as the rate of inflation increased and the foreign exchange rate was relatively stable, real funding costs for investment would be relatively cheap. However, as the government depreciated the won (the Korean currency) by 18% in 1971 in order to boost its exports, large corporations experienced severe funding difficulties.[2] Accordingly, the debt-to-equity ratios jumped and dependence on the curb market increased. Thus the curb market flourished and the funding costs of the corporations increased substantially due to the high interest rates of the curb market (Park 1985: 189). In addition, the Korean government intended to transform its economy, from being labour-intensive light industry-oriented to heavy and chemical industry-oriented. Hence, the government wanted to provide active support to non-financial corporations.

[2] The trend of high growth in the late 1960s had slowed at the beginning of the 1970s. The economic growth rate, which was 11.1% during the period of 1966-69, decreased to 8.2 % in 1970-71, while the consumers' price index jumped from 11.3% during the period of 1966-69 to 14.7% in 1970 -71. The export growth rate slowed down and corporate balance sheets deteriorated greatly; for example, return on aggregate

Against this background, the Korean government on 3 August 1972 introduced an emergency policy measure called the "Presidential Orders regarding Growth and Stability of the Economy" (hereafter '3 August Measure'). The main contents of the measure were as follows (Park 1985: 190):

- Private loans (as compared with loans made by financial institutions) had to be reported to the authorities by the corporate borrowers and the curb moneylenders; the loans should be either convertible into equities or repayable with a low monthly interest rate of 1.35%.[3]
- Korean won 200 billion of short-term loans from banks were converted into loans payable after five years with an 8% annual interest rate payable after a 3-year grace period.
- Annual interest rates payable by financial institutions were reduced: 12.6% from 17.4% for long-term deposits and 15.5% from 19.0% for short-term loans.
- A "Short-term Financial Business Act" was enacted on 17 August 1972.[4] Under the terms of this Act, IFCs could be incorporated.

Emergence of Investment Finance Companies

IFCs were NBFIs transacting short-term financial business. In accordance with

---

capital decreased from 5.3% in 1968 to 2.5% in 1970.

[3] The monthly interest rate in the curb market was 3.25%, i.e. 40 % per annum.

[4] There were two more Acts, aimed at legalizing the curb market: the Mutual Savings and Finance Company Act and the Credit Union Act. Together with the Short-term Financial Business Act, those three acts were called "Three Acts for Legalizing Curb Money."

the "Short-term Financial Business Act," the government authorized the formation of IFCs "In order to channel curb loan funds to ordinary funds in the financial market, and to ease the circulation of short-term funds by way of the issuing or underwriting of commercial paper" (Article 1 of the "Short-term Financial Business Act" of 1972).

The model for the IFCs was the short-term finance companies in Thailand (Kang 2000). The first IFC was the Korea Investment and Finance Co., founded with investment from the International Finance Corporation, a subsidiary of the IMF.[5] Between 1972 and 1974, six IFCs in Seoul and four IFCs in local areas were established. In order to support business in local areas, nine more IFCs were established outside Seoul between 1979 and 1981. When financial scandals in relation to the curb market occurred in 1982, twelve additional IFCs were allowed to be established in order to absorb the curb market money within the institutionalized financial market in Korea.[6]

Interest rates on commercial paper, such as unsecured promissory notes of corporations, were much closer to market interest rates, compared with those of loans and deposits at the DMBs. Also, the margin between interest on deposits and loans of the IFCs was much bigger than that of the DMBs. Moreover, in order to protect the IFCs from competition from other groups of financial institutions, such as the DMBs, short-term financial business such as the issuing and underwriting of commercial paper was

[5] The Korea Investment and Finance Co. transformed into a DMB, the Hana Bank, in 1991.

[6] With the financial scandals, for example, a large-scale fraud by a woman peddling political connections, the government tried to restrain the curb market and to unify the nation's financial market (Woo 1991: 192).

restricted to IFCs and merchant banks. As a consequence, the size of the assets of non-bank financial institutions compared to those of deposit money banks continuously increased during the 1970s and 1980s. In addition, the commercial paper market experienced rapid growth due to the emergence and the formation of more IFCs (Lee 1985: 223-229).

However, the increase in the number of IFCs in 1982 started to reduce the profitability of those financial institutions. At the end of the 1980s, the government decided that the IFCs could be transformed into other forms of financial institutions, such as DMBs, securities companies or merchant banks. In fact, the profitability of short-term financing business decreased, since the merchant banks which had been established in 1975 were the main players and had the edge on the newcomers. It became very difficult for the IFCs to survive in the 1990s from the profits of intermediating commercial paper. Due to the reduction in the gap between nominal and real interest rates as a consequence of interest rates liberalization, the non-bank financial institutions had little advantage to offer to their investors. Moreover, whenever banking scandals occurred, e.g. unwise lending, the amount of bad loans to be written off increased due to the characteristic nature of their business, i.e., uninsured short-term business.

Consequently, the government introduced the "Financial Institutions' Merger and Transformation Act," which was approved in the National Assembly in February 1991. Most groups of financial institutions, except for insurance companies, i.e., DMBs, securities companies, merchant banks as well as IFCs, were able to merge with other institutions in order to convert themselves into other forms of financial institution. However, the underlying intention of the law was to convert the IFCs into long-term financing institutions (Kang 2000). Soon after, eight Seoul-based IFCs transformed themselves into two DMBs and five securities companies.[7] Twenty-four IFCs remained as at the end of 1993, consisting of eight in Seoul and sixteen in local areas (Table 7.1).

Table 7.1 Changes in the Number of IFCs and Merchant Banks (end Period)

	1981	1982		1991		1994		1996	
		Seoul	Local	Seoul	Local	Seoul	Local	Seoul	Local
IFCs	20	16	16	8	16	8	7	-	-
Merchant banks	6	6	-	6	-	6	9	14	16
Total	26	38		30		30		30	

*1991: 8 IFCs in Seoul transformed into Banks and Securities companies.
** 1994: 9 IFCs in local areas transformed into merchant banks.
*** 1996: The remaining fifteen IFCs (8 in Seoul and 7 in local areas) all transformed into merchant banks.
Source: Ministry of Finance and Economy (1997)

Emergence of Merchant Banks

The establishment of merchant banks in Korea goes back to the second half of the 1970s. The Korean government allowed the formation of these banks in order to overcome the foreign exchange crisis during the mid-1970s, caused by the first oil shock, and to supply non-financial corporations with mid- and long-term funds. Thus, the 'Merchant Banking Act' was approved at the end of 1975, and joint ventures with foreign financial institutions could establish merchant banks in accordance with the Act. Six merchant banks were allowed to be established between 1976 and 1979. While the IFCs

[7] The leader in this business, the Korea Investment Finance Co. was transformed into the Hana Bank. Two other IFCs integrated into the Boram Bank, while five other IFCs owned by DMBs and *chaebol* were transformed into securities companies.

aimed at institutionalising the domestic curb market, the merchant banks aimed at attracting foreign funds. In spite of such different funding targets, both the merchant banks and IFCs were to mobilize funds for investment in the heavy and chemical industries in Korea during the second half of the 1970s.

The Merchant Banking Act aimed at "Improving foreign currency funding in international capital markets, promoting the domestic private long-term financial market by introducing advanced financial techniques from abroad, thus fulfilling financial demand from non-financial companies" (the Merchant Banking Act, 31 December 1975). The major business area of the merchant banks was clearly prescribed in the Act: "business of intermediary of foreign funds and others." The Act entrusted the Finance Ministry with the right of authorization for other businesses, apart from that of foreign currency intermediary. The other businesses were wide-ranging including investment and loans to non-financial corporations, discount, trade, and underwriting of commercial paper, underwriting and sale of securities and issuance of corporate bonds. In addition, merchant banks could manage leasing business, securities investment trust business and trust business other than trust money, provided that the bank was authorized by related legislation, such as the Leasing Business Act, the Securities Investment Trust Act and the Trust Business Act.

As Table 7.2 shows, foreign financial institutions which became large shareholders of the banks were Boston Overseas Financial Co., Chemical International Finance Ltd. (United States of America), Barclays and Robert Fleming (United Kingdom), Long-term Credit Bank and Yasuda Trust Bank (Japan), Societe Generale (France) and Commerzbank (Germany). Foreign shareholders were the major funding sources for the newly-established merchant banks. The Korean partners of the foreign banks in the joint ventures were government-owned banks, such as Korea Development Bank (KDB) and Korea Exchange Bank (KEB), and *chaebol*, such as Daewoo, Hyundai, and Hanjin. The merchant banks were therefore the only financial sector which was owned and controlled by private investors, while the other financial sectors were largely controlled by the Korean government as described in Chapters 5 and 6. Those six merchant banks (Group A) grew with large profits (Ministry of Finance and Economy 1997) due to restrictions over additional entrants to the merchant banking business for the following fifteen years and the gap between international and domestic interest rates. The application of advanced financial techniques and the operation of various financial businesses allowed by the authorities were also beneficial to the merchant banks.

Table 7.2 Large Shareholders of Merchant Banks (Group A) (As at end 1993)

	Establishment	Large Shareholders	
		Domestic	Foreign
Korea	April 1976	Daewoo etc. 40% Five DMBs 10%	Boston Overseas Financial Co. 25%, Barclays 25%
International (Hyundai since June 1994)	December1976	Hyundai group 22.8%, KEB etc. 48.12%	Kuwait Financial Centre etc. 28.7%, Robert Fleming etc. 0.38%
Saehan	February 1977	KDB 20.5%, KEB 6.8%, Daewoo securities etc. 38.6%	Chemical International Finance Ltd. 20.1%, Long-term Credit Bank of Japan etc. 14%
Han-Bool	July 1977	Hanjin group 32.0%, KEB etc. 18.8%	Societe Generale 49.2%
Asia	February 1977	Taihan Textile 44%, KEB etc. 14%	Yasuda Trust Bank 35%, Denington 7%
Han-Oe	May 1979	KEB 31.4%, KDB etc. 33.7%	HSBC 14.0%, Commerzbank 20.9%

Source: Ministry of Finance (1993)

The business climate for the merchant banks was not as good in the 1990s as they had been in the 1970s and 1980s. This was because non-financial big companies were able to obtain foreign funds direct and foreign financial institutions came into the Korean market to transact foreign currency business. The competition was not only between the merchant banks but also with other groups of financial institutions, in particular the DMBs and securities companies. The government allowed the DMBs to accept Money Market Deposit Accounts (MMDA), which are short-term financial instruments with high interest rates, and also permitted the securities companies to trade large amounts of CP (Ministry of Finance and Economy 1997).

Investment and trust companies (which were different from the IFCs) provided asset management services. Moreover, short-term financing business by the merchant banks was already being carried out by the IFCs. The only other business available to the merchant banks was therefore the leasing business, which was funded from foreign currency short-term borrowings on which the interest payable was much lower than that earned on long-term leasing. From this business, however, the merchant banks were still able to enjoy an over 10% return on equity, which was higher than that enjoyed by any other group of financial institutions. However, this return decreased as new merchant banks entered the business during the mid-1990s.

Table 7.3 List of Merchant Banks (As at end Sep. 1998)

Name of the banks	Establishment	Transformed from IFCs	Revocation of the license
Han-Kook	April 1976		
Hyundai (International, before July1994)	Dec. 1976		
Saehan	Oct. 1977		12 Aug. 1998
Han-Bool	Jul. 1977		
Asia	Nov. 1977		
Han-Oe	May 1979		
LG	May 1973	28 Jun. 1994	
Samyang	Dec. 1977	30 Aug. 1994	15 Apr. 1998
Keumho	Jul. 1974	28 Sep. 1994	
Hansol	Oct. 1974	28 Sep. 1994	16 Mar. 1998
Han-Gil	Dec. 1979	28 Sep. 1994	12 Aug. 1998
Kyungsoo	Nov. 1981	28 Sep. 1994	
Korea	Jul. 1983	28 Sep. 1994	17 Feb. 1998
Kyungnam	Nov. 1979	28 Sep. 1994	17 Feb. 1998
Youngnam	Jun. 1973	27 Oct. 1994	
Dae-Han	Jul. 1973	1 Jul. 1996	
Dong-Yang	Jul. 1973	1 Jul. 1996	
Joong-Ang	Jul. 1973	1 Jul. 1996	
Je-Il	Jul. 1977	1 Jul. 1996	18 May 1998
Tae-Gu	Dec. 1979	1 Jul. 1996	1 Apr. 1998
Ssang-Ryong	Jan. 1980	1 Jul. 1996	17 Feb. 1998
Hang-Do	Sep. 1980	1 Jul. 1996	17 Feb. 1998
Chung-Sol	Nov. 1980	1 Jul. 1996	17 Feb. 1998
Ulsan	Nov. 1981	1 Jul. 1996	
Nara	Nov. 1982	1 Jul. 1996	
Shinhan	Nov. 1982	1 Jul. 1996	17 Feb. 1998
Samsam	Dec. 1982	1 Jul. 1996	17 Feb. 1998
Hanhwa	Dec. 1982	1 Jul. 1996	17 Feb. 1998
Shinseghe	Jan. 1983	1 Jul. 1996	17 Feb. 1998
Kyung-Il	May 1983	1 Jul. 1996	17 Feb. 1998

Source: Ministry of Finance and Economy (1998: 496)

7.3 Ownership and Merchant Banks-Chaebol Relations

There was a significant change in ownership of the merchant banks since the Korean government allowed the transformation of the IFCs in local areas into merchant banks in 1991. After that, foreign investors started to sell its shares and leave Korea, and the gap was filled with *chaebol* and large corporates in particular belonging to the construction industry. The transformation was originally to boost the business of Small- and Medium-Sized Enterprises (SMEs) according to the suggestion of a deliberation committee of the Finance Ministry, but the transformed merchant banks served the interest of *chaebol* and large companies after all.

The policy of the transformation goes back to the discussion on the development of merchant banking business in the "Deliberation Committee on the Development of Financial Sector" in 16 June 1992.[8] The Committee proposed that the Finance Ministry should establish new merchant banks as well as allow the IFCs to transform into merchant banks for the following three reasons: (1) in order to address the need for financial opening; (2) to supply SMEs with comprehensive financial services; and (3) to

[8] Deliberation Committees can be divided into three categories by the level of the establishment regulations; constitution, law, ordinance or ministry regulation. The committees established on the basis of the first two types of regulations usually conduct decision-making, while the committees based on the third regulation only conduct consultation. The Deliberation Committee for the Development of the Financial Sector belonged to this third type. The committees usually consisted of academics in universities and research institutes (usually belonging to the government) and people from the public sector, and the policy of the relevant ministries was largely reflected in the proposals of the committees. In this regard, one of notable exceptions was the establishment of the Presidential Committee for Financial Reform at the beginning of 1997. Participation of the officials of the Finance Ministry was not permitted.

strengthen the function of international financing (Ministry of Finance 1992).

Change in Ownership

In relation to the first aspect of financial opening, the Committee proposed that foreign investment to the merchant banking sector should be allowed earlier than that to other financial institutions, in particular DMBs because the merchant banks were relatively small in size and one of the major businesses of the banks was international financing. At the same time, the committee suggested that competition in the domestic market among the merchant banks should be intensified by allowing Korean companies to invest in the IFCs, to be transformed into merchant banks. Afterwards, however, foreign investment was not realized; rather, existing foreign investors started to sell their shares in the merchant banks. This was due to the prospect that the business situation of merchant banking would deteriorate because of new entrants to the business (Korean Economic Daily, 22 December 1994).

Kuwait Financial Centre, which was the major shareholder of the International Merchant Banking Corporation, sold its dominant status to Hyundai group (then the biggest *chaebol* in Korea), which renamed the Corporation to Hyundai Banking Corporation from June 1994. Not only did International Merchant Banking Corporation, but also did other major merchant banks experienced a change in their major shareholders. Boston Overseas Financial Co. was the controlling shareholder of Korea Merchant Banking Corporation, which was the biggest merchant bank, established for the first time in April 1976. Since 1995, however, its share as well as those of Barclays (then, the other foreign major shareholder) continuously decreased, while Daewoo group (then the third biggest *chaebol* in Korea) increased its shares by purchasing stocks from Korean shareholders such as Hyundai Motor Co. The Korea Banking Corporation became a disguised affiliate of Daewoo group in that year (Monthly Chosun 2001).[9]

Hanjin (then the fifth biggest *chaebol* in Korea) also tried to increase its share, though Societe Generale maintained its dominant status. In addition, Chemical International Finance Ltd. which was the second biggest shareholder (possessing 20.11%) of Saehan Merchant Banking Corporation next to Korea Development Bank (possessing 20.5%), decided to sell its shares. The Seoul branch of Chemical Bank, the mother company of Chemical International Finance Ltd., wanted to increase its paid-in capital from 3 billion won to 43 billion won in January 1995. The source of the capital increase was going to be the proceeds from its selling the shares of Saehan Merchant Banking Corporation (Korean Economic Daily, 12 January 1995). Other *chaebol*, such as the Samsung and Lotte group, wanted to enter into the merchant banking business by either purchasing the shares from foreign investors or participating in the process of increase in paid-in capital of the local IFCs.

In the end, five of the biggest *chaebol* (Hyundai, Samsung, Daewoo, LG, and Hanjin) became the first or second major shareholders of the merchant banks. Beyond Hyundai and Ulsan (by Hyundai group), Korea (by Daewoo group), and Han-Bool (by Hanjin group) Merchant Banking Corporation, the LG group had been the major

[9] Daewoo purchased the shares of the merchant bank possessed by Hyundai at great expense which was five times higher than that transacted in the stock market (Statement of former director of Daewoo Corp, Kim Woo-Il, appeared in Monthly

shareholder of Busan Investment Finance Company (which was transformed into LG Merchant Banking Corporation in 1994) and the Samsung group became the major shareholder of Hanil Investment Finance Company in 1994 (which was renamed Sinsege Investment Finance Company and transformed into a merchant bank in 1996). Hyundai had been the major shareholder of Ulsan Investment Finance Company, which was transformed into a merchant bank in 1996. As a result, the Hyundai group owned two merchant banks before the crisis.

Due to the relatively small size in paid-in capital, the local IFCs and newly transformed merchant banks became a target of Merger and Acquisition (M&A) during the same period when those IFCs transformed into merchant banks in 1994 and 1996. The major shareholders of the nine merchant banks changed from 1994 and four more merchant banks were targeted by hostile M&As. The new owners of the merchant banks were relatively small *chaebol* or construction companies. Small *chaebol* wanted to use the merchant banks for financing and fund management. Construction companies wanted to resolve terms of mismatch in funding, which was a kind of inherent characteristic of the construction industry (Ministry of Finance and Economy 1997: 6).

Preponderance of Loans to Chaebol

During the 1970s and 1980s, the NBFIs including merchant banks in Korea rapidly grew and came to be a major funding source for corporates. As Table 7.4 shows, the ratio of loans by financial institutions among the total funding mobilized in the financial markets increased from 27.7% in 1970 to 53.8% in 1990 and this was largely

---

Chosun, November 2001).

due to the increase in the credit by the NBFIs (Lee Y-H 1999a).

Table 7.4 Outstanding Balance of Corporate Funding by Sources

(Units: %, Billion Won, End of Period)

	1970	1975	1980	1985	1990
Indirect financial market	30.4	40.7	54.0	62.7	73.7
Lending	27.7	36.9	46.2	52.2	53.8
Banks	22.1	27.0	29.3	27.7	24.9
NBFIs	5.6	9.9	17.0	24.5	28.9
Purchasing Securities	2.6	3.8	7.8	10.4	19.9
Direct financial market	11.2	14.0	14.9	15.2	15.6
Bonds	0.9	0.6	1.5	1.7	1.5
Stocks	6.9	9.7	8.5	7.8	8.9
Money invested	3.4	3.0	3.0	4.0	2.3
CP	0.0	0.7	1.9	1.7	2.8
Foreign funds	21.6	26.2	22.5	14.6	5.6
Government budget	36.8	19.1	8.6	7.6	5.2
Total	100.0 <3,831.6>	100.0 <12,719.6>	100.0 <52,571.8>	100.0 <138,824.4>	100.0 <338,661.5>

Source: Cited from Lee Y-H (1999a: 404)

More than any other financial sector, the preponderance of loans to *chaebol* among total loans was high in the NBFIs, in particular the merchant banking sector. Table 7.5 shows that over 35% of total loans made by the NBFIs went to the thirty biggest *chaebol* throughout the period of 1991-1996, while the corresponding ratio of banks, i.e. DMBs, development banks and foreign banks' branches in Korea, was under 20%. Moreover, Table 7.6 shows that the merchant banking sector concentrated its loans on *chaebol* more than any segment of NBFIs. Almost half (48.1%) the total loans made by the merchant banks was to the thirty biggest *chaebol* as at end of June 1997, while the corresponding data for insurance and leasing companies were 37.3% and 39%, respectively. This implies that the reason for the transformation of the IFCs into merchant banks suggested by the Deliberation Committee in 1992 was either disingenuous or distorted by the then growing influence of *chaebol.*

Table 7.5 Loans to Chaebol by Banks and NBFIs

(Units: %, Billion Won, End-Period)

	1991	1992	1993	1994	1995	1996	Jul. 1997
Loans by banks (B)	137407	159787	180019	218699	253573	300912	325067
To 5 biggest *chaebol* (B5)	14341	16269	14033	15852	17490	23858	26939
B5/ B	10.4	10.2	7.8	7.2	6.9	7.9	8.3
To 10 biggest *chaebol* (B10)	19643	22499	21595	23308	25265	32973	38506
B10/B	14.3	14.1	12.0	10.7	10.0	11.0	11.9
To 30 biggest *chaebol* (B30)	26788	30372	29938	32483	35293	NA	NA
B30/B	19.5	19.0	16.6	14.9	13.9	NA	NA
Loans by NBFIs (NB)	55496	73803	85934	102354	137210	NA	NA
To 5 biggest *chaebol* (B5)	NA	NA	NA	NA	NA	NA	NA
NB5/ B	NA	NA	NA	NA	NA	NA	NA
To 30 biggest *chaebol* (B10)	20316	26547	31926	38128	52869	NA	NA
NB30/NB	36.6	36.0	37.2	37.3	38.5	NA	NA

Source: Extracted from Lee Y-H (1999b: 435, 446)

Table 7.6 Share of Loans Made to Chaebol by NBFIs

(Units: %, Billion Won, End-Period)

	1994	1995	1996	June 1997
Total loans by Merchant banks (MB)	48555.1	67244.6	89232.9	117046.4
to 30 biggest *chaebol* (MB30)	19983.0	31649.1	48162.0	53308.9
MB30/ MB (%)	41.2	47.1	54.0	48.1
Total loans by Insurance companies (I)	16012.4	16878.8	21724.9	21923.8
To 30 biggest *chaebol* (I30)	6257.8	6355.7	7430.0	8227.6
I30/I (%)	39.1	37.7	34.2	37.5
Total loans by leasing companies (L)	NA	NA	NA	30236.6
To 30 biggest *chaebol* (L30)	4777.1	8708.8	11404.9	11781.5
L30/L (%)	NA	NA	NA	39.0
Total loans by NBFIs (T)	NA	NA	NA	169206.8
To 30 biggest *chaebol* (T30)	NA	NA	NA	73318.0
T30/T (%)	NA	NA	NA	45.0

Source: Lee Y-H (1999b: 446)

It should be noted in Table 7.6 that the share of loans to the thirty biggest *chaebol* among total loans made by the merchant banks jumped from 41.2% as at the end of 1994 to 54.0% as at the end of 1996. It decreased to 48.1% as at the end of June 1997, reflecting the withdrawal of the loans from *chaebol* after Hanbo, Sammi, and Jinro fell into de facto bankruptcies.

It is difficult to identify the difference between the businesses of the six merchant banks controlled by the five biggest *chaebol* and those of other merchant banks. In order not to be the subject to the Fair Trade Act, Korea Merchant Banking Corporation (owned by Daewoo) and Shinsege (owned by Samsung) were not in theory affiliates of those *chaebol*. Also, Han-Bool Merchant Banking Corporation was not an affiliate of the Hanjin group, which was the second biggest shareholder of the merchant bank. Accordingly, there was no specific data for those five merchant banks.[10]

7.4 Explaining Regulatory Policy Applied to Merchant Banks

The DMBs were asked to conduct the role of inflation-controllers by the Bank of Korea (BoK) as they supplied funds and were rationed credits in accordance with the policy of the authorities at least until 1980s, while the NBFIs including the IFCs and

---

[10] The governance structure and market share of those six merchant banks owned by the five biggest *chaebol* could be investigated by the Fair Trade Commission, which could only conduct an examination on the internal transactions among affiliates of the *chaebol*. Moreover, the Finance Ministry did never submit specific data on the merchant banks belonging to the *chaebol* before the crisis. According to a research (Lee Y-H 1999a), however, the asset structure of Hyundai and LG Merchant Banking Corporation was different from that of other banks. The share of foreign currency loans (9.8%) and leases (35.3%) among the loans in total was much higher than average in the sector, which were 2.08% and 18.68%, respectively. It is therefore believed that the high share of leases contributed to the illiquidity of assets of those *chaebol*-owned merchant banks.

merchant banks were not subject to regulatory control by the authorities (Lee 1985: 213).

The regulatory policy applied to the merchant banks was looser than that applied to the DMBs. Given that the Finance Ministry supervised the business of the development banks, prudential supervision imposed over the merchant banks was even weaker than that over the development banks. In relation to the authorization of new entrants such as the merchant banks during the 1990s, which has been at issue in the existing literature, this chapter finds some evidence that the authorities tried to exert some control. Such control was not eventually realized due to opposition from other parts of the government, which reflected growing private influence on the government's decisions. In addition, due to the lack of regulatory capacity of the Finance Ministry and inappropriate delegation of authority by the Finance Ministry to the Office of Bank Supervision (OBS), regulations imposed on the merchant banks were hardly implemented. The connection between the Finance Ministry and former officials of the Ministry lobbying for the merchant banking sector as well as the importance of the merchant banks as a major funding source for special interest groups, i.e. *chaebol* and big construction companies, can also partly explain the regulatory failure in the merchant banking sector.

Review on Prudential Measures Applied to the Merchant Banks

The NBFIs including the IFCs and merchant banks were established by special Acts, distinct from the General Banking Act. This implied that from the beginning the government intended to apply relaxed regulatory measures to those institutions, in contrast with the relatively strict attitude of the BoK towards DMBs. The Korean government wished to increase Korea's non-monetary financial assets and to develop financial markets in various ways. The government believed relaxed regulations including liberalization of interest rates setting was necessary for non-bank financial institutions (Lee 1985: 222). This was to mobilize the curb market money.

The NBFIs were fundamentally different from the DMBs in the following two respects. First, NBFIs were not monetary financial institutions. Those institutions could only intermediate financial assets, rather than increase the money supply (by making credit available) which monetary financial institutions, such as the DMBs, can do. Second, in order to absorb curb market funds, interest rates payable on the deposits with the NBFIs had to be higher than those payable by the DMBs. Therefore, most of the prudential regulatory measures prescribed in the General Banking Act were not applied to the NBFIs including the merchant banks (Lee 1985: 222-23).

Capital adequacy requirements were not imposed over the merchant banks, though the Finance Ministry set a limit on the size of their liabilities, which was 2000 % of equity capital. There was no large exposure limit on the assets management of the merchant banks until the ministry set a single exposure limit, which was 150% of equity capital.[11] The restriction on connected lending to major shareholders was 100% of the merchant bank's equity capital.[12] The regulatory authority over the merchant banks was the Finance Ministry, though the Ministry delegated its on-site examination authority to the OBS; but because the Ministry determined the scope of the on-site examination in

[11] In the wake of the crisis, the limit was reduced to 100%, and it is now the same as that for the DMBs, 25%.

[12] The limit was reduced to 50% in the wake of the crisis, and it is now 15%.

advance, the delegation was *de facto* nominal. It was revealed in the wake of the crisis that the Finance Ministry did not delegate the authority over leasing business to the OBS, which was the major business area of the merchant banks. As the larger part (60%) of the foreign currency assets of the merchant banks consisted of leases, the OBS could not review the soundness of the foreign currency asset management of the merchant banks (Testimony of Lee Hun-Jae, the OBS Governor).[13]

Authorization of the Merchant Banks

Literature on regulatory failure focuses on the authorization process in 1994 and 1996 for new entrants such as the merchant banks. As already mentioned, only six merchant banks existed until 1994, when the government authorized another nine IFCs in local areas to convert into merchant banks. Thereafter, in 1996, the remaining fifteen IFCs were allowed to convert into merchant banks.

As regards the authorization of new entrants to the merchant banking industry, Haggard (2000) suggests that the transformation of the IFCs into merchant banks shows how financial reforms can be captured in their basic design.

> "In the early 1980s, the government expanded the number of investment and finance companies (IFCs) in an effort to bring informal financial market players under government regulation. In the 1990s, the IFCs expressed a strong interest in transforming themselves into merchant banks because of the number of privileges those institutions enjoyed. The government licensed 24 IFCs as merchant banks... supposedly to contribute to a more market-based financial system. In fact,

[13] Minutes of the Special Investigation Committee on the Foreign Currency Crisis at the National Assembly, the 7th Meeting in the 200th Congress on 21 January 1999.

the licensing process was the result of intense lobbying efforts ... involved kickbacks from the new merchant banks to bureaucrats and politicians... According to an investigation... three of the IFCs licensed in 1996 were insolvent *at the time of they were licensed*... of the 16 merchant banks whose licenses were revoked by the government in 1998, 15 were new entrants in 1994-96. " (Haggard 2000: 37)

The transformation of twenty-four IFCs into merchant banks was in accordance with the 1993 "Five Year Plan for New Economy" made by the then newly-incumbent government, which suggested the integration of the business areas of the IFCs and merchant banks.[14] The rationale for this integration was to accord with the trend of universal banking and to increase the competitiveness of the financial industry through promoting competition among financial institutions (Ministry of Finance and Economy 1997).

The rationale for the authorizations of 1994 was slightly different from that of the 1996 authorization. The former was to provide non-financial companies in local areas with one-stop comprehensive financial service, although those reasons were revealed as disingenuous. Only nine IFCs, which met certain conditions including the size of equity capital, were allowed to become merchant banks in 1994. However, the authorization for the 1996 conversion of IFCs into merchant banks was effected by the revision of the Merchant Banking Act at the end of 1995.

The completely revised version of the Merchant Banking Act at the end of 1995,

---

[14] As described earlier, it was originally suggested by a deliberation committee in

which affected the authorizations in 1996, resulted in the transformation of the then remaining fifteen IFCs into merchant banks. This is not well-known, but the Act of 1995 included some aspect of prudential measures in order to maintain the soundness of the merchant banking sector, i.e., Article 7 of the Act required that the Finance Ministry should maintain proper competition among the merchant banks. In other words, the Finance Ministry should ask the merchant banks to specialize in one of three major areas of merchant banking, i.e., short-term financing business, corporate financing and foreign exchange business. Despite this, comprehensive rules pursuant to the Article 7 of the Act were not issued, and even some rules which were issued were not strictly implemented. These merit close investigation.

As regards the failure to issue comprehensive rules pursuant to Article 7 of the Merchant Banking Act, a former Director of the Finance Ministry, Jin Young-Wook, who was in charge of supervision over the financial sector, stated that there was a regulatory clause on proper competition between merchant banks in the draft of the 'Presidential Decree on Merchant Banking,' which was intended to be included in the rules issued pursuant to the Merchant Banking Act of 1995. However, in the course of discussions within the government during January 1996, the Fair Trade Commission strongly opposed the introduction of such a clause requiring proper competition. The argument from the Commission was that this kind of regulation would cause inefficiency within the sector. Eventually, the clause requiring proper competition was dropped in the final draft of the decree of January 1996 (Testimony of Mr Jin Young-Wook, former Director of the

---

1992.

Finance Ministry).[15]

There were still some prudential rules issued on the occasions of the authorization of merchant banks in 1994 and 1996. The authorities imposed a rule regarding foreign currency liquidity for new entrants. It was that the new entrants had to fund 70% of their long-term assets by long-term borrowings during the year following their transformation into merchant banks. Also, the proportion of leasing assets to gross assets was limited for the merchant banks authorized in 1994; to within 30% for the first year and then to 40% for the second year. Moreover, offshore business was not allowed for the first year. However, there was no serious investigation as to whether conditions laid down at the time of authorization were complied with because of the government's lack of regulatory capacity and its bias towards deregulation and liberalization. Moreover, these two regulatory conditions on leasing and offshore business were not imposed on the merchant banks authorized in 1996.

Another Director in the Finance Ministry, Lee Jong-gap, revealed that his department had tried to impose a regulatory limit, of Korean won 100 million per year, on a single *chaebol*'s commercial paper, dealt with by a merchant bank. But, this proposal was strongly criticized by the "Regulatory Reform Commission" within the government, which was under the strong influence of the private sector and hence failed to be imposed. This failure contributed to the situation whereby 75% of commercial

[15] Minutes of the Special Investigation Committee on the Foreign Currency Crisis in the National Assembly, January 1999.

paper was issued in the market by *chaebol* and mainly intermediated by the merchant banks (Testimony of Mr Yoon Jeng-Hyun, a former Director of the Finance Ministry).[16]

Moreover, the reorganization of the government at the end of 1994, in consequence of the fervour for deregulation within the government, led to a significant reduction in the number of officials in the new Finance Ministry, the Ministry of Finance and Economy. The number of officials in the department of the Finance Ministry which was responsible for supervision over the financial sector, was reduced to 35 from 46, as a consequence of the amalgamation at the end of 1994 of the EPB and Finance Ministry into the Ministry of Finance and Economy. Thus, for example, only one official with his one assistant came to be in charge of supervision over the merchant banks. Such administrative capacity made the Finance Ministry's supervision of the financial sector difficult. The former Director, Jin Young-Wook mentioned, "There was a perspective within the government that, in order to relax regulations, it would be the best to reduce the number of officials responsible for the area." He recalled that the officials who were originally responsible for financial supervision were dissatisfied with that perspective. That perspective was, of course, what the EPB officials, who had actually initiated the reorganization of the EPB and the MoF, had strongly supported (Testimony of Mr Jin Young-Wook, a former Director of the Finance Ministry, before the Special Investigation Committee on the Foreign Currency Crisis in the National Assembly, January 1999).[17]

---

[16] Minutes of the Special Investigation Committee on the Foreign Currency Crisis at the National Assembly, January 1999.

[17] This was also confirmed in an interview with a core member of the team, who drafted the re-organisation at the end of 1994, Park Byung-Won. Mr Park was the chief secretary officer to the deputy premier, Kang Kyung-Sik, in 1997.

The direction of the reorganization of the government was strongly influenced by private sector interest as described in Chapter 4. In the wake of the crisis, it is argued that at least fifty officials were required for supervision of the merchant banking sector (Testimony of Lee Heon-Jae, the Governor of Financial Supervisory Service, in 1999).

7.5 Assets and Liabilities Structure of the Merchant Banks and the Crisis

Not all merchant banks were equally affected by the crisis. The financial situation of six merchant banks in the group A (the merchant banks in existence prior to 1994) was much better than those in group B (the new entrants in 1994 and 96). They had different asset and liability structures. The merchant banks, which were ordered by the government in December 1997 to suspend banking operations, all belonged to group B and had unsound asset and liability structures. On the other hand, the asset and liability structure of the group A banks was relatively sound and they were relatively less damaged.

According to a BoK document at the end of August 1997, a major source of funds for the merchant banks in group A was foreign currency borrowing (47.0%) and the issuance of commercial paper (16.0%). They made profits from various sources: international business (32.1%), leasing (25.5%), and securities and investment trust business (23.0%). Profits from short-term finance business, which had been the main business area of the group B banks, were not substantial (19.4%). By contrast, the major business of the banks in group B was unchanged, despite their conversion into merchant banks. Short-term finance business, i.e., buying uninsured CP and selling it to investors, accounted for almost 60% of the profits of the banks in group B (the Fund Department of the Bank of Korea 1997).

In order to promote the sale of CP, the merchant banks in group B guaranteed uninsured commercial paper issued by corporations even though this was against to the rules.[18] These guarantees caused major problems when many big companies and SMEs became insolvent after 1996, causing the banks' level of bad debts to soar when their guarantees were called and they were obligated to repay the principal and interest of the CP (the Fund Department of the Bank of Korea 1997).[19]

The BoK's document confirmed that the rapid increase in bad debts of the merchant banks was due to the increase in their short-term finance business. For five years between 1992 and 1996, the value of CP discounted by the merchant banks increased by 31.7% per annum as a result of financial liberalization. Cho (1999) indicates, "the authorities continued their control of the bank interest rates and corporate bond yields even after formal deregulations while they had completely deregulate interest rates of short-term securities such as CP. This caused rapid expansion of the CP market starting in 1993" (P. 2).

---

[18] This document was originally prepared for members of the Monetary Management Board of the BoK on 28 August 1997 and was collected at the end of the Board meeting. This document was submitted to the Special Investigation Committee in the National Assembly on the Currency Crisis in January 1999.

[19] Bad debts consisted of the CP of failed companies and the CP of companies under Court protection whether or not that CP had matured, but only if the CP had been guaranteed by a merchant bank.

The increase in CP discounted was far above the level of the increase in bank loans, which was 15.4% per annum. In 1996, the value of the discounted CP increased by 37.2%, compared to the previous year's level (see Table 7.7). At the end of July 1997, the bad debts of the merchant banks were over Korean won 1.5 trillion, which was an increase of 63.1% over the level as at the end of 1995.

There was, however, a big difference between the merchant banks. The group A banks only recorded a 3.1% ratio of bad debts to their equity capital, while it was 54.5 % for the banks in group B. Among the group B banks, the bad debt ratio of the merchant banks, which had been converted in 1996, was 171.8 %, a much worse ratio than that of the merchant banks, which had been converted in 1994 (see Table 7.8).

Table 7.7 Exposure to Corporations of Merchant Banks and DMBs Compared

(%)

	92	93	94	95	96	Average
CP discounted by merchant banks (A)	15.4	43.7	30.0	32.2	37.2	31.7
Lending of DMBs (B)	14.2	12.4	20.5	13.6	16.3	15.4
A – B	1.2	31.3	9.5	18.6	20.9	16.3

Source: Fund Department of the BoK (1997)

Table 7.8 Ratio of Merchant Banks' Bad Debts to Equity Capital as at the end of June 1997

(KRW, billion)

	Group A	Group B				Total
			Seoul based	Regional based		
				Converted in 1994	Converted in 1996	
Equity Capital(a) Capital	1279 (266)	2766 (828)	1706 (409)	742 (245)	318 (174)	4045
Bad Debts (b)	40	1506	596	364	546	1546
b/a (%)	3.1	54.4	34.9	49.0	171.8	38.2

Source: Fund Department of the BoK (1997)

Moreover, if the assets, exposed to the three medium-sized *chaebol*, Jinro, Daenong, and Kia, which were de facto insolvent, amounting to KRW 5245 billion, were included in the bad debts, the ratio for the group B banks would have reached 228.0%; whereas that for group A would only have been 37.8%. Their assets were excluded since the three *chaebol* were theoretically solvent because they were the subject of a Bankruptcy Protection Agreement with their creditors. After the bankruptcy of Hanbo Steel, it became very difficult for companies to borrow money from Korean financial institutions.

The NBFIs including the merchant banks tended to distance themselves from companies with possible liquidity problems. As a result, many such companies went bankrupt although the NBFIs avoided exposing more of their assets to the companies. Even viable companies could have become insolvent in this scenario. The approach taken in London when faced with a similar problem was therefore considered in order to rescue such viable companies. The OBS drafted a Bankruptcy Protection Agreement following the model of that used in London and the association of DMBs approved the draft.[20] The merchant banks soon decided to use the same agreement. Under the new Bankruptcy Protection Agreement scheme, the financial difficulties caused by the de facto failure of Kia the sixth biggest *chaebol* affected the merchant banks very badly as they had been heavily exposed to it (see Table 7.9).

Table 7.9 Exposure to Three Insolvent Chaebol as at the end of June 1997

(KRW, billion)

	Loans*	Guarantees	Total Exposure
JinRo	889	74	963
DaeNong	415	200	615
Kia	2529	1139	3668
Total (C)	3833	1412	5245

* including discounted CP, mid and long-term loans, and lease financing

Source: Fund Department of the BoK (1997)

The merchant banks had difficulty in selling CP due to the increase in company insolvencies. This was mainly due to the doubtful creditworthiness of companies, issuing the CP and the lack of creditworthiness of the merchant banks themselves. The major purchasers of CP, intermediated by the merchant banks, had been the trust accounts of the DMBs. However, the level of CP discounted by the DMBs decreased after April 1997. It appeared to start to recover during the first half of July but again dropped when Kia came under a bankruptcy protection agreement in the middle of July. As the DMBs bought only the CP issued by a small number of sound companies or where repayment was secured, the merchant banks, particularly those in group B, had to hold the rest, i.e., CP with high credit risks and no security. The financial situation of the merchant banks, in

[20] With reference to the details of the London Approach, see Brierley and Vlieghe (1999). The agreement was effective on 21 April 1997, 3 days after the 34 members of the association of banks had agreed it on 18 April 1997.

particularly those in group B, therefore deteriorated. As only sound companies' CP was able to be discounted, the short-term financial market got into serious difficulty.

Matters went from bad to worse. When the fourth stage measure for interest rates liberalization was implemented in July 1997, the DMBs and securities companies were allowed to sell high-yield financial instruments, such as Money Market Deposit Account (MMDA) for DMBs and high interest repurchase agreements (RP) for securities companies. This contributed to a rapid reduction of funding sources for the merchant banks. During the forty days between 11 July and 20 August 1997, the deposits held by the DMBs resulting from the sale of MMDA instruments increased by won 7,218 billion. Moreover, the merchant banks experienced an outflow of won 887 billion from their deposits. This contrasted with the increase of Won 2,716 billion in their deposits during the same period in the previous year. Money thus moved from the merchant banks to the DMBs, the major losers being, needless to say, the merchant banks in group B (see Cho 1999).

Those assets exposed to *chaebol* were illiquid due to the Bankruptcy Protection Agreement, whereas the merchant banks had to pay investors the principal and interest on the guaranteed CP when it matured. This added to the difficulties experienced by the merchant banks in obtaining funding. Although according to the agreement, some of the discounted CP intermediated by the merchant banks and rediscounted by the trust accounts of DMBs could be renewed, the non-renewable exposures were still large with no yield. Furthermore, other financial institutions, such as the DMBs, avoided supplying call money to the merchant banks, particularly those in group B, and regulation also limited short-term borrowing to the merchant banks to a level of three-times their equity capital.

As regards the foreign exchange business of the merchant banks, foreign currency assets rapidly increased in 1995 and 1996, a 50% increase per annum, due to the newly-converted merchant banks starting to enter into foreign currency transactions (Table 7.9). Most of their foreign currency assets were foreign currency leases, foreign currency loans for facilities investment and foreign currency securities, which had medium- or long-term maturity. These amounted to 92.9 % of all their foreign currency assets. By contrast, only 35.3 % of all foreign currency funding was long-term. Consequently, the term period mismatch between assets and liabilities was too great. The situation of the group B banks was again poorer than that of the banks in group A. The short-term obligations of the group B banks were 73% of all liabilities, 34% being borrowings with a maturity of less than a week (Table 7.10).

Table 7.10 Foreign Currency Assets in the Merchant Banks

(US$ billion)

1993	1994	1995	1996	10 Aug. 1997
4.6	5.6	8.9	13.3	14.6
<12.4%>	<21.0>	<59.9%>	<48.9%>	<9.4%>

( ) is the increased ratio of the assets against the previous year's level

Source: Fund Department of the BoK (1997)

Table 7.11 Structure of Merchant Banks' Foreign Currency Assets and Liabilities (as at 10 August 1997)

(US$ billion, %)

	The Group A	The Group B	Total
Mid and long-term assets	7.32 (94.8)	6.20 (90.6)	13.52 (92.9)
Foreign currency nominated loans	0.97 (12.6)	0.65 (9.5)	1.62 (11.1)
Foreign currency leases	6.17 (79.9)	3.36 (49.1)	9.53 (65.5)
Securities	0.18 (2.3)	2.19 (32.0)	2.37 (16.3)
Short-term assets	0.4 (5.2)	0.64 (9.4)	1.04 (7.1)
Short-term deposits with other financial institutions	0.15 (1.9)	0.10 (1.5)	0.25 (1.7)
Total foreign currency assets	7.72 (100.0)	6.84 (100.0)	14.56 (100.0)
Mid and long-term liabilities	3.29 (41.6)	1.79 (26.8)	5.08 (35.3)
Bank loan	1.43 (18.5)	0.95 (14.2)	2.38 (16.5)
Issuance of foreign currency securities	1.71 (22.2)	0.74 (11.1)	2.45 (17.0)
Deposits of the BoK	0.15 (1.9)	0.10 (1.5)	0.25 (1.7)
Short-term liabilities	4.43 (57.4)	4.90 (73.2)	9.33 (64.7)
Extremely short-term liabilities	0.30 (3.8)	2.25 (33.6)	2.55 (17.7)
Total foreign currency liabilities	7.72 (100.0)	6.69 (100.0)	14.41 (100.0)

Source: the Fund Department of the Bank of Korea (1997)

Analysis of the foreign currency assets shows the vulnerability of the merchant banks to the reversal of capital flows. The assets such as leases and loans for facilities investment were difficult to liquidate. Moreover, as at the end of March 1997, overseas investment by the merchant banks totalled US$ 6.6 billion, 48% of which was in South East Asian countries. The merchant banks were the major investors in foreign currency securities. As a result, for example, when One Holding Company, a Thailand real estate company, failed in March 1997, US$ 28 million worth of bad debts resulted. The merchant banks had, by the end of June 1997, made loans of US$ 160 million to 58 Thai finance companies, which were suspended by the Thai authorities. There is no exact data, but most of the exposure to the South East Asian countries was made by the group B banks, which, unlike the group A banks, did not have any internal country-risk assessment system.

As a result of this scenario and in particular the increase in bad debts, the credibility of Korean financial institutions dropped in international financial markets and the merchant banks experienced difficulties in obtaining foreign funds. Roll-over rates for short-term foreign currency borrowings by the merchant banks was 84%, 79%, and 65.5% in January, February and June 1997 respectively, much lower than the roll-over rates of the seven major DMBs during the same periods of 115%, 94% and 106% respectively (Minutes of the Special Investigation Committee on the Foreign Currency Crisis, 20 January 1999).

It should be noted that the KDB and some Korean DMBs supported the funding of the merchant banks by being lead or co-lead managers during the first half of 1997. In particular, group B merchant banks depended on the KDB and other Korean banks. Thus, when the KDB started to reduce its exposure to the group B merchant banks, those banks experienced difficulty. By contrast, the financial situation of group A banks was much sounder and they did not have to receive similar support from the KDB.

As at the end of July 1997, foreign currency borrowing by the merchant banks from domestic banks (domestic development banks, DMBs and foreign banks' branches in Korea) was US$ 4.3 billion, which amounted to 67.4 % of all their foreign currency liabilities. The remainder of their overseas liabilities was also to the overseas branches of Korean financial institutions (Fund Department of the Bank of Korea 1997). As a result, most of the group B banks were having great difficulty in repaying their debts. When development banks started to withdraw part of their foreign currency lending to group B banks and foreign banks' branches in Korea reduced their credit lines to those banks, some merchant banks in that group could not meet their liabilities without help from the Korean authorities. Table 7.12 shows that some of the group B banks were technically in default after 11 August 1997.

Table 7.12 Support in Foreign Funds of the BoK and KDB for the Group B Banks
(US $ million)

Date	Funds required to avoid default	Total	Support
11th Aug.	Hansol 20, Kyungnam 10	30	KDB N.Y. (O/N)*
14th Aug.	Kyungnam 60, Hangil 58	118	KDB N.Y. (O/N)
18th Aug.	Hansol 135, Samyang 37, Hangil 68, Keumho 22, Koryo 33, Kyungnam 89, LG 58	442	International Reserve (Roll-over)
30th Oct.	Samyang 26, Kyungnam 35, Hangil 40, Daehan 45	146	International Reserve (O/N), Shinhan Bank (O/N)
3rd Nov.	Kyungnam 54, Koryo 45, Youngnam 26	125	International Reserve (O/N)
4th Nov.	Kyungnam 25, Koryo 22, Daehan 22, Samyang 37.5, Hangil 8	114.5	International Reserve (O/N)
6th Nov.	Kyungnam 25, Hangil 27, Kyungil 4.5	56.5	International Reserve (O/N)

* Over-night loans
Source: Fund Department of the Bank of Korea (997)

As the financial situation got worse, the only option for most merchant banks was to raise money through asset-based financings. However, most of the proposed financing did not proceed. Amid the uncertainty in Asian markets and increasing concern over the exposure of the merchant banks to the most troubled *chaebol*, the lead managers for the financing adopted a wait-and-see attitude. In addition, Moody and S&P were also said to be deferring submission of their reports and delaying carrying out due diligence on the proposed assets to back the financing. In the event, the proposed asset-based financing did not proceed, as the government forced the most troubled merchant banks to merge with their sounder commercial counterparts and, on November 25 1997, ordered eight of them to transfer their foreign assets to certain commercial banks.

The proposed scheme for the issue by the merchants banks of Asset Backed Securities (ABS), which did not in the event proceed, may also have reflected the weakened regulatory capacity of the very department responsible for the merchant banking sector.

Liquidation of Some Merchant Banks in the Wake of the Crisis

During the course of 1997, the problems of the merchant banks were not the main concern of the authorities. In this regard, the merchant banks may not be the villains of the crisis. The merchant banks suffered from huge bad debts due to the introduction of the Bankruptcy Protection Agreement in April 1997. As DMBs were thereafter allowed to transact short-term finance business (including the taking of deposits) which was one of the major business areas of the merchant banks, the merchant banks, in particular those in the group B, were faced with a run on deposits placed with them, and therefore suffered a serious liquidity crisis in mid-1997.

When the authorities were considering the option of asking for support from the IMF, the BoK advised the Finance Ministry to suspend the business of many merchant banks and a few DMBs. A BoK document, including a table, stated that "insolvent merchant banks and certain deposit money banks, which were unlikely to become solvent, should be ordered to suspend their business and their liabilities should be frozen" (International Department of the BoK 1997i). The government did not allow any financial institutions to be liquidated until February 1998 when it ordered the repeal of the licenses of ten merchant banks belonging to group B. That is, the government only changed in the crisis period (see Olson 1982).

7.6 Conclusion

This chapter has shown that, although the reduction of the barriers for new entrants to the merchant banks have resulted from the lobbying by the IFCs, as argued by the existing regulatory capture argument, there were some other factors exacerbating that regulatory failure.

First, the regulatory capacity of the Finance Ministry was constrained by the fervour for regulatory deregulation and liberalization within the government. Accordingly, the Ministry could not impose fit and proper regulation for new entrants to the merchant banking business.

Second, there was very close relations between the merchant banks and special interest groups, i.e. *chaebol* and construction companies, as a result of changes in ownership within the merchant banking sector. As a result, loans by the merchant banks to *chaebol* and construction companies increased.

In sum, by examining the way in which regulatory policies applied to the merchant banks, this research has shown that the regulatory failure in the sector was not simple. Ownership of the sector by *chaebol*/construction companies, regulatory centralization within the Finance Ministry and the results of previous financial repression (in the 1970s) and liberalization (in the 1980s) all contributed to the regulatory failure in the merchant banks. Accordingly, more than any other types of financial sector, the extent of regulatory forbearance towards the merchant banking sector was significant.

Chapter 8 Conclusion

The main question raised in this thesis is "In the context of the developmental state, what explains Korea's financial regulatory policy before the 1997 crisis?" Two explanations have been given in the literature.

The first explanation cites the exogenous breakdown of the developmental state. Wade (1998, 2000) argues that the Korean government was forced by the US government to remove controls on capital account transactions. He claims that such financial regulatory liberalization was not consistent with the developmental state model. The second explanation focuses on endogenous forces, especially "capture" and corruption, reflecting the growing influence of business over government (Haggard 2000). This thesis has shown that these endogenous forces did lead, as these authors suggest, to failures of financial regulatory policy.

However, where this thesis disagrees with the Haggard and Kang argument is in its emphasis upon the importance of regulatory centralization within the Finance Ministry, which had historical proximity to the private sector. The thesis has also investigated in much more detail the different regulatory outcomes applied to different financial sectors. The difference resulted from different business-government balance of power by sector. Chapter 8 elaborates on these three contributions.

First of all, the growing influence of private interests "captured" government decisions over financial regulatory outcomes leading to regulatory failure. Such regulatory capture largely explains both the selective financial sector liberalization, including the liberalization of capital account transactions and the weak prudential regulatory controls (Chapters 3 and 4).

With regard to capital account liberalization, Chapter 3 has investigated three issues on which external and internal forces were in conflict in order to achieve their goals: the US government pressure for the appreciation of won-dollar exchange rate and a more market-oriented foreign exchange rate system in the 1980s, the bilateral Financial Policy Talks between the US and Korean governments during the first half of 1990s and Korea's multilateral negotiations with the OECD member countries on financial liberalization. Chapter 3 has shown that external pressure from the US and OECD countries on the Korean government was strong but unsuccessful in achieving their preferences. Appreciation of the Korean won against the dollar was limited. The external pressure failed to achieve the outcomes they wanted in the bilateral Financial Policy Talks between the US and Korean governments and the multilateral talks surrounding Korea's entry to the OECD.

Hence, external pressure was basically irrelevant in explaining regulatory outcomes in Korea, contrary to the argument of Wade (1998, 2000) and others (e.g. Chang 1998). The breakdown of the Korean developmental state was mostly endogenous as Haggard (2000) argues. Close business-government relations, which had previously been praised in the developmental state literature, became perverse as private influence grew. The developmental states in East Asia were highly commended for having developed good "institutional mechanisms" and "effective prudential regulation," in the famous World Bank's *East Asian Miracle* report (World Bank 1993: 6, 213). With hindsight, however, they got it wrong for financial repression was being exercised instead of effective prudential regulation. In this regard, the regulatory liberalization process was central to the undermining of the model.

Second, however, this thesis differs from the endogenous explanation, such as that given by Haggard (2000), in its focus on regulatory institutional features, i.e. its hierarchical structure with the centralization of authority in the Finance Ministry. The Ministry, with its historical proximity to the business sector, facilitated the regulatory capture while financial liberalization was occurring.

This thesis has set out such crucial aspects of the financial regulatory institutional framework in Korea prior to the crisis (Chapter 2). It has indicated that such regulatory structure started with an emphasis on the developmental objectives of the Korean government, which were consistent with those of business interests. The policy objectives of stabilization and prudential regulation of intermediate regulatory authorities i.e. the Bank of Korea (BoK) and the Office of Banking Supervision (OBS), over the deposit money banks (DMBs) was not implemented effectively due to the then regulatory feature (Chapter 5). The Finance Ministry established the development banks and non-bank financial institutions including merchant banks in order to support business interests (Chapters 6 and 7).

As indicated in most of the developmental state literature, institutional centralization, along with close business-government relations, had been a principal requirement for the developmental state and such institutional characteristics were clearly observed in the financial regulatory area before the crisis. However, this thesis has argued that, contrary to the expectation of the developmental state literature, such centralization in the financial regulatory area proved to be a weakness rather than a strength in the period when financial liberalization was occurring. Accordingly, this argument is quite contrary to that of Haggard, Maxfield and Lee et al. (1993), who argued that the integrity and cohesion of the state apparatus itself allowed them to gain access to and to control the decision-making process of financial regulatory policy.

Combined with the historical proximity of the Finance Ministry to the business sector, institutional centralization enabled the Ministry to disregard the intermediate regulatory agencies' concern with sound banking. In other words, prudential regulation was hardly regarded as the main policy objective of the regulatory authorities due to the fact that the BoK and the OBS were subordinated to the Finance Ministry. The result of such an institutional feature was seen to be particularly perverse, from the beginning of the 1990s, when the influence of business interests on the government's decisions was great enough to suffocate the public interest.

Regulatory centralization is also central in explaining the moral hazard problem of Korean banks, particularly in relation to their foreign exchange businesses. With regard to the outbreak of the crisis, moral hazard literature (e.g. Corsetti et al. 1988) indicates that financial liberalization, together with the inherent moral hazard problem of financial institutions, brought about the financial crisis. This thesis has revealed that there were explicit guarantees provided by the government regarding the Korean banks' foreign currency business, which went unnoticed in the moral hazard literature. Instead of restraining Korean financial institutions, the Korean government encouraged the financial institutions to take risks with the management of their foreign currency assets, creating moral hazard (mainly in Chapters 4 and 5).

From February 1992, the BoK made foreign currency deposits with the main offices of the Korean banks at interest rates lower than Libor (London Inter-Bank Offered Rate). The value of the deposits was huge, more than US$ 30 billion by the end of 1996; and these deposits could not be used when they were needed. The deposits were not calculated as part of the country's international reserves. The BoK wanted to reduce these deposits and to increase the amount of its international reserves, but the growth-oriented Finance Ministry, reflecting the strong influence of private interests, over-rode the concerns of the BoK. This resulted in the weakening of the country's external position, i.e. a shortage of usable international reserves against immense short-term external liabilities.

Third, the thesis investigated in much more detail the various regulatory outcomes applied to different financial sectors. It argues that the difference resulted from different business-government balance of power by sector.

Part II (Chapters 5 to 7) were case studies of various regulatory policies applied to different financial sectors. Different regulatory policies were imposed on the financial sectors, i.e. the DMBs, development banks, and merchant banks. In short, regulations were strict with regard to the DMBs and lax with regard to other sectors. As the regulatory authorities responsible for the financial sectors were different and the influence of the private sector differed in each sector, the extent of regulatory forbearance to different financial sectors also differed. More than regulatory policy applied to the DMBs, regulatory relaxation and failure in relation to the development banks and merchant banks were significant. This implies that the micro-level institutional explanation offered by this study, which differs from the prevalent macro-level institutional explanation, is better in understanding the variance of regulatory policy over different financial sectors.

Having indicated contributions to the literature, this research suggests that existing developmental state literature needs to incorporate Olson's 1982 argument, which focused on the perverse influence of special interest groups on the economy. He argued that "The accumulation of distributional coalitions increases the complexity of regulation, the role of government, and the complexity of understandings, and change the direction of social evolution" (Olson 1982: 73). The demise of the developmental state model and the complexity of regulation on the eve of the crisis in Korea resulted from the growing influence of special interest groups (i.e. *chaebol*) on the government. This was the inherent flaw in the Korean developmental state.

In addition, the fact that strict implementation of prudential regulation was successfully initiated in the wake of the crisis also seems to reinforce Olson's argument. The emergence of a relatively independent regulatory authority (independent of the Finance Ministry, rather than the government) which introduced prudential measures, which were close to international standards, would not have been achieved without the outbreak of the crisis.

Whether the supposedly prudent regulatory institutions and regulatory measures set up in the wake of the crisis will survive is still an open question as the resumed strong influence of *chaebol* on the government has recently prevented the regulatory authority from making prudent decisions in some areas.[1]

The regulatory capacity of the government strengthened in the wake of the crisis, enabling it to compel the second biggest *chaebol*, Daewoo, to undertake the workout (restructuring) process. The newly-established regulatory authority has forced corporates to reduce greatly their debt-equity ratios (BoK 2002c). As at the end of June 2002, the debt-equity ratio of Korea's listed manufacturers is 135.6 per cent, which is much lower than the 396.3 per cent as at the end of 1997.[2] As some DMBs were liquidated or the

---

[1] As a major example, an introduction of regulation to prevent credit card companies from attracting new members in the street had been blocked by the regulatory reform committee, the majority of whose members came from the private sector in 2001. After that, competition among credit companies increased and the delinquent ratio of the credit companies has sky-rocketed by over 10 per cent since September 2002.

[2] This is lower than those in Japan and the US, which were 162.5 and 159.4 per cent respectively, as at the end of 2001 (BoK 2002c). However, other research of the BoK indicates that this was mainly due to the revaluation of corporates' assets (in 1998 and 99), a debt-equity swap by financial institutions, and one-off restructuring occasion (Daewoo). One of the effect of such assets revaluation and Daewoo's restructuring is the

profitability of financial institutions came to be much more important than ever before, the Korean financial sector has no longer been willing to extend *chaebol* too much credit. Accordingly, the amount of non-performing loans in the Korean financial sector is recognized as the lowest among other Asian countries including Japan (Berger et al. 2002).[3]

However, the Korean government remains highly interventionist by comparison to much of the rest of Asia and is still influenced by special interests. There is evidence that even some in the Financial Supervision Service have accepted bribes, and there is also plenty of evidence of continued regulatory forbearance such as that shown towards Hyundai Construction Co. and Hynix.

---

anticipated 120 per cent improvement in the debt-equity ratio (BoK 2003).

[3] This is, of course, the result of an injection of public money into the banking sector to write-off the bad loans possessed by the sector. However, it should be noted that the banks which have received the public money had to restructure themselves, including lay-offs, changes in ownership and management and being a subject of M&A. Thus, banks are not willing to undertake risky asset management as opposed to what was observed before the crisis.

Bibliography

Interviews

Cho Moon-Ki, Deputy general director for International Department, the BoK, 12 November 2002

Chung Tae-Yon, Deputy Director for Monetary Policy, the BoK, 13 November 2002.

Dr Cho Yoon-Je, Senior Counceller to Deputy Prime Minister (Minister of Finance and Economy), Hong Jae-Hyung and Han Seung-Soo between 1995-96, and Special Advisor to Deputy Prime Minister (Minister of Finance and Economy), Kang Kyung-Sik, in 1997, on August 17th 1999, at his office in the Seogang University, Seoul, Korea.

Han Seng-Su, Deputy Prime Minister (Minister of Finance and Economy) in 1995 – 96, on August 12th 1999 at his Office of Members at the National Assembly, Seoul, Korea.

Dr Kim Choong-Soo, Secretary for Regulatory Reform in the Presidential Secretariats in 1993-94, Chief Negotiator for the Entry to the OECD during 1995- 96, and Special Advisor to Deputy Prime Minister (Minister of Finance and Economy), Kang Kyung-Sik, in 1997, on August 1999 at his office at the Kyung-Hee University, Kyung-gi Province, Korea.

Dr Kim Joon-Il, Senior Counceller to Deputy Prime Minister (Minister of Finance and Economy and Economy), Kang Kyung-Sik and Lim Chang-Yeol between 1997 and 1998, on August 1999 at the Korea Development Institute, Seoul, Korea.

Kim Jong-In, Senior Advisor for Economic Affairs to the President, Rho Tae-Woo, in 1990-91 at his office, on August 1999, Seoul, Korea.

Kim Young-Sup, Chief Representative of the London Branch of the Korea Development Bank, on May 2001, London, U.K.

Kim Won-Ken, Manager of the London Branch of the Korea Development Bank, on January 2001, London, U.K.

Dr Nam Sang-Woo, Senior Advisor to Deputy Prime Minister (Minister for the Economic Planning Board), Kim Joon-Sung, in 1982, and Vice President of the Korea Development Institute in 1990-94, on August 9th 1999, at the KDI (Korea Development Institute) School of Public Policy and Management, Seoul, Korea.

Dr Oum Bong-Sung, Senior Counceller to Deputy Prime Minister (Minister for the

Economic Planning Board, Na Woong-Bae, between 1988 and 89, and to Minister of Finance, Lee Yong-Man and Hong Jae-Hyung, between 1990 and 94, on September 13th 1999, at the Korea Development Institute, Seoul, Korea.

Park Byung-Won, Chief Advisor to Deputy Prime Minister (Minister of Finance and Economy), Kang Kyung-Sik, between March 1997 and November 1997, Director of the Department of Economic Policy in Ministry of Finance and Economy, on September 2000 at the European Bank for Reconstruction and Development, London, U.K.

Staff of International Reserves Management Team of the Bank of Korea, on August 2000, Seoul, Korea

Public Documents

American Chamber of Commerce in Korea (1994). *US-Korea Trade and Investment Issues,* 1994. Seoul, Korea.

Bank of Korea (1995a) "Key Contents of Foreign Currency Financing/ Funding Business and Policy Direction" Paper read at Economics Class (5th), September 15, at Bank of Korea. Seoul, Korea.

Bank of Korea (1995b) "Performance of Relaxation on Financial Regulation during the First Half of 1995" (Seoul, Korea)

Bank of Korea (1995c) Data for the Members of the Committee for Finance and Economy in the 177th Regular Session, August 1995.

Bank of Korea (1996), *Choegeun-uim gugjesujidonghyanggwam daechaeg[Recent Situation of Balance of Payments and Measures],* October 1996 (Seoul, Korea)

Bank of Korea (1997a) *Choegeunm gyeongjesanghwanggwam jeongchaegbanghyang [Recent Economic Situation and Direction for Policy Measures], March 1997* (Seoul, Korea)

Bank of Korea (1997b) *Geum-yungsijang anjeong-eulm-wihanm jonghabdaechaeg [Overall Measure for the Stability of the Financial Market],* August 1997.

Bank of Korea (1999a) *Hangug-uim geum-yungjedo [Financial System in Korea].* (Seoul, Korea)

Bank of Korea (1999b) *Oehwanteug-wimjechulm oehwan-wigimbogoseo [Report on the Foreign Currency Crisis, submitted to the Special Committee on the Crisis in the National Assembly]* (Seoul, Korea).

Bank of Korea (2000) *Hangug-eunhaengbeobm haeseol [Explanation on the Text of Bank of Korea Act]* (Seoul, Korea).

Bank of Korea (2002a) *Financial System in Korea* (Seoul, Korea).

Bank of Korea (2002b) *Monthly Research and Statistics*, October 2000.

Bank of Korea (2002c) *Press Release: The Results of Analysis on Corporate Performance*, 26 December 2002.

Bank of Korea (2003) *Press Release: Financial Structure and Profitability of Corporates in Korea, the US and Japan Compared*, 27 February 2003.

Board of Audit and Inspection (1998) *1997 Nyeonm-oehwan-wigi-emgwanhanm pyeongga-wam-won-inbunseog [Evaluation and Causal Analysis on the 1997 Foreign Currency Crisis]* (Seoul, Korea)

Export-Import Bank of Korea, *Annual Report, 1995, 1996, 1997* (Seoul, Korea)

Export-Import Bank of Korea (1999) *Gughoejaegyeong-wim jechuljalyo [Data for Members of the Committee for Finance and Economy at the National Assembly], October 1999.*(Seoul, Korea)

Export-Import Bank of Korea (2000) *Gughoejaegyeong-wim jechuljalyo [Data for Members of the Committee for Finance and Economy at the National Assembly], September 2000.* (Seoul, Korea)

Federation of Korean Industries (1992) Yearbook of the FKI

Financial Supervisory Commission (1999) Yearbook of the FSC

Financial Supervisory Commission (1999) *Dae-ugeulub-ui gujojojeong chujinsanghwangkkg [Situation of Thrust in Restructuring Daewoo Group]* August 11th 1999. (Seoul, Korea)

Foreign Currency Analysis Team of the International Department in the Bank of Korea (1996), *Hyeonhaengm yeog-oegeum-yungjedo-uim munjejeommmichm gaeseonbang-an [Problem of Current Offshore Financing System and Measures for Improvement]*, January 1996 (Seoul, Bank of Korea)

Foreign Currency Planning Team of the International Department in the Bank of Korea (1996a), *Hae-oe-un-yongjageumji-won-yongm yetagjedo-em gwanhanm geomto [Review on the BoK's Foreign Currency Deposits with Domestic Banks for Overseas Business]*, May 1996 (Seoul, Bank of Korea)

Foreign Currency Planning Team of the International Department in the Bank of Korea (1996b), *Oehwajageum-uimgeubgyeoghanm-yuchulganeungseonggwamdae-eungbang-an* [Possibility of Rapid Run on Foreign Funds and Countermeasures], August 1996 (Seoul, Bank of Korea)

Fund Department of the Bank of Korea (1997) *Jonggeumsa-uim gyeong-yeongsanghwa daechaeg [Business Situation of Merchant Banks and Policy Measures],* August 28th 1997 (Seoul, Bank of Korea)

International Monetary Fund, *Republic of Korea --- Request for Stand-By Arrangement,* Prepared by the Asia and Pacific Department (In consultation with other departments) and Approved by Hubert Neiss and Joaquin Ferran, December 3, 1997.

International Monetary Fund, *Letter of Intent of the Government of Korea, July 24, 1998.*

IMF Transcript: Capital Account Liberalization: What's the Best Stance? (with Barry Eichengreen, Michael Mussa, Jagdish Bhagwate, Richard Cooper and Ricardo Hausman] October 2, 1998, 2:30 p.m. at International Monetary Fund, Washington, D.C. http://www.imf.org/external/np/tr/1998/tr981002a.htm

International Department in the Bank of Korea (1996a) *Jungjanggim-oejado-ib paeteonbyeonhwa-wa jeongchaegjeogmsisajeom* [Change in the Pattern of Long-term Foreign Currency Funding and its Policy Implications], Background Data for Directors' Meeting on March 25th 1996, (Seoul: Bank of Korea).

International Department in the Bank of Korea (1996b) *Gugjesujibang-eoleulm-wihanmdangidaechaeg [Short-term Measure for Defending Balance of Payments],* September 1996. (Seoul, Bank of Korea)

International Department in the Bank of Korea (1996c), *Mid and Long-term Foreign Exchange Policy Direction*, November 1996, (Seoul, Bank of Korea)

International Department in the Bank of Korea (1997a) *Gugnae-eunhaengdeul-uimhae-oecha-ib-yeogeongwamdaechaegbang-an [Foreign Currency Funding Situation of Domestic Banks and Measures],* January 1997 (Seoul, Bank of Korea)

International Department in the Bank of Korea (1997b) *Choegeun-uim-oehwandonghyanggwamdae-eungbang-an [Recent Foreign Currency Situation and Measures],* February 1997. (Seoul, Bank of Korea)

International Department in the Bank of Korea (1997c) *Choegeunmgeum-yunggigwan-uim-oehwajageumsajeongmmichmdaechaeg [Recent Situation on Foreign Currency Funding of Financial Institutions and Measures],* March 1997 (Seoul, Bank of Korea)

International Department in the Bank of Korea (1997d), *1997. 2/4 bungim-oehwanbo-yu-aegmjeonmangmichmdaechaeg [Prospect on the International Reserves and Measures in the Second Quarter]*, March 1997. (Seoul, Bank of Korea)

International Department in the Bank of Korea (1997e) *Gi-asatae-ihumhae-oecha-ib-yeogeonmbyeonhwa-wamdaechaeg [Deterioration of Foreign Currency Funding Situation and Measures in the Wake of Kia's Collapse], August 1997.* (Seoul, Bank of Korea)

International Department in the Bank of Korea (1997f) *Choegeun-uim-oehwandonghyangkkg dae-eungbanghyangkkg [Recent Situation of Foreign Exchange and Countermeasures],* August 1997 (Seoul, Bank of Korea)

International Department in the Bank of Korea (1997g) *97nyeonm 9wolm-oehwanbo-yu-aegm-un-yongbang-ankkgkkg [Management Plan of International Reserves on September 1997]* (Seoul, Bank of Korea)

International Department in the Bank of Korea (1997h) *97.9 wolm-oehwanbo-yu-aegm-un-yongbang-an [Plan for Use of International Reserves],* October 1997. (Seoul, Bank of Korea)

International Department in the Bank of Korea (1997i) Oehwam-yudongseongmsajeonggwamdae-eungbang-an [Condition of Foreign Currency Liquidity and Countermeasures], November 1997. (Seoul, Bank of Korea)

International Department in the Bank of Korea (1997j) *IMF ji-won-yocheong-imgugnaegyeongje-emmichineunm-yeonghyanggwambo-wandaechaeg [Impact of Asking Support from the IMF on Domestic Economy and Supplementary Measures],* November 1997. (Seoul, Bank of Korea)

Korea Development Bank, *Annual Report of the KDB, 1995; 1996; 1997.*

Research Department of the Korea Development Bank (1997) *Hangugsan-eob-eunhaengbeobmhaeseol [Explanation on the Korea Development Bank Act]* (Seoul, Korea: Korea Development Bank).

Korea Development Bank (2000) *Gughoejaegyeong-wimjechuljalyo [Data Demanded by Members of the Committee for Finance and Economy at the National Assembly],* September 2000 (Seoul, Korea)

Letter of Intent of the Republic of Korea, July 24, 1998

Ministry of Finance, Data for Members of the Committee for Finance and Economy, September 1989

Ministry of Finance (1993) *New Economy 5 Years Plan – Part of Financial Reform, 27.5.1993*

Ministry of Finance and Economy (1995) *Subject of Thrust for Economic Regulatory Relaxation*, September 1995

Ministry of Finance and Economy (1996) *Gughoemjaegyeong-wimjechuljalyo [Data for Members of the Committee for Finance and Economy at the National Assembly], October 1996* (Seoul: Korea)

Ministry of Finance and Economy (1996) *Data for Members of the Committee for Finance and Economy at the National Assembly, 1996* (Seoul: Korea)

Ministry of Finance and Economy (1997) Jonggeumsa-uimhyeonhwanggwam jeongchaegbanghyang *[Current Situation of Merchant Banks and Policy Measures]*, 23 October 1997 (Seoul: Korea)

Ministry of Finance and Economy (1998), 1997 *nyon-oehwan-wigi-uim-won-insmdae-eungsmgyeolgwa [Causes, Countermeasures, and Results of the 1997 Foreign Currency Crisis]*, 30th January 1998 (Seoul, Korea)

Ministry of Finance and Economy (1998) Bodojalyom: 97 nyon-malmhyeonjaemdae-oejibulbudammhyeonhwang *[Press Release: State of Aggregate External Liabilities as at end – 199]*. (Seoul, Korea)

Ministry of Finance and Economy (1998) *Gughoemjaegyeong-wimjechuljalyo [Data for Members of the Committee for Finance and Economy at the National Assembly]* (Seoul: Ministry of Finance and Economy).

Ministry of Foreign Affairs and Trade (1996) *Confidential: Korea's Response to the Chairman's Conclusions on the Joint CMIT/CIME Meeting with Korea, July 1996.* [This document was submitted to the member of the Committee for Foreign Affairs and Trade at the National Assembly of Korea on October 1996.]

Ministry of Foreign Affairs and Trade (1999) Three Stage Financial Sector Liberalization and Market Opening (blueprint), January 1999.

Monitoring Team in International Department of Bank of Korea (1996), *Choegeun gugnae-eunhaeng-ui oejajodalgujo bul-anjeongseong simhwahyeonsanggwa daechaeg* [Recent Situation of Domestic Banks' Deepening of Instability in Financing Foreign Funds and a Suggestion], June 1996 (Seoul, Bank of Korea)

Monitoring Team in International Department of Bank of Korea (1996) *Choegeun gugnae-oegughwan-eunhaeng-ui hae-oejeunggwon tujahyeonhwanggwa jeongchaegjeog sisajeom* [Recent Situation of Overseas Securities Investment of

Domestic Banks and its Policy Implications], August 1st 1996. (Seoul, Bank of Korea)

National Assembly (1996) *Minutes of the National Assembly, the 181st Session: Interpellation and Reply on the Investigation by the Board of Audit and Inspection on Financial and Tax Policy, and Management of National and Public Assets on September 17, 1996* 181 Ed. (Seoul, Korea: Secretariat of the National Assembly)

National Assembly (1999) Minutes of the Special Investigation Committee on the Foreign Currency Crisis at the National Assembly.

Office of Bank Supervision (1995) *Eunhaengbeobm haeseol [Interpretation on the General Banking Act]* (Seoul: OBS in the Bank of Korea).

Office of Bank Supervision (1998) *Press Release, August 1998.*

Presidential Committee for Financial Reform (1997a) *Geum-yunggaehyeogm ilchabogoseokkg -dangigwajeleulmjungsim-eulokkg [The First Report for Financial Reform - focusing on short-term tasks], April 1997* (Seoul: Presidential Committee for Financial Reform).

Presidential Committee for Financial Reform (1997b) *Geum-yunggaehyeogm ichabogoseokkg [The Second Report for Financial Reform], June 1997* (Seoul: Presidential Committee for Financial Reform).

Presidential Committee for Financial Reform (1997c) *Geum-yunggaehyeogm samchabogoseokkg [The Third Report for Financial Reform], November 1997* (Seoul: Presidential Committee for Financial Reform).

Presidential Committee for Financial Reform (1997d) G*eum-yunggaehyeogm choejongbogoseokkg[The Final Report for Financial Reform], December 1997* (Seoul: Presidential Committee for Financial Reform).

Presidential Secretariats, *Early Necessity to Deal with* Parliamentary *Bills for Financial Reform*, Nov. 21 1997.

Private-Sector Consulting Committee for Relaxation of Administrative Regulations (1992) *Proposal on Relaxation of Administrative Regulations: First Proposal - Overall Issues* (Seoul: The Federation of Korean Industries).

Research Department in the Korea Development Bank (1997) *Choegeunmjonghabgeum-yunghoesa-uimgyeong-yeong-wigimsilsanggwamjeonmang [Recent Situation on the Crisis of Merchant Banks and Prospect]* October 1997, Seoul, the Korea Development Bank.

Schricke, Christican (1996) *Chairman's Conclusions on the Joint CMIT/CIME Meeting*

With Korea held on 4-5 July 1996 (Letter to Minister Kim Choongsoo, Ambassade de Coree – Korean Embassy, Paris), July 17th 1996. [This document was submitted to the member of the committee for foreign affairs and trade at the National Assembly of Korea on October 1996.]

Testimony of Chairman Alan Greenspan (1998a) "The Current Asia Crisis and the Dynamics of International Finance" at *the Committee on Banking and Financial Services, U.S. House of Representatives*, January 30 1998. in http://www.federalreserve.gov/boarddocs/testimony/1998/19980130.htm

Testimony of Chairman Alan Greenspan (1988b) "The Current Asian Crisis" at *the Subcommittee on Foreign Operations of the Committee on Appropriations U.S. Senate.* March 3 1998. in http://www.federalreserve.gov/boarddocs/testimony/1998/199803032.htm

U.S. Congress, Senate.1989. Treasury Report to Congress on International Economic and Exchange Rate Policy, Hearing before the Committee on Banking, Housing, and Urban Affairs, 101st Congress, 1st Session on May 5. Washington, D.C.: Government Printing Office.

U.S. Congress, Senate. 1989. Second Annual Report submitted to Congress by the Treasury Pursuant to the Requirement contained in the 1988 Omnibus Trade Bill. The Purpose of the Provision in that Legislation was to institutionalize an Ongoing Reporting and Consultation Process between the Administration and the Congress, Hearing before the Subcommittee on International Finance and Monetary Policy of the Committee on Banking, Housing, and Urban Affairs, 101st Congress, 1st Session on November 16. Washington, D.C.: U.S. Government Printing Office.

U.S. Congress, Senate, 1993. Countries that Manipulate Their Exchange Rates to Gain Unfair Trade Advantages with the United States, Hearing before the Subcommittee on International Finance and Monetary Policy of the Committee on Banking, Housing, and Urban Affairs, 103rd Congress, 1st Session on May 25. Washington, D.C.: U.S. Government Printing Office.

U.S. Congress, Senate, 1994. the Omnibus Trade Act of 1988 that Requires the Secretary of the Treasury to submit a Report on International Economic Policy, including Exchange Rate Policy, and to Identify in each Report Countries that Manipulate their Exchange Rates to Gain Unfair Trade Advantage with the United States, Hearing before the Committee on Banking, Housing, and Urban Affairs, 103rd Congress, 2nd Session on July 21. Washington, D.C.: U.S. Government Printing Office.

US Department of the Treasury (1990) *National Treatment Study: Report to Congress on Foreign Treatment of US Financial Institutions*. November, pp. 242-71

Laws and Ordinances

The Bank of Korea Act of 1950 and its Revisions in 1962, 1963, 1968, 1977, 1982, 1993, 1996, and 1997.

> The Enforcement Decree of the Bank of Korea Act of 1950 and its Revisions in 1962, 1963, 1964, 1969, 1978, 1994, 1997.

The Export-Import Bank of Korea Act of 1969 and its Revisions in 1974, 1977, 1986, 1997, 1998, 1999.

The Foreign Exchange Management Act of 1961 and its Revisions in 1963, 1966, 1967, 1991, 1995, 1997, 1998.

The Foreign Exchange Transaction Act of 1998.

The General Banking Act of 1950 and its Revisions in 1962, 1966, 1969, 1977, 1978, 1982, 1991, 1994, 1997, 1998, 1999.

> The Enforcement Decree of the General Banking Act

> The Regulation on Supervision of Banking Institutions

The Korea Development Bank Act of 1953 and its Revisions in 1961, 1963, 1968, 1969, 1974, 1977, 1981, 1988, 1995, 1997, 1988, 1999.

The Korea Exchange Bank Act of 1966 and its Revisions in 1968, 1969, 1974, 1977, and 1989.

The Long-term Credit Bank Act of 1979 and its Revisions in 1991, 1997 and 1998.

The Merchant Banking Act of 1975 and its Revisions in 1979, 1991

The Merchant Banking Corporation Act of 1975 and its Revisions in 1995, 1998, 1999

> The Enforcement Decree of the Merchant Banking Corporation Act

> The Regulation on Supervision of Merchant Banking Corporations

The Provisional Act on Financial Institutions of 1961

The Short-term Financing Business Act of 1972 and its Revisions in 1993 and 1998.

The Structural Improvement of Financial Industry Act of 1991 and its Revisions in 1997, 1998, and 1999.

The Trust Business Act of 1961 and its Revisions 1968, 1998 and 1999

Books and Articles

Adams, Charles F., and International Monetary Fund. (1998) *International capital markets : developments, prospects, and key policy issues* (Washington, DC: International Monetary Fund).

Andrews, D. M. (1994). "Capital Mobility and State Autonomy: Toward a Structural Theory of International Monetary Relations." *International Studies Quarterly* **38**(2): 193-218.

Ariyoshi, Akira, Karl Habermeier, Bernard Laurens, Inci Otker-Robe, Jorge Ivan Canales-Kriljenko, and Andrei Kirilenko (2000) *Capital Controls: Country Experiences with Their Use and Liberalization*: IMF).

Baig, Taimur and Ilan Goldfajn (1999) Financial Market Contagion in the Asian Crisis ([Washington, D.C.]: International Monetary Fund, Asia and Pacific Department).

Baliño, Tomás J. T., Angel J. Ubide, and International Monetary Fund. Monetary and Exchange Affairs Department (1999) *The Korean financial crisis of 1997 : a strategy of financial sector reform* ([Washington, D.C.]: International Monetary Fund, Monetary and Exchange Affairs Department).

Bank for International Settlements (1988) *International Convergence of Capital Measurement and Capital Standards.*

Bank for International Settlements (1999) *Supervisory Lessons to be Drawn from the Asian Crisis.*

Bank of Korea (1994) *Financial Liberalization and Internationalization in Korea* (Seoul: Money and Banking Division in Research Department, the Bank of Korea).

Bank of Korea (1997) "Examination on the Entry into Banking Business" (Seoul: Monetary Economy Research Institute of the Bank of Korea).

Bank of Korea (1998) "Lender of Last Resort Function of Central Bank" in *Monthly Research and Statistics*, April 1998.

Berger, Laurence W., George R. Nast, and Christian Raubach (2002) "Fixing Asia's Bad-debt Mess" in *the McKinsey Quarterly*, 2002 Number 4

Bhagwati, Jagdish (1982) "Directly-Unproductive Profit-seeking (DUP) Activities" *Journal of Political Economy* **90** (5): 988-1002.

Bhagwati, Jagdish (1998). "The Capital Myth." *Foreign Affairs* **77**(3): 7-12.

Black, Stanley W. (1996) *Issues in Korean Exchange Rate Policy*, NBER Working Paper 5747.

Blustein, P. (2001). *The Chastening: Inside the Crisis that Rocked the Global Financial System and Humbled the IMF*. New York, Public Affairs.

Brierley, Peter and Gertjan Vlieghe, "Corporate Workouts, the London Approach and financial ability" *Financial Stability Review*, Bank of England, November 1999.

Campbell, John L., J. Rogers Hollingsworth, and Leon N. Lindberg, eds. (1991) *Governance of the American Economy*. New York: Cambridge University Press.

Caprio, Gerard, Patrick Honohan, and Joseph Stiglitz (1999) "Financial Liberalization: How Far? How Fast? (Introduction and Overview)"

Cargill, Thomas F., and Shoichi Royama (1988) *The transition of finance in Japan and United States : a comparative perspective* (Stanford: Hoover Institution Press).

Cerny, P. G. (1993). *Finance and world politics : markets, regimes and states in the post-hegemonic era*. Aldershot, E. Elgar.

Chang, Ha-Joon (1994) *The Political Economy of Industrial Policy* (London: Macmillan).

Chang, Ha-Joon (1997) "The Economics and Politics of Regulation" *Cambridge Journal of Economics* **21**: 703-728.

Chang, Ha-Joon (1998) "Korea: The Misunderstood Crisis" *World Development* **26** (8): 1555-1561.

Chang, Ha-Joon (2002) *Kicking Away The Ladder: Development Strategy in Historical Perspective*, Anthem Press, London

Chang, Ha-Joon, Hong-Jae Park, and Chul Gyue Yoo (1998) "Interpreting the Korean Crisis: financial liberalisation, industrial policy and corporate governance" *Cambridge Journal of Economics* (22): 735-46.

Chang, Ha-Joon, and Peter Evans (1999) "The Role of Institutions in Economic Change (First Draft)"

Chang, H.-J., J. G. Palma, et al. (2001). *Financial liberalization and the Asian crisis*. Houndmills, Basingstoke, Hampshire ; New York, N.Y., Palgrave.

Cheng, Tun-Jen, Stephan Haggard, et al. (1996). *Institutions, economic policy and growth in the Republic of Korea and Taiwan province of China*. Geneva, United Nations.

Cheng, Tun-Jen, Stephan Haggard, and David Kang (1998) "Institutions and Growth in Korea and Taiwan: The Bureaucracy" *The Journal of Development Studies* **34** (6): 87-111.

Choi, B.-S. (1993). "Financial Policy and Big Business in Korea: The Perils of Financial Regulation" *The Politics of Finance in Developing Countries*. S. Haggard and C. H. Lee: 23-54.

Cho, Yoon Je, Joon-Kyung Kim, and World Bank. (1995) *Credit policies and the industrialization of Korea* (Washington, D.C: World Bank).

Cho, Yoon Je (1999) *Financial Crisis of Korea: A Consequence of Unbalanced Liberalization?* (Seoul: Sogang Graduate School of International Studies).

Cohen, B. J. (1996). "Phoenix Risen: The Resurrection of Global Finance." *World Politics* **48**(January 1996): 268-96.

Corsetti, Giancarlo, Paolo Pesenti, and Nouriel Roubini (1998) *Paper Tigers? A model of the Asian crisis*.

Cooper, Richard (1999). "Should Capital Controls Be Banished?" *Brookings Papers on Economic Activity* . Washington, D.C.: Brookings Institution.

Cullis, John G., and Philip Asterley Jones (1987) *Microeconomics and the public economy : a defence of Leviathan* (Oxford: Basil Blackwell).

Cumings, Bruce (1998) "The Korean Crisis and the End of "Late" Development" *New Left Review* (231): 43-72.

Demetriades, Panicos O, and Bassam A. Fattouh (1999) "The South Korean Financial Crisis: competing explanations and policy lessons for financial liberalisation" *International Affairs* **75** (4): 779-792.

Diaz-Alejandro, Carlos F. (1988) "Good-bye Financial Repression, Hello Financial Crash" in A. Velasco (ed) *Trade, Development and the World Economy* (Oxford, New York: Basil Blackwell Inc.).

Dooley, Michael P (1996) *A Survey of the Academic Literature on Controls over International Capital Transactions*. IMF Staff Papers 43(4): 639-87

Dornbusch, Rudiger, Yung Chul Park, Korea Institute of Finance, and International Center for Economic Growth. (1995) *Financial opening : policy lessons for Korea* (Seoul, Korea: San Francisco, CA, USA: Korea Institute of Finance ; International Center for Economic Growth).

Editorial Committee for the History of the EPB (ed) (1999) *Yeong-yog-uimhanguggyeongje: bisa-gyeongjegihoeg-wonmssssnyeon [Glory and Shame of the Korean Economy: hidden history - 33 years of the Economic Planning Board]*. (Seoul: Mail Economic Daily Newspaper).

Edwards, S. (1995). *Capital controls, exchange rates, and monetary policy in the world economy.* Cambridge [England] ; New York, NY, Cambridge University Press.

Edwards, Sebastian (1999) "How Effective Are Capital Controls?" *Journal of Economic Perspectives* **13**(4): 65-84.

Eichengreen, Barry, Michael Musa, Giovanni Dell' Ariccia, Enrica Detragiache, Gian Marian Mihesi-Ferretti, and Andrew Tweedie (1998) *Capital Account Liberalization: Theoretical and Practical Aspects* IMF Occasional Paper 172, Washington, D.C.

Eichengreen, Barry (1999) *Toward A New International Financial Architecture: A Practical Post-Asia Agenda* (Washington, DC: Institute for International Economics).

Eichengreen, Barry (2001) "Capital Account Liberalization: What Do Cross-Country Studies Tell Us?" *The World Bank Economic Review* **15** (3): 341-365.

Evans, Peter (1995) *Embedded Autonomy: States and Industrial Transformation*, Princeton, NJ: Princeton University Press.

Evans, Peter (1997) "The Eclipse of the State? Reflections on Stateness in an Era of Globalization" *World Politics* **50** (October): 62-87.

Evans, Peter (1997) "State Structures, Government-Business Relations, and Economic Transformation" in Maxfield, Sylvia, and Ben Ross Schneider (1997) *Business and the state in developing countries* (Ithaca: Cornell University Press): 63-87.

Evans, Peter (1998) "Transferable Lessons? Re-examining the Institutional Prerequisites of East Asian Economic Policies" *The Journal of Development Studies* **34** (6): 66-86.

Evans, Peter, H. K. Jacobson, et al. (1993). *Double-edged diplomacy : international bargaining and domestic politics.* Berkeley, University of California Press.

Fischer, Stanley (2002) *The International Financial System: Crises and Reform*, Lectures prepared for delievery at the London School of Economic, October 29-31, 2001.

Foot, R. and A. Walter (1999). “Whatever happened to the Pacific Century?” *Review of International Studies* **25**(5): 245-269.

Frankel, J. A. (1993). Liberalization of Korea's Foreign-Exchange Markets and the Role of Trade Relations with the United States. *Shaping A New Economic Relationship: The Republic of Korea and the United States.* J. Mo and R. H. Myers. Stanford, California, Hoover Institution Press: 119-142.

Frankel, Jeffrey A. (1998) "The Asian Model, the Miracle, the Crisis and the Fund" at the U.S. International Trade Commission.

Frieden, J. A. (1991). “Invested Interests: The Politics of National Economic Policies in a World of Global Finance.” *International Organization* **45**(4): 425-451.

Frieden, J. A. and R. Rogowski (1996). "The Impact of the International Economy on National Policies: An Analytical Overview." *Internationalization and Domestic Politics.* R. O. Keohane and H. V. Milner. Cambridge [England] ; New York, NY, USA, Cambridge University Press.

Frieden, J. A. and D. A. Lake (2000). *International political economy : perspectives on global power and wealth.* Boston, Bedford/St. Martin's.

Garret, G. and P. Lange (1996). "Internationalization, Institutions, and Political Change" *Internationalization and Domestic Politics.* R. O. Keohane and H. V. Milner. Cambridge [England] ; New York, NY, USA, Cambridge University Press.

Garret, Geoffrey, Alexandra Guisinger, and Jason P. Sorens (2000) *The Political Economy of Capital Account Liberalization* Department of Political Science, Yale University, February. Processed

George, A. L. (1979). "Case Studies and Theory Development: The Method of Structured, Focused Comparison" *Diplomacy.* P. G. Lauren. N.Y. and London, The Free Press.

Gilpin, R. (1987). *The political economy of international relations.* Princeton, N.J., Princeton University Press.

Goldstein, Kaminsky, and Reinhart (2000) *Assessing Financial Vulnerability: An Early Warning Systems for Emerging Markets* (Washington: Institute for International Economics)

Goodhart, C. A. E. (1998) *Financial regulation : why, how, and where now?* (New York: Routledge).

Haggard, Stephan (1990) *Pathways from the periphery : the politics of growth in the newly industrializing countries* (Ithaca, N.Y: Cornell University Press).

Haggard, S. (1998). "Business, politics and policy in East and Southeast Asia" *Behind East Asian Growth: the political and social foundations of prosperity.* H. S. Rowen. London:New York, Routledge: 78-104.

Haggard, S. (1999). "Governance and Growth: Lessons from the Asian Economic Crisis." *Asian Pacific Economic Literature* **13**(2): 30-42.

Haggard, Stephan (2000) *The political economy of the Asian financial crisis* (Washington, DC: Institute for International Economics).

Haggard, Stephan, Richard N. Cooper, and Susan Collins (1993) "Understanding Korea's Macroeconomic Policy" in S. Haggard (ed) *Macroeconomic Policy and Adjustment in Korea, 1970-1990* (Cambridge, Ma: Harvard Institute for International Development/Korean Development Institute): 3-19.

Haggard, Stephan, and Susan Collins (1993) "The Political Economy of Adjustment in the 1980s" in S. Haggard, R. N. Cooper, S. Collins, C. Kim and S.-T. Ro (eds) *Macroeconomic Policy and Adjustment in Korea, 1970-1990*(Cambridge, Ma: Harvard Institute for International Development/Korean Development Institute): 75-107.

Haggard, S., R. R. Kaufman, et al. (1992). *The politics of economic adjustment : international constraints, distributive conflicts, and the state.* Princeton, N.J, Princeton University Press.

Haggard, Stephan, and Chung-in Moon (1990) "Institutions and Economic Policy: Theory and a Korean Case Study" *World Politics* **42** (2): 210-237.

Haggard, Stephan, Harvard Institute for International Development., and Korea Development Institute. (1993) *Macroeconomic policy and adjustment in Korea, 1970-1990* (Cambridge, Mass: Harvard Institute for International Development/Korean Development Institute).

Haggard, Stephan and Chung. H. Lee (1993). "Political Dimension of Finance" *The Politics of Finance in Developing Countries.* S. Haggard and C. H. Lee: 3-20.

Haggard, Stephan, Chung. H. Lee, and Sylvia Maxfield et al. (1993). *The politics of finance in developing countries.* Ithaca, Cornell University Press.

Haggard, S. and S. Maxfield (1993). "The Political Economy of Capital Account Liberalisation" *Financial Opening: Policy Issues and Experiences in Developing Countries.* H. Reisen and B. Ficher. Paris, OECD.

Haggard, S. and S. Maxfield (1996). "The Political Economy of Financial Internationalization in the Developing World" *Internationalization and Domestic Politics. R. O. Keohane and H. V. Milner.* Cambridge [England] ; New York, NY, USA, Cambridge University Press: 209-236.

Haggard, Stephan, and Jongryn Mo (2000) "The Political Economy of the Korean Financial Crisis" *Review of International Political Economy* **7** (2): 197-218.

Hall, P. A. (1998). "The Role of Interests, Institutions, and Ideas in the Comparative Political Economy of the Industrialized Nations" *Comparative Politics: Rationality, Culture, and Structure* M. I. Lichbach and A. S. Zuckerman. Cambridge, Cambridge University Press.

Haas, Peter M. (1992) "Introduction: Epistemic Communities and International Policy Coordination." *International Organization* 46:1-35

Helleiner, E. (1994). *States and the reemergence of global finance : from Bretton Woods to the 1990s.* Ithaca, NY, Cornell University Press.

Hollingsworth, J. Rogers, Philippe Schmitter, and Wolfgang Streeck, eds. (1994) *Governing Capitalist Economies.* New York: Cambridge University Press.

Honohan, Patrick (1999) "Financial Liberalisation: How Far? How Fast? (Draft Concept Paper for Research Project)"

Johnson, Chalmers (1982) *MITI and the Japanese miracle : the growth of industrial policy, 1925-1975* (Stanford, Calif.: Stanford University Press).

Johnson, Chalmers (1998) "Economic Crisis in East Asia: the clashes of capitalisms" *Cambridge Journal of Economics* **22** (6): 653 - 661.

Johnston, R. Barray, and Natalia t. Tamirisa (1998) *Why Do Countries Use Capital Controls?* IMF Working Paper no. WP/98/181, Washington, D.C.

Jones, L. P. and I. SaKong (1980). *Government, business, and entrepreneurship in economic development : the Korean case.* Cambridge, Mass, Council on East Asian Studies Harvard University : distributed by Harvard University Press.

Kang, David (2002) "Bad Loans to Good Friends: Money Politics and the Developmental State in South Korea" *International Organization* 56(1): 177-207

Kang, Man-Soo (2000) "Oehwan-wigi-uimdohwaseonsmjonggeumsa-uimseulpeunmjahwasangkkg" [Sad Record of Merchant Banks, the Fuse to the Crisis] *Monthly Chosun, August 2000 Issue.*

Kahler, Miles (1998) *Capital flows and financial crises* (Ithaca, N.Y.: Cornell University Press).

Katzenstein, P. J., R. O. Keohane, et al. (1998). "International Organization and the Study of World Politics." *International Organization* **52**(4): 645-686.

Keohane, R. O. and H. V. Milner (1996). *Internationalization and domestic politics.* Cambridge [England] ; New York, NY, USA, Cambridge University Press.

King, Gary, Robert O. Keohane, and Sidney Verba (1994) *Designing Social Enquiry: Scientific Inference in Qualitative Research* (Princeton, New Jersey: Princeton University Press).

Kim, Byung-Kook (1965) *Central Banking Experiment in a Developing Economy: Case Study of Korea* (Seoul, Korea: The Korean Research Center).

Kim, Hwa-Kyun (2000) "The Myth of Iron Rice Bowl, which Has Never Broken" *Newsmaker* (Weekly Current Newspaper) (375) May 20th 2000.

Kim, Nam-Kook (1995) "State-Capital Relationship in the light of" *Currents and Prospect* (Summer, 1995): 242-269.

Kim, Yong-Ki (2000) "Evaluation on the Increase in International Reserves to US$ 81.4 bn has been Exaggerated" *Sisa Journal* (Weekly Current Newspaper) (565).

Kong, Tat Yan (2000) *The politics of economic reform in South Korea : a fragile miracle* (London: Routledge).

Krugman, Paul (1998) *What Happened to Asia?*

Kwack, Tae Woon (1990) *Choice of the Exchange Rate System in Korea*, Seoul: Korea Economic Research Institute, Federation of Korean Industries.

Lastra, R. M. and LSE Financial Markets Group. (1996). *Central banking and banking regulation.* London, LSE Financial Markets Group.

Lastra, Rosa María, and LSE Financial Markets Group. (2001) *The governance structure for financial regulation in Europe* (London: LSE Financial Markets Group).

Leblang, David A. (1997) "Domestic and Systemic Determinants of Capital Controls in the Developed and Developing World" *International Studies Quarterly* **41**(3): 435-54

Lee, Jae-Woong (1985) "Financial Liberalization in Korea and Non-Bank Financial Institutions" in *Financial Reform and Financial Rennovation* (Seoul: National Association of Banks): 211-243.

Lee, Sung-Tae (1997) "Closed Coffin ... Desperate Companies" *Weekly Donga.*

Lee, Yoon-Ho (1999a) "Ownership of Financial Sector and Management" in Economics Section of People's Solidarity for Participatory Society (ed.) *White Paper on the Five Biggest Chaebol, 1995-1997*, NaNam Publishing Co.

Lee, Yoon-Ho (1999b) "Capital Structure and Funding" in Economics Section of People's Solidarity for Participatory Society (ed.) *White Paper on the Five Biggest Chaebol, 1995-1997*, NaNam Publishing Co.

Lindblom, Charles Edward (1977) *Politics and Markets: The World's Political-Economic Systems* (New York: Basic Books).

Loriaux, Michael (1991) *France After Hegemony: International Change and Financial Reform* (Ithca, New York 14850: Cornell University Press).

Loriaux, M. (1997). "The End of Credit Activism in Interventionist States". *Capital Ungoverned: Liberalizing Finance in Interventionist States.* M. Loriaux, M. Woo-Cumings, K. E. Calder, S. Maxfield and S. Perez. Ithaca and London, Cornell University Press: 1-16.

Loriaux, M. M. (1997). *Capital ungoverned : liberalizing finance in interventionist states.* Ithaca, Cornell University Press.

Maxfield, Sylvia, and Ben Ross Schneider (1997) *Business and the state in developing countries* (Ithaca: Cornell University Press).

McKinnon, Ronald I. (1973) *Money and capital in economic development* (Washington: Brookings Institution).

McKinnon, Ronald I. and H. Pill (1996). Credible Liberalizations and International Capital Flows: The "Overborrowing Syndrome". *Financial Deregulation and Integration in East Asia.* T. Ito and A. O. Krueger. Chicago and London, The University of Chicago Press: 7-50.

McKinnon, Ronald I., and Huw Pill (1998) "International Overborrowing: A Decomposition of Credit and Currency Risks" *World Development* **26** (7): 1267-1282.

Milner, H. V. (1997). *Interests, institutions, and information: domestic politics and international relations.* Princeton, N.J., Princeton University Press.

Mo, J. and R. H. Myers (1993). "Introduction" *Shaping A New Economic Relationship: The Republic of Korea and the United States.* J. Mo and R. H. Myers. Stanford, California, Hoover Institution Press: 1-10.

Mo, J. and R. H. Myers (1993). *Shaping a new economic relationship : the Republic of Korea and the United States.* Stanford, Calif, Hoover Institution Press Stanford University.

Moon, Chung-in (1994) "Changing Patterns of Business-Government Relations in South Korea" in A. MacIntyre (ed) *Business and Government in Industrializing East and Southeast Asia* (Sydney: Allen and Unwin).

Monthly Chosun (1997) *Interview with Senior Advisor to the President, Kim In-Ho*, August 1997.

Monthly Chosun (ed) (1999) *White Paper on the Foreign Currency Crisis.* (Seoul: Chosun Ilbo).

Monthly Chosun (2001) Statement of The Last Director for Corporate Restructuring in Daewoo Group, Kim Woo-Il, November 2001.

Mueller, Dennis C. (1979) *Public choice* (Cambridge ; New York: Cambridge University Press).

Neely, Christopher J. (1999) An Introduction to Capital Controls. Federal Reserve Bank of St. Louis Review 81(6): 13-30.

Newman, Peter, Murray Milgate, and John Eatwell (1992a) *The New Palgrave dictionary of money & finance, Vol. 1* (New York: Stockton Press).

Newman, Peter, Murray Milgate, and John Eatwell (1992b) *The New Palgrave dictionary of money & finance, Vol. 2* (New York: Stockton Press).

Noland, Marcus, Li-Gang Liu, Sherman Robinson, and Zhi Wang (1998) *Global Economic Effects of Asian Currency Devaluation* (Washington: Institute for Internatinoal Economics)

Obstfeld, Maurice (1996) "Models of Currency Crises with Self-fulfilling Features", *European Economic Review* **40**: 1037-1047.

Oh (1997) "Capital Account Liberalization and Change in the Structure of Balance of Capital Accounts" *Review of Monthly Statistics by Bank of Korea.*

Olson, Mancur (1971) *The logic of collective action: public goods and the theory of groups* (Cambridge, Mass. ; London: Harvard University Press).

Olson, Mancur (1982) *The rise and decline of nations : economic growth, stagflation, and social rigidities* (New Haven ; London: Yale University Press).

Organisation for Economic Co-operation and Development . Committee on Capital Movements and Invisible Transactions. (1995). *Introduction to the OECD codes of liberalisation of capital movements and current invisible operations.* Paris, Organisation for Economic Co-operation and Development.

Park, Jae-Yoon (1985) "Financial Reform in Korea and the Development of Banking Industry" in *Financial Reform and Financial Rennovation* (Seoul: National Association of Banks): 179-210.

Park, Yung Chul (1994) "Korea: Development and Structural Change of the Banking System" in H. T. Patrick and Y. C. Park (eds) *The Financial Development of Japan, Korea, and Taiwan: Growth, Repression, and Liberalization* (New York, Oxford: Oxford University Press): 188-221.

Pempel, T. J. (1999). "The Developing Regime in a Changing World Economy" in M. Woo-Cumings (ed) *TheDevelopmental State.* 137-181.

Private Sector Committee of Strengthening National Competitiveness (1996) *National Competitiveness in Korea*

Quinn, Dennis P., and Carla Inclan (1997) "The Origins of Financial Openness: A Study of Current and Capital Account Liberalization" *American Journal of Political Science* **41**(3): 771-813.

Radelet, Steven, and Jeffrey D. Sachs (1998) "The Onset of the East Asian financial crisis" in http://pages.stern.nyu.edu/~nroubini/asia/

Rodrik, Dani. (1998) "Who Needs Capital-Account Convertibility?" In Peter Kenen (ed.) *Shoul the IMF Pursue Capital Account Convertibility? Essays in Interantional Finance no. 207*, Princeton: Princeton University Press.

Rogowski, R. (1990). *Commerce and coalitions : how trade affects domestic political alignments.* Princeton, N.J., Princeton University Press.

Rossi, M. (1999). *Financial Fragility and Economic Performance in Developing Economies: Do Capital Controls, Prudential Regulation and Supervision Matter?* [Washington, D.C.], International Monetary Fund Monetary and Exchange Affairs Department.

Schneider, Ben Ross (1998) "Review Article: Elusive Synergy, Business-Government Relations and Development" *Comparative Politics* **31** (October): 101-122.

Shim, Young (2000) *Korean bank regulation and supervision : crisis and reform* (Hague, Boston, MA: Kluwer Law International).

Simmons, Beth, and Zachary Elkins (2000) *Globalization and Policy Diffusion:*

Explaining Three Decades of Liberalization. University of Califonia, Department of Political Science, Berkeley. Processed.

Sparrow, Malcolm K. (2000) *The regulatory craft : controlling risks, solving problems, and managing compliance* (Washington, D.C.: Brookings Institution Press).

Strange, S. (1993). *States and markets : an introduction to political economy*. London, Pinter.

Strange, S. (1996). *The retreat of the state : the diffusion of power in the world economy*. Cambridge, Cambridge University Press.

Stiglitz, Joseph (1998a) *Sound Finance and Sustainable Development in Asia: Keynote Address to the Asia Development Forum* (Paper read at the Asia Development Forum), March 12, 1998, at Manila, the Philippines.

Stiglitz, J. (1998b). *Knowledge for Development: Economic Science, Economic Policy, and Economic Advice*. Annual World Bank Conference on Development Economics, Washington, D.C.

Stiglitz, Joseph (1999a) *Keynote Speech, The Korean Miracle: Growth, Crisis, and Recovery Accomplishments of the Past, Challenges of the Future* (Paper read at the Korea Development Institute Symposium), November 1999, at Seoul, Korea.

Stiglitz, Joseph E., and Bangladesh Economic Association. (1999b) *State versus market : have Asian currency crises affected the reform debate?* (Dhaka: Published for Bangladesh Economic Association [by] University Press).

Stiglitz, Joseph (2000) "Capital Market Liberalization, Economic Growth and Instability" *World Development* **28**(6): 1075-86.

Stiglitz, Joseph E., and Shahid Yusuf (2001) *Rethinking the East Asia miracle* (Washington, D.C. New York: World Bank ;Oxford University Press).

Stiglitz, Joseph (2001) "From Miracle to Crisis to Recovery: Lessons from Four Decades of East Asian Experience" in J. Stiglitz and S. Yusuf (eds) *Rethinking the East Asian Miracle*: Oxford University Press): 509-526.

Summers, L. H. (1998). *Opportunities Out of Crises: Lessons From Asia*. Overseas Development Council.

Wade, Robert (1990) *Governing the market : economic theory and the role of government in East Asian industrialization* (Princeton, N.J: Princeton University Press).

Wade, Robert (1998) "The Asian Debt-and-development Crisis of 1997-?: Causes and Consequences" *World Development* **26** (8): 1535-1553.

Wade, Robert (2000) *International Institutions and the US Role in the Long Asian Crisis of 1990-2000* (Paper read at Conference titled 'New Institutional Theory, Institutional Reform and Poverty Reduction) 7th & 8th September 2000, at LSE.

Wade, R. and F. Veneroso (1998). "The Gathering World Slump and the Battle over Capital Controls." *New Left Review* **1998**(231): 13-42.

Walter, A. (2001). *The Political Economy of International Money (Processed).*

Wang, Wen-Kyun (1993) "Exchange Rates, Current Account Balance of Korea, and U.S.-Korea Negotiations on Exchange-Rate Policy" in J. Mo and R. H. Myers (eds) *Shaping a New Economic Relationship: The Republic of Korea and the United States* (Stanford, California: Hoover Institution Press).

Weiss, Linda, and John Hobson (1995) *State and Economic Development* (Cambridge: Policy Press).

Weiss, Linda (1998) *The myth of the powerless state : governing the economy in a global era* (Cambridge: Polity Press).

Williamson , John, and Molly Mahar (1998) "A Survey of Financial Liberalization" *Essays in International Finance 211*. Princeton University, Department of Economics, Interantional Finance Section, Princeton, N.J.

Wolf, Charles Jr. (1998) "Too Much Government Control" *Wall Street Journal*, 4 February 1998.

World Bank. (1993) *The East Asian miracle : economic growth and public policy* (Oxford ; New York, N.Y: Oxford University Press for the World Bank).

Woo, Jung-en (1991) *Race to the swift : state and finance in Korean industrialization* (New York: Columbia University Press).

Woo-Cumings, Meredith (1997) *Bailing Out or Sinking In? The IMF and the Korean Financial Crisis*

Woo-Cumings, Meredith (1999) "Introduction: Chalmers Johnson and the Politics of Nationalism and Development" in M. Woo-Cumings (ed) *The Developmental State* (Ithaca: Cornell University Press).

Woods, N. (2000) *The United States and the International Financial Institutions: power and influence within the World Bank and the IMF.*