Regulated Deregulation of the Financial System in Korea

Ismail Dalla
Deena Khatkhate
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Ismail Dalla
Deena Khatkhate

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FOREWORD

In the last few years, almost all developing and transition economies have moved decisively towards liberalizing their economies. As a part of this process they also focused on deregulating their financial systems and policies. The experiences of the countries undergoing financial reform however have not been uniform. While the countries in Latin American and Africa have run into serious problems in the early stages of their financial reform, the progress of the East Asian countries has been generally acclaimed as highly successful, with some exceptions. Korea is one of the countries which started its financial liberalization program in the early 1980s, and though it passed through vicissitudes, which impelled it to follow stop-go policies; it has been credited with impressive achievements in management of its financial sector. Korea’s performance however did not conform to a textbook version of financial sector reform as modeled by the academics like McKinnon and Shaw and implemented in Latin America. In Korea’s financial reform strategy, the government continued to play a role, but it did not prevent its financial system’s market-orientation. In a way Korea’s policies reflected the broad analytical and policy framework which has been a sterling feature of the East Asian economic miracle, as extensively documented in the World Bank’s cross-country study of 1993. Yet by 1993, Korea’s financial reform policies resembled a conventional type of financial liberalization, when it announced a blueprint of reforms spread over a period of five years ending in 1997.

The World Bank has contributed importantly to this new phase of Korea’s financial reform, when it undertook a financial sector study, at the request of the Korean authorities. The final blueprint is thus the result of the joint effort of the Government of Korea and the World Bank. The authors of this paper, have placed the Korean’s recent policy shift in a more general analytical perspective, underscoring the institutional and historical aspects of the Korean economy which made it possible for its government to enhance efficiency of its financial system rather than impede it. I hope that this paper would help the policy makers in countries preoccupied with pursuing financial reform to perceive the Korea’s non-market approach to the financial reform in its relevant context and to alert them to the risks involved in generalizing its lessons for other countries.

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Director
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ABSTRACT

This paper examines the anatomy of the Korean financial reform policy since 1974 in order to place its financial reform plan of 1993 in the right perspective. It starts with a conceptual framework which provides a rationale for why the financial liberalization in Korea proceeded gradually with government guidance which was market-conforming. It argues that the Korea's approach to regulated financial reform was rooted in its institutions, history and its peculiar genius to devise non-market institutions as complementary and supportive to the market system. After surveying Korea's progress in financial system liberalization, the paper focuses on Korea's blueprint of complete deregulation introduced in 1993 and brings out its underlying logic. It however adds a caution that the Korean model is not possible to replicate in other developing countries.
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I. INTRODUCTION

Financial liberalization policy as modeled by the academicians like KcKinnon (1973) and Shaw (1973) and implemented in several developing countries in Asia and Latin America in early 1970s has undergone changes in regard to its connotation, operational mode, sequencing and above all its very interpretation in light of the experiences gained. An emerging perspective on these issues can be attributed to several factors. First of all, the institutional context in which financial liberalization policies have been initiated and implemented has varied from country to country, and thus has influenced its ultimate results. Second, the instrumentality of financial deregulation has lacked uniformity across countries. In countries like Korea and Taiwan (and for that matter even Japan), their financial systems have been made more efficient even by perpetuating a mild degree of financial repression during the early phases of their deregulation policies though the criteria by which the consequences of their liberalization policies are evaluated remained similar to those used in regard to a fully market-determined deregulation. For instance, a concept of financial liberalization negates the presence of government in decision-making of financial institutions in regard to credit allocation and its cost, but in these countries where it was pursued with a substantial degree of success, the government was conspicuously active. However, the debate on financial liberalization in general, its speed and the lessons drawn from the experiences of failure or success in the countries which underwent financial liberalization, ignores a distinction between financial liberalization with government guidance and without it and its impact on the final outcome of liberalization policies. Third, a sequencing pattern has not been as originally envisaged in the original financial liberalization model, as it is determined by the initial conditions, particularly the state of the financial system prevailing when a deregulation policy is formulated. If, for instance, banks are overburdened with non-performing loans, the mode of deregulation is measured and in discrete steps.

This is no where more evident than in the execution of interest rate deregulation policies. It is now well recognized that the dismantling of interest rate ceiling in many countries have been conceived without regard to the state of the economy, state of the banking system and its nature, the quality of the liability structure of the borrowing firms and the host of other lesser issues. It was not therefore surprising that actual results of interest rate deregulation in several countries following a standard prescription totally diverged from what was intuitively expected. The increased freedom of entry into the financial sector resulting in indiscriminate bidding for fund can raise interest rate levels to excessively high level (Khatkhate, 1922; Sundararajan and Balino, 1991). The structure of the banking system that emerges from regulatory changes can also result in concentration of power in banking, increased interlocking ownership and concentrated lending; such an environment is particularly vulnerable to market failure. The belief that in the deregulatory environment interest rates would find their true equilibrium value or they could automatically tend to converge to international rates over time, has also been falsified by the experience. These unexpected results came about not only because the interest rate deregulation was introduced in the midst of macro-economic instability - this rationale is
now accepted without dissent - but also because wrong timing of the interest rate deregulation - essentially a structural reform could accentuate the macroeconomics instability which it seeks to eliminate in the first place.¹

While a comprehension of some of the nuances of financial liberalization policies has helped to crystallize issues in academic discourse, a question may be pertinently raised whether it is analytically meaningful and operationally relevant to consider that financial repression in the sense McKinnon-Shaw have defined it is necessarily harmful. The countries like Japan, Taiwan and Korea made rapid strides both in regard to GDP growth and the development of their financial systems by permitting their governments to strongly influence the credit allocation and interest rates. A counterpoint to this is provided by many countries in Latin America, Africa, and South Asia. Where the government intervention became a cause celebre, it brought about a decline of their economies through financial repression, price distortions, and market segmentation. This calls for a greater precision in defining terms such as government intervention in credit markets and financial repression and the specification of the conditions under which the interventionist stance could succeed (Cho and Hellman, 1993). There is a further question in that case, whether a financial deregulation should always imply a total absence of government intervention or it could be consistent with a modified government presence. While answers to these questions will help to formulate a more generalized notion of financial liberalization, they may still fall short of explaining why countries which begin with government-guided financial deregulation switch eventually over to a full throttle, conventional type of financial liberalization.

All these aspects are thrown in bold relief in the case of Korea. Financial deregulation in Korea first initiated in 1979 coincided with similar programs in Southern cone countries and some of the East Asian countries like Indonesia, the Philippines and Malaysia. However, Korea’s financial liberalization was qualitatively different. It accomplished positive real interest rates, ensured competition among banks, improved directed credit programs through gradual reduction of subsidy, while continuing financial repression, though in a mild form. Its deregulation policy ran a zigzag course and at times underwent even a reversal. Korea moved decisively however since 1993 in a direction of a conventional type of financial liberalization policy, when it announced a blueprint of reforms spread over a period of five years ending in 1997. This paper examines the anatomy of the Korean financial reform policy since 1979 in order to place its financial reform plan of 1993 in the right perspective.

The rest of the paper is organized as follows. Section II presents a conceptual framework of the Korean financial system and policy which underscores the

¹ This conclusion has been derived from macroeconomic analysis of economic reform process. Cho (1994) has recently shown on the basis of microeconomic analysis of the financial liberalization policy that if financial reform is pursued when inflation is high or rising, the corporate sector’s profitability will be strained and it will be in serious financial distress.
institutional features of the Korean economy which facilitated a constructive and successful role that government played in its financial development. Interest rate reform in regard to structure, level and policies and credit allocation system changes undertaken in earlier phases are discussed in Section III and IV. The rationale of the final financial reform phase, sequencing order of its various elements and the assessment are contained in Section V. Section VI presents some broad conclusions.

II. KOREAN FINANCIAL SYSTEM AND POLICY - A CONCEPTUAL FRAMEWORK

The Korean financial system has been, since 1960, pervasively dominated by the government in all its functioning's. With nationalization the financial institutions had been under direct government control during 1960-1979 and the business enterprises were subjected to similar control, but mainly indirectly through the financial system. Interest rates were regulated and credit allocation was guided according to a strict scheme of priorities, which was inevitable under the controlled financial system. Theoretically, such a system should have led to reduced savings resulting from low or even negative real interest rates and inefficient and loss-making industries as credit was allocated not on the basis of market criteria but discretionary judgments of the government bureaucrats. However, the actual results diverged substantially from the theoretically expected outcome. The savings far from declining, increased rapidly and the productive efficiency of enterprises remained high and thus capital intensity of their production low despite the subsidized credit and special preferences received by them (World Bank, 1993, (a) and (b)). The government controlled financial system mimicked, as if it were, a free-market allocation of resources. This was contrary to the experiences in a large number of other countries where governments had intervened significantly (Giovanni, 1983; Van Wijnbergen, 1982; Khatkhate, 1988). It is widely recognized in theory that government intervention to remove market failure has certain transaction costs as there are in free-wheeling markets. The major component of costs is in regard to obtaining information about prices and how the market would respond to them. The other equally important component is represented by the effort of the intervening agencies to act without delay once the information becomes available. The government's interventionist policy succeeds only if the transaction costs which it entails are less than those that prevail in free markets (Coase 1988). Obviously, in the Korean case these costs have been consistently low at least until 1992. However, this fact by itself is less illuminating than the knowledge of the conditions in Korea which reduced the transaction costs of government intervention to overcome successfully the credit and product market failures.

The government intervention in Korea tended to become market-conforming because of its particular institutional features. The Korean economic system is divided into two subsystems - a public system committed to developmental goals and a private system pursuing profit motives. The relationship between these two subsystems is continuous and interactive because the intents of both are harmonized. Thus "the intent of the public system is to manipulate the decisions of private enterprises so that its
developmental goals are achieved, whereas the intent of the private system is to maximize profits, limit risks, and achieve stable growth.” (Johnson, 1985 and Lee, 1988; World Bank 1993; Page, 1994). Harmonious and mutually beneficial relationship between the two subsystems is maintained through coopting the financial system in a coalition, in order to provide credit at subsidized rates to the private sub-system and according to certain priority order. This relationship forms an internal organization under the hegemony of the government where the contact is intimate and direct. In fact, this relationship is well described as a partnership in which the government is a senior partner and private enterprises junior partners. The instruments used to forge these relationships conducive to mutual benefit are “deliberation Councils” and “discussion groups” which transmit essential information more directly than would be possible through markets (Lee 1988; Cho and Hellman 1993; World Bank, 1993 (a)).

This kind of quasi-internal organization becomes a surrogate for the efficiently operating capital market which tends to minimize risk, and uncertainty, reduces credit rationing and fills in the gaps in information channels which the enterprises need for their decisions to maximize profits. Without such an artifact of internal organization, a less developed country as Korea was in the 1960s would have faced as Stiglitz (1989) argued “double disadvantage: not only are there informational imperfections, leading to credit and equity rationing, not only are these informational imperfections likely to be more important within LDCs, because the process of change itself leads to greater informational problems; but more importantly the institutional framework for dealing with these capital market imperfections are probably less effective, because of the small scale of firms within LDCs and because the institutions for collecting, evaluating, and disseminating information are likely to be less well developed” (Stiglitz, 1989).

The efficiency of internal transactions relative to those of market transactions is ensured by two characteristics of the internal organization which help to overcome informational imperfections. As Williamson (1975) underscored, first, the bounds of rationality are extended by the internal organization because its hierarchical structure permits specialization of decision-making and economizes on communication costs. Second, the internal organization, removes uncertainty by making it possible to coordinate the decisions of interdependent units to adapt to unforeseen contingencies. In Korea’s case both of these characteristics were present in its internal organization led by the government. The government and large private enterprises (the relationship with small firms were of “an arm’s length” type) were able to share the information through vehicles such as deliberative bodies, without having to wait for it to be conveyed through market prices. “Thus decisions over the allocations of credit could be made before price changes could signal the direction of credit allocation and private agents could respond to these signals. In addition, by coordinating these enterprises, the quasi-internal organization could adapt to unforeseen contingencies” (Lee, 1992).

A pertinent question is how a quasi-internal organization ensures its efficiency which, in the case of a private firm, is maintained only through competition. In absence of any competition, the internal organization changes prices which the
government often do through administrative fiat to cover the losses of a wrong decision about credit allocation. But its efficiency would suffer as a point would be reached sooner or later, when the internal organization will have to wind up, not being able to raise prices or pass on the losses to the government. Such hazards were however avoided in Korea, as the quasi-internal organization that it set up was exposed to the outward-oriented development strategy. Prices being externally determined parameters, the government could not just “arbitrarily change prices to cover the consequences of an inefficient allocation of credit. Because of this constraint, an inefficient internal allocation of credit which supports the wrong projects will result in financial losses for the large enterprises undertaking the projects. They may be able to survive with subsidies from the government but their losses are nevertheless internal to the quasi-internal organization. Thus, whether there are subsidies or not, the quasi-internal organization will be suffering financial losses, and it will eventually be forced to reverse its pattern of credit allocation” (Lee 1992).

Besides, efficiency was maintained by the integration of credit policies with other macro-policies and development strategies. Being directly involved in economic activity, the government could correct in time policy distortions damaging the industrial sectors, thereby preventing a large amount of non-performing loans of the banking system and an increase in government’s own quasi-fiscal deficit. (Cho and Hellman, 1993). Thus, the pernicious impact of government intervention in the form of credit allocation and subsidized cost of credit is more than offset. In other words, even a quasi-internal organization, even though it could compensate for information deficiency and absence of price signals could not have made the repressed financial system yield efficiency gains without there being outward competition to spur it.

Furthermore, the efficiency of the government-led internal organization is assured by the good implementation of policy. The transaction costs were reduced by less “opportunism and uncertainty, small number of indeterminances, better information, and group-oriented atmosphere” (Lee 1992). The government coordinated interdependent enterprises to provide for unforeseen contingencies, and it could resolve by fiat, small number of bargaining indeterminancies among enterprises to the benefit of the public good.

It is this accommodation effected by the government and private business that made what is commonly regarded as a repressed financial system a part of the internal capital market. But from this, it should not be inferred that government intervention in the credit system is justified in all cases as Amsden, and Euh suggest (1993). If the institutional environment is without an internal capital market, the repressed financial system that would follow in the wake of government intervention will not ensure efficient private economy. It is also necessary to view the role of government in a dynamic context. In the early stages of economic development when market imperfections are pronounced and persistent, the private sector is incipient, markets are either non-existent or still evolving, there is a need to have a government-led internal organization which meets the credit needs of the private sector at below market rates. Once the critical barrier is crossed by the private economy, with more sophistication of productive apparatus, advanced techniques of credit evaluation, the size of internal organization
reaches a point when diseconomies of scale set in and quasi-internal organization tends to outlive its usefulness. This means a repressed financial system which previously worked to the advantage of the private economy with efficiency gains becomes not only redundant but harmful to the efficient allocation of resources.

It is in this analytic perspective that Korea’s financial liberalization policy has to be assessed rather than with a reference to a general format of similar policies prescribed by the academic economists and implemented pro-forma in most of the developing countries. A hallmark of the Korean’s deregulation policy has been one with a visible hand of government, steering its course through time towards market-environment. Its distinguishing feature was not a total withdrawal of government intervention; it was more designed to diminish financial repression gradually as the quasi-internal organization led by the government began to yield ground in a fast maturing Korean economy which ceased to be hobbled by credit and equity rationing. This also explains why Korea launched a plan in 1993 for a conventional type of financial liberalization policy.

III. INTEREST RATES - LEVEL, STRUCTURE AND POLICY

The Korean deregulation policy, as first initiated in 1979 has several facets - privatization of banks, free entry of non-bank financial intermediaries, introduction of new financial instruments, modification of interest rate ceilings and relaxation of directed credit. However, only last two are singled out for analysis in this paper as they form the core of the final liberalization policy in 1993. Korean interest rate policy as an integral part of its financial deregulation program, can be seen in three phases. First 1979-87, the second 1988-1992 and the final one in the blueprint of 1993. First two will be described and evaluated in this section, leaving the last one to be discussed in Section IV.

First Phase of Interest Rate Deregulation 1979-1987

Korea embarked on a major economic and trade reform towards the end of 1970s and as a part thereof, relaxed interest rate ceilings, though a formal regulatory apparatus was retained. Interest rate ceilings were adjusted upward in 1979 to yield positive real interest rates, but this move was frustrated by the acceleration of the inflation rate in 1980 and 1981, following in the wake of the oil price crisis. In 1987, with the privatization of banks, preferential lending rates were abolished and the bank loan rates were unified at 10 percent. Commercial paper was allowed to be issued for non-bank financial intermediaries (NBFIs) at market interest rates. The band system for bank lending rates was introduced and further widened, together with the liberalization of short-term inter-bank rates and the introduction of certificates of deposits for banks in 1984; Cash Management Account by short-term finance companies and household trust accounts and paying of market interest rates, primary market interest rates were freed from formal restrictions on corporate bonds and certificate of deposits (CDs). In 1987, securities companies were permitted to issue the bond management fund, similar to but more
restrictive in asset management than money market funds in the advanced countries like the United States (Cho and Khatkhate, 1989; Nam, 1994).

The impact of interest rate relaxation was immediately seen on the interest rates of banks and non-banks. Bank loan and deposit rates which were consistently negative in real terms throughout the 1974-80 period, turned increasingly positive after the 1981 financial reform (Table 1). The positive real interest rates stemmed, however, mainly from a decline in the inflation rate, but unlike the case during the 1970s, equally important was the government's commitment to maintaining positive real interest rates, made certain by its constant watch over movement of inflation rate in order to adjust bank interest rates (Cho and Khatkhate, 1989). A notable aspect of Korea's interest rate policy during this period, was that it remained market-oriented, although the government continued to intervene in the determination of interest rates. However, this approach did not shun the risk of negative real interest rates if warranted by the circumstances as borne out by the fact that the nominal deposit and loan rates were adjusted downward frequently in 1982, despite persistently high inflationary expectations, because, at that time many corporate firms had difficulties meeting their debt repayment obligations. Although this induced some shift in deposits away from banks to nonbank financial intermediaries (NBFIs), it contributed substantially to the reduction of the corporate debt burden; if the government had refrained from adjusting the lending and deposit rates, there would have been massive bankruptcies of the corporate firms and the problem of the banks' non-performing loans might have become more acute. The Korean experience in regard to a timely adjustment in interest rates through government intervention may be seen in contrast to that in the Philippines in 1986 and in Malaysia in the 1980s, where market-determined interest rates lagged behind the decline in the inflation rate (Cho and Khatkhate, 1989).

Domestic banks' interest rates, although high in nominal but not in real terms, were also higher than those prevailing abroad and were sustained at that level because stringent foreign exchange controls and the expectations of exchange rate depreciation. Since 1980, however, despite continued control on capital flows, the gap between domestic and foreign interest rates was narrowed. The effective cost of foreign currency loans was higher during 1980-85 than in the 1970s. This trend was reversed in 1986, however, as the Won appreciated against the US dollar with the emergence of a current account surplus. On the whole, the level of domestic interest rates was not sensitive to foreign interest rates to the extent expected because of the insulation of the
Table 1. Regulated and Market Interest Rates

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<th>Regulated Rates</th>
<th>Market Rates</th>
<th>Average Borrowing</th>
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<th>Consumer Inflation Rate</th>
<th>Real GNP Growth</th>
<th>M2 Growth Rate</th>
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<td>Bank 1-Year Time Dep.</td>
<td>General Bank Loans</td>
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<td>15.5</td>
<td>20.1</td>
<td>41.3</td>
<td>11.3</td>
<td>25.4</td>
<td>6.4</td>
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<td>20.4</td>
<td>40.5</td>
<td>11.9</td>
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<td>42.4</td>
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<td>7.2</td>
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<tr>
<td>1980</td>
<td>22.7</td>
<td>23.4</td>
<td>30.1</td>
<td>44.9</td>
<td>18.7</td>
<td>28.7</td>
<td>-3.7</td>
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<td>1981</td>
<td>19.3</td>
<td>19.8</td>
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<td>30.6</td>
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<td>7.1</td>
<td>7.2</td>
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<td>1983</td>
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<td>25.8</td>
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<td>24.8</td>
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<td>2.8</td>
<td>12.9</td>
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<td>22.7</td>
<td>13.0</td>
<td>7.1</td>
<td>12.4</td>
</tr>
<tr>
<td>1989</td>
<td>10.0</td>
<td>11.5</td>
<td>15.2</td>
<td>19.1</td>
<td>13.6</td>
<td>5.7</td>
<td>6.8</td>
</tr>
<tr>
<td>1990</td>
<td>10.0</td>
<td>11.5</td>
<td>16.4</td>
<td>18.7</td>
<td>12.7</td>
<td>8.6</td>
<td>9.0</td>
</tr>
<tr>
<td>Jun-91</td>
<td>10.0</td>
<td>11.5</td>
<td>18.6</td>
<td>0.0</td>
<td>0.0</td>
<td>10.1</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Note a/ Calculated by dividing interest payments of the year by the average outstanding of borrowings including corporate bonds.

domestic financial market from the international market. On the other hand, it could be argued that capital controls were instrumental in preventing capital flight from Korea in the early 1980s when the public's confidence in the Government's ability to manage the economy was low, the political situation was volatile, and there was a widespread distrust of the domestic banking system. With free capital movement, Korea might have lost control over the deposit base of domestic financial intermediaries, as happened in other countries like the Philippines, Indonesia, and the Southern Cone countries in Latin America around the same time (Cho and Khatkhate, 1989).

With all these liberalization measures, however, progress was generally half-hearted and faltering. The government was apprehensive about the impact of higher interest rates on the business sector, which made them intervene whenever they thought the market interest rates overshot the level perceived to be sustainable. Although the deregulation program was de facto abandoned, a brush with it, though on a limited scale during this period made the policy-makers and the market participants aware of the positive impact of financial deregulation. This set the stage for a fresh impetus for deregulation by the government in 1988. Coincidentally, these moves toward financial deregulation were induced by the notable improvement in the macroeconomic conditions in Korea during a major part of the 1980s, and by high savings in excess of domestic investment which narrowed the disparity between the regulated and free market rates, i.e., curb market rates.

**Second Phase of Interest Rate Deregulation, 1988**

In 1988, most bank and non-bank lending rates and some long-term deposit rates were decontrolled, except for the rates on policy loans and short-term deposit rates - the latter on the ground of preventing excessive competition among financial intermediaries. Deregulated interest rates or yields also included those on financial debentures, corporate bonds, asset management accounts and funds, and such money market instruments as commercial paper (CP), certificates of deposits (CD), and large repurchase agreements (RPs). In order to prevent any massive transfer of funds to liberalized financial assets, restrictions were imposed in the form of a minimum transaction unit (in regard to CP) and ceilings on the handling of some business such as CDs and asset management accounts and funds (Nam, 1994; World Bank 1993 (b)).

However, this policy was not allowed to run its full course. As soon as the interest rates moved upward from the repressed level in response to deregulation, there was backtracking as the authorities gave a tacit consent to, and even encouraged, collusion on interest rates by financial institutions. As a result, bank lending rates and most rates in the primary market did not respond to market conditions to the extent necessary, suggesting thereby that the Korean financial market was still far from being fully competitive and integrated domestically. In many of the primary securities markets, the issuing rates deviated markedly from the market rates, resulting in various irregularities associated with the underwriting and underdevelopment of secondary markets (exhaustively documented in World Bank 1993 (b)).
A most dramatic impact of the interest rate deregulation policy, for all its imperfection and frequent reversibility was reflected in the development of the money market. Until 1989, the call-money market was divided into two segments: the exchange market - mainly for banks and the over-the-counter market - mainly for NBFIs. In the first market, the inter-bank rate was allowed to move freely, though in practice its movement was hamstrung by money market regulation of one type or another, thereby attenuating its market character. In the over-the-counter markets, where both borrowing and lending rates were higher than in the first market, reflecting more realistically the market conditions. Since 1989, both these markets were integrated into a single market to improve the efficiency of the money market (Kang, 1990; World Bank 1993 (b)). The newly integrated money market's characteristics which made it more competitive than the earlier twin-markets are displayed in Table 2.

The size of the money market, as a result, expanded substantially and the instruments traded therein also increased in number and diversity (Table 3). A measure which relates the value of a money market instruments to narrowly defined money (M1), regarded as a close substitute for money market instruments, is used as an indicator of the size, and importance of the money market instruments and rates of change in the quantity of these instruments relative to the change in M1 as an indicator of the relative growth of those instruments (Table 4). Between the end December 1980 and end December 1991, the M1 increased by 276.4%; the value of transactions in the call money market increased by 544.8% during the same period, giving a growth elasticity of all transactions of 1.71 relative to M1; the value of commercial paper increased during the same period by 821.8%, giving a growth elasticity of commercial paper of 2.45 relative to M1. Except the growth elasticity of repurchase agreements which fluctuated, growth elasticity of all the instruments increased between 1980-89. The growth of the money market and its diversity have paved a way for a bolder action to liberalize the interest rates which have long been constrained by a straight-jacket of government and Bank of Korea regulations.

The level and structure of interest rates prevailing in the Korean money market are presented in Table 5. Despite the difference in time, one feature that emerges from the Table is that the rates in the money market proper - that is the interbank market and CD market - were higher than those on bank deposits and loans of identical maturities, suggesting that money market rates are more reflective of the market forces of demand and supply. Furthermore, there is some empirical evidence that money market interest rates and curb rates showed a considerable integration in that the various interest rates in the market moved in tandem, either in upward or downward direction. However, despite a rapid development of the money market in recent years, it is still not as efficient as it should be, mainly because the financial intermediaries - especially the deposit money banks have been operating under the informal "window guidance" from the BOK and MOF.
Table 2. Korea - Changes in Characteristics of the Money Market, Post-1989

<table>
<thead>
<tr>
<th></th>
<th>Pre-Integrated Call Market</th>
<th>Over the Counter Market (Unofficial market)</th>
<th>Integrated</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Participants</strong></td>
<td>Mainly banks a/</td>
<td>Non-bank financial institutions b/</td>
<td>All financial institutions</td>
</tr>
<tr>
<td><strong>Transaction by type</strong></td>
<td>Concentrate in the Call Transaction Center</td>
<td>Over-the-counter market</td>
<td>Over-the-counter market through seven brokers c/</td>
</tr>
<tr>
<td><strong>Maturities</strong></td>
<td>1, 3, 7, 15 days</td>
<td>1, 3, 7, 15 days</td>
<td>1, 3, 5, 7, 9, 11, 15 days</td>
</tr>
<tr>
<td><strong>Ceiling on call money</strong></td>
<td>Within a five percent of average deposits recorded two months ago</td>
<td>No restrictions</td>
<td>No restrictions</td>
</tr>
<tr>
<td><strong>Transaction time</strong></td>
<td>From Monday to Friday: 13:30 - 16:30 Sat.: 10:00-12:30</td>
<td>No restrictions</td>
<td>No restrictions</td>
</tr>
<tr>
<td><strong>Interest rates</strong></td>
<td>Single rate which can implement most transactions</td>
<td>Freely determined rates at each transactions</td>
<td>Same with the left</td>
</tr>
<tr>
<td><strong>Clearing system</strong></td>
<td>Through BOK’s reserve accounts of each banks</td>
<td>Through individual current accounts at banks</td>
<td>Inter-bank transactions: through BOK’s reserve accounts Others: through transfer of banks’ account according to brokers’ notice</td>
</tr>
<tr>
<td><strong>Fees</strong></td>
<td>5/100,000%</td>
<td>None</td>
<td>5/100,000%</td>
</tr>
<tr>
<td><strong>Collateral</strong></td>
<td>Generally without collateral</td>
<td>Without collateral</td>
<td>Without collateral</td>
</tr>
</tbody>
</table>

a/ Participants in the exchange market (official market): Banks (including foreign bank branches); National Investment Fund, Investment and Finance Companies (IFC), Merchant Banking Corporations (MBC), Investment Trust Companies (ITC), insurance companies, Korea Securities Finance.

b/ Participants in the over-the-counter market (unofficial market): IFC, MBC, insurance companies, KSFC, CIF, securities companies, lease companies, mutual savings and finance companies.

c/ The previous Call Transactions Center and the six IFCs are approved as broker.

Source: Ministry of Finance, Bank of Korea.
<table>
<thead>
<tr>
<th>Year</th>
<th>Call Market</th>
<th>Commercial Paper</th>
<th>Rps</th>
<th>Negotiable CDs</th>
<th>Commercial Bill</th>
<th>Bankers Acceptances</th>
<th>Treasury Bills</th>
<th>MSBs</th>
<th>Total (A)</th>
<th>M1 (B)</th>
<th>M3 (C)</th>
<th>Nominal GNP (D)</th>
<th>A/B (%)</th>
<th>A/C (%)</th>
<th>A/D (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>178.7</td>
<td>2,083.3</td>
<td>129.5</td>
<td>1,080.0</td>
<td>150.0</td>
<td>3.2</td>
<td>36,672.3</td>
<td>66.8</td>
<td>66.8</td>
<td>3,807.0</td>
<td>17,062.2</td>
<td>36,672.3</td>
<td>66.8</td>
<td>14.2</td>
<td>6.9</td>
</tr>
<tr>
<td>1985</td>
<td>432.7</td>
<td>7,283.0</td>
<td>2,562.7</td>
<td>1,651.4</td>
<td>504.1</td>
<td>504.1</td>
<td>78,088.4</td>
<td>159.1</td>
<td>159.1</td>
<td>7,557.8</td>
<td>55,450.0</td>
<td>78,088.4</td>
<td>159.1</td>
<td>21.5</td>
<td>15.4</td>
</tr>
<tr>
<td>1987</td>
<td>490.7</td>
<td>9,432.3</td>
<td>2,720.9</td>
<td>1,752.7</td>
<td>8,174.5</td>
<td>10,000.0</td>
<td>106,024.4</td>
<td>233.1</td>
<td>233.1</td>
<td>10,107.3</td>
<td>93,637.7</td>
<td>106,024.4</td>
<td>233.1</td>
<td>25.1</td>
<td>22.1</td>
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<tr>
<td>1988</td>
<td>634.4</td>
<td>12,330.6</td>
<td>2,360.1</td>
<td>1,847.7</td>
<td>15,373.5</td>
<td>2,130.0</td>
<td>126,230.5</td>
<td>276.9</td>
<td>276.9</td>
<td>12,151.4</td>
<td>120,356.6</td>
<td>126,230.5</td>
<td>276.9</td>
<td>29.1</td>
<td>26.8</td>
</tr>
<tr>
<td>1989</td>
<td>1,152.3</td>
<td>19,207.5</td>
<td>2,146.0</td>
<td>1,847.7</td>
<td>17,305.5</td>
<td>23,130.0</td>
<td>141,794.4</td>
<td>311.4</td>
<td>311.4</td>
<td>14,329.0</td>
<td>153,831.2</td>
<td>141,794.4</td>
<td>311.4</td>
<td>29.0</td>
<td>31.5</td>
</tr>
<tr>
<td>1990</td>
<td>3,396.9</td>
<td>22,863.4</td>
<td>2,410.9</td>
<td>6,803.5</td>
<td>15,240.5</td>
<td>22,940.0</td>
<td>206,026.5</td>
<td>338.9</td>
<td>338.9</td>
<td>15,905.3</td>
<td>197,847.0</td>
<td>206,026.5</td>
<td>338.9</td>
<td>22.8</td>
<td>31.4</td>
</tr>
<tr>
<td>1991</td>
<td>3,118.7</td>
<td>22,051.5</td>
<td>3,594.6</td>
<td>9,440.0</td>
<td>15,496.5</td>
<td>17,562.5</td>
<td>238,705.0</td>
<td>255.5</td>
<td>255.5</td>
<td>21,752.4</td>
<td>243,955.9</td>
<td>238,705.0</td>
<td>255.5</td>
<td>22.8</td>
<td>30.0</td>
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<tr>
<td>1992</td>
<td>3,118.7</td>
<td>23,364.8</td>
<td>5,017.1</td>
<td>11,943.3</td>
<td>17,305.5</td>
<td>19,940.0</td>
<td>267,405.0</td>
<td>275.8</td>
<td>275.8</td>
<td>24,586.3</td>
<td>294,843.7</td>
<td>267,405.0</td>
<td>275.8</td>
<td>23.0</td>
<td>28.4</td>
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</table>

(b/ Balances of discounts.  
(c/ Balances of sales.  
(d/ Balances of issuance.  

Sources: Ministry of Finance, Bank of Korea
Table 4. Korea - Growth Indicators of Money Market Instruments, 1980-89

<table>
<thead>
<tr>
<th>Period</th>
<th>Call Money/M1</th>
<th>CP/M1</th>
<th>RPs/M1</th>
<th>CDs/M1</th>
<th>BAs/M1</th>
<th>IBs/M1</th>
<th>MSBs/M1</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 1980</td>
<td>0.0469</td>
<td>0.5472</td>
<td>0.0340</td>
<td>-</td>
<td>-</td>
<td>0.0394</td>
<td>-</td>
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<tr>
<td>December 1985</td>
<td>0.0573</td>
<td>0.9786</td>
<td>0.3391</td>
<td>0.1430</td>
<td>-</td>
<td>-</td>
<td>0.0667</td>
</tr>
<tr>
<td>Elasticity to M1</td>
<td>1.22</td>
<td>1.79</td>
<td>9.97</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>December 1987</td>
<td>0.0485</td>
<td>0.9418</td>
<td>0.2692</td>
<td>0.1634</td>
<td>-</td>
<td>0.0989</td>
<td>0.8088</td>
</tr>
<tr>
<td>Elasticity to M1</td>
<td>0.85</td>
<td>0.96</td>
<td>0.79</td>
<td>1.14</td>
<td></td>
<td></td>
<td>12.13</td>
</tr>
<tr>
<td>December 1988</td>
<td>0.0522</td>
<td>1.0175</td>
<td>0.1959</td>
<td>0.1442</td>
<td>-</td>
<td>0.0930</td>
<td>1.2652</td>
</tr>
<tr>
<td>Elasticity to M1</td>
<td>1.08</td>
<td>1.08</td>
<td>0.73</td>
<td>0.88</td>
<td></td>
<td>0.94</td>
<td>1.56</td>
</tr>
<tr>
<td>December 1980-89</td>
<td>544.8</td>
<td>821.8</td>
<td>1,557.1</td>
<td>70.9 a/</td>
<td>-</td>
<td>1,182.5</td>
<td>3,332.9 a/</td>
</tr>
<tr>
<td>Elasticity to M1</td>
<td>1.71</td>
<td>2.45</td>
<td>4.41</td>
<td>0.90 a/</td>
<td>-</td>
<td>3.41</td>
<td>18.11</td>
</tr>
</tbody>
</table>

a/ December 1985-December 1989 for Negotiable Cds and MSBs.

Source: Moon-Suo Kang, Money Markets and Monetary Policy in Korea, 1990, Korea Development Institute.
Table 5: Korea - Structure of Monetary Market Interest Rates, 1990-93
(Percent per Annum)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
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<tbody>
<tr>
<td>Discount Rate</td>
<td>7.0</td>
<td>7.0</td>
<td>7.0</td>
<td>5.0</td>
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<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposit Rate</td>
<td>10.0</td>
<td>10.0</td>
<td>10.0</td>
<td>8.5</td>
</tr>
<tr>
<td>Lending Rate</td>
<td>10.0</td>
<td>10.0</td>
<td>10.0</td>
<td>9.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Call Rates</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overnight</td>
<td>16.8</td>
<td>13.5</td>
<td>11.5</td>
<td></td>
</tr>
<tr>
<td>Inter-Bank Transactions</td>
<td>16.3</td>
<td>13.0</td>
<td>11.3</td>
<td></td>
</tr>
<tr>
<td>Transactions between Non-Banks</td>
<td>17.2</td>
<td>13.8</td>
<td>11.7</td>
<td></td>
</tr>
<tr>
<td>1-15 Day Average</td>
<td>17.4</td>
<td>13.5</td>
<td>11.6</td>
<td></td>
</tr>
<tr>
<td>CD Yields</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>91 Day</td>
<td>18.4</td>
<td>15.2</td>
<td>12.3</td>
<td></td>
</tr>
<tr>
<td>180 Day</td>
<td>18.5</td>
<td>15.2</td>
<td>12.5</td>
<td></td>
</tr>
<tr>
<td>MSBs</td>
<td>17.6</td>
<td>14.1</td>
<td>12.0</td>
<td></td>
</tr>
<tr>
<td>Yield on RPs</td>
<td>18.2</td>
<td>16.0</td>
<td>12.7</td>
<td></td>
</tr>
</tbody>
</table>

Existing Monetary Policy Procedures

The BOK has been using both direct and indirect controls to target monetary aggregates and the cost of credit. Until the 1970, the BOK relied heavily on reserve requirements (RRs) and direct measures to control monetary aggregates and domestic credit. In 1982, indirect control procedures, which usually depended on discount window, open market operations, and RRs, were officially adopted to replace direct control. In actual practice, however, the BOK had limited option in applying indirect control instruments despite a fairly well-developed money market. Now and then, the BOK turned to direct control measures, like window guidance and moral suasion.

The BOK uses rediscount policy to influence money market rates, which took two forms - rediscount of commercial bills and lending to banks against collateral of their specified assets. However, these loans and discounts meant for accommodating conventional requirements of banks accounted on average for less than 5% of total loans and discounts (S.J. Kim 1992; World Bank 1993 (b)). By far the most important use of discount lending by the BOK was to channel credit at below-market rates into particular industries selected for reasons of industrial policy (discussed in detail in Section IV). Apart from this, the BOK could not use changes in discount rates to control the volume of discount loans flowing into the monetary base as there was a chronic excess demand for bank credit, which banks often met by borrowing from the BOK, given a discount rate of 7.8 percent and bank lending rates well below the market rates. For these reasons, rediscount rate in Korea did not operate as an indirect monetary control instrument in the same way as it normally functions in a well-developed financial market. Reserve requirements (RRs), the other indirect monetary policy instrument, is not used as often as it could have been used because the BOK was reluctant to disturb the portfolio of the banking system.

There has not been any open market operations in a traditional sense. What passed off as an open market operation was an allocation of Monetary Stabilization Bonds (MSBs) or government securities or securities fully guaranteed by the government to the financial institutions, particularly NBFI{s}, to absorb liquidity when needed. The MSBs were used since the mid-1980s when the surpluses in the balance of payments shifted into deficit in 1990s, the BOK could not simply rely on MSBs, and increasingly turned to government securities to regulate liquidity. Paper other than MSBs like foreign exchange stabilization bonds had also been used for this purpose since 1987.

The BOK has issued and repurchased MSBs in a captive market. Most sales of MSBs were conducted by direct sales or acceptances. Auctioning to the general public was very limited both in size and frequency. In direct sale and acceptance, the operations desk unilaterally determines the issuing rate and the size of a transaction and allocates the MSBs among NBFI{s}, including bank trusts. A sale of MSBs involved heavy losses for the BOK and in consequence led to an expansion of the monetary base. The issuing rates of MSBs were linked to the interest rates on time deposits with comparable maturities. But secondary market rates of MSBs were two to five hundred basis points
higher than the issuing rates. These spreads reflected the cost to the NBFIs which purchased MSBs from the BOK. In addition, the large volume of MSB issuance had crowded out the underwriting capacities of the designated dealers among NBFIs and caused upward pressure on market interest rates.

Since 1989, the BOK made greater use of repurchase agreements (RPs) for controlling short-term liquidity in banking institutions. After considering changes in the credit conditions of financial markets, money supply, and the reserves of banks, the BOK’s operations desk determined the timing and size of repurchase agreements. As in the case of outright sales or purchases, the BOK set the terms of RPs and assigned the RPs to banks at the BOK’s discretion. However, unexpected assignments of the RPs at the BOK’s discretion severely restricted the asset management of banks.

It would thus be seen that the indirect monetary policy instruments could not be operated in Korea in their full potentiality, notwithstanding the intention of the authorities. This was because there was covertly or overtly regulation of the banks’ interest rates and as a result the money and capital markets remained segmented, preventing them to be fully competitive, necessary for making interest rates market-determined.

IV. CREDIT ALLOCATION SYSTEM

The financial sector was used as the principal instrument to implement successfully the industrial policy, because, as analyzed in section II, the quasi-internal organization, involving the government, large businesses and the financial institutions minimized the informational inadequacy, thereby reducing uncertainty in decision-making and ensuing maximum profits through competitive efficiency. The financial system achieved this through the allocation of credit to stimulate industrialization and its pattern. This allocation took the form of policy loans.

Sources and Size of Policy Loans

Policy loans are provided by the government from its budget, the BOK through its refinancing of loans by deposit banks, the banks from its own resources and some nonbank financial intermediaries like the Korean Development Bank (KDB) and the Korean Export-Import Bank (KEXIM) which is funded by the government. The sources and the magnitude of policy loans over the last five years are presented in Table 6.

Impact of Directed Credit on the Financial System

The impact of the policy loans on the financial system can be analyzed in four ways -- cost of subsidy, the size of non-performing assets of the banking system, the profitability of the BOK and the quality of the services rendered by the banking system. Taking the first, it is estimated that the quantifiable cost to the financial system was
substantial. The amount of interest rate subsidies was calculated on the basis of comparing the commercial paper rate against the average on lending rates of three widely utilized policy loans: the export promotion fund, the machinery industry promotion fund and the NIF. The resulting average interest rate differential was then applied to the outstanding amount of the policy loans to arrive at the amount of interest rate subsidy. This, however, could not include other costs such as cost of carrying non-performing assets on the books of the banks and the BOK as they could not be calculated for want of relevant information. On this basis, the interest subsidy involved in policy loans amounted to about W 2.0 trillion or 1 percent of GNP and 6.2 percent of government expenditure in 1991; the cumulative subsidy during 1981-91 amounted to W 2 trillion per annum (World Bank, 1993 (b)).

During the period 1980-91, the reported non-performing assets of the Korean Banking System fluctuated between 1.3 percent and 7.5 percent of their total assets. In 1993, they were around 1.76 percent, which by international standards could be considered to be within a tolerable limit. However, this magnitude is suspect because the definition of non-performing loans is different from say the US standard, since the collateral value was deducted from the total value of loans which were not serviced. In Korea, only bad debts or non-performing loans are defined as only those which are in doubtful and estimated loss categories. Doubtful loans comprise that portion of substandard loans that do not have sufficient collateral, which are expected to be losses, but not realized. Estimated loss loans are those substandard credits that have inadequate collateral and collection is not expected. This classification methodology understates the size of non-performing loans under international classification standards, as the definition of non-performing assets ignores collateral values. If a loan is not being serviced on time, even though it is fully collateralized, the loan still remains non-performing, and the collateral only affects the level of provisioning. In Korea, since collateral is deducted from the loan outstanding in order to arrive at the level of doubtful or loss loans, the actual exposure of banks to non-performing loans is dependent critically on a subjective valuation of the collateral. This means if collateral value is added back to the definition, the size of the non-performing loans would be considerably higher (Dongbang Peregrene, April 1994). The high level of non-performing assets thus might have impaired the profitability of the banking system to a significant degree.

Use of the subsidized credit has resulted in transferring the financing burden from the government budget to the BOK. The BOK's discount window played only a limited role in monetary policy because many of its loans were automatic rediscounts of policy loans by the commercial banks. This often resulted in reserve money creation. In order to absorb this liquidity, the BOK issued a large amount of MSBs at below market rates and sold mainly to a captive market of NBFIs. However, the progressive expansion of outstanding MSB's had some adverse effect on the BOK's balance sheet. Though the interest rate on the MSB's was below market rate, it always incurred a negative spread of 6 percent per annum -- the spread between the MSB rate and the discount rate charged on refinancing. In 1992, it was estimated that the policy loans imposed a cost of about W 1 trillion or 2 percent of the 1992 budget. Comparing it
to the BOKs operating deficit of W 1.27 trillion during January to May 1992 period, the cost was certainly onerous (World Bank, 1993 (b)).

The system of credit allocation had an adverse effect on the development of the financial system, particularly in regard to the quality of its services. Intervention in day to day management and assets allocation decisions of banks, admittedly impeded the development of professional bank managers and removed any incentives for banks to become efficient in the intermediation of financial resources. Nor did the bank management have the opportunities to seek borrowers on their own, through evaluating the risks involved; rather it passively accommodated the credit demand of the government favored borrowers. However, these adverse consequences could be considered to be a small price to pay in the broader context, where the directed credit program as a part of the quasi-internal organization filled the important gap arising from credit and equity rationing in the early stage of the Korean economic development, though its time has now gone.

V. FINANCIAL SECTOR REFORM OF 1993 AND ITS SEQUENCING

In 1993 Korea left behind its earlier policy of "stop-go" kind of financial liberalization with overt or covert government guidance and embarked on a full throttle liberalization of the financial system analogous to that adopted in several countries. The explanation commonly offered for this departure from the earlier practice was that the local banks were greatly handicapped in conducting their operations competitively, vis à vis the foreign banks not subjected to interest rate ceilings and the NBFIs, which determine freely their interest rates. It was also contended that the Korean financial system could not escape being a part of the global financial market. With the tenth largest economy in the world, Korea has no other option but to make its financial system compatible with that of its trading partners (World Bank, 1993 (b)). While these could be plausible explanations for the Korean leapfrogging in financial deregulation, there is beneath them a more fundamental rationale for the Korea's new stance.

Rationale for Complete Financial Deregulation

It was seen in Section II, that what was regarded as a repressed financial system in Korea during the period 1960-1986, was in fact manifestation of an internal capital market in which the government, large private enterprises, together with the financial system constituted an internal organization for conducting productive activity. This implies that if the Korean authorities now deemed it necessary to eliminate the government intervention from its overall economic and financial policies, the quasi-internal organization must have become redundant or posed an impediment in the environment of more sophisticated Korean economy. As Lee (1992) hypothesized, the quasi-internal organization might have faced growing organizational failures as the size of the Korean economy expanded, not least because of the diseconomies of scale, impairing its efficiency. Alternatively, there might have emerged arrangements of financing investment,
devised by the well-developed private enterprises, thereby obviating the problem of credit
and equity rationing that bedeviled earlier private enterprise functioning. Though the firm
evidence is lacking, a combination of both of these inferences seems to have been
validated by the casual empiricism.

The declining usefulness of the quasi-internal organization in Korea is
reflected both in the financial fragility of the banking system and its profitability. The
banking system is now saddled with non-performing assets, which is a mirror image of the
weaknesses in the industrial sector. Perhaps the financial system's chaperoning of the
industry at the behest of the government has reached a point of diminishing returns and is
failing to achieve the original intent of the quasi-internal organization. The low
profitability of banks reflects their inefficiency in mediating financial transactions. One of
the indicators of the low efficiency of banks compared to their counterparts in Japan and
the US is a low labor productivity whether measured in terms of assets, loans or deposits
per employee. Moreover, weak competition among banks, resulting from government
mandating their operations is reflected in the interest rate margin - the difference between
loans and deposit rates which has been about twice the level in the US and more than three
times as large in Japan (World Bank, 1993 (b)).

There seems to be enough evidence though not systematic too that the
repressed financial system which Korea maintained for so long as a part of the internal
organization to overcome credit and equity rationing is proving to be unnecessary. The
Korean firms have increasingly replaced bank loans with issue of equities. In 1991, the
ratio of securities in total financing increased to 55% compared to 27% in 1987 (World
Bank, 1993 (b)). One of the vexatious problems in Korea had been a high gearing ratio of
the industrial firms (Sundararajan, 1985). This could be reduced with more incentives to
issue of equity and there is no better way to do so than to liberalize interest rates. Stiglitz
(1989), for instance, has argued that equity rationing occurs because the firms are
reluctant to offer new equity issues to raise capital as they would result in large fall in their
market value. Thus the firms desire to avoid new equity issue in view of its adverse
impact on their networth. With the Korean firms resorting increasingly to equity
financing, the equity rationing problems have receded to the background. In the same way
credit rationing occurs as a result of the asymmetry of information and the risk averse
proclivity of banks. However, this asymmetry tends to decline rapidly with a well
functioning equity market (Cho, 1986). Since the Korean equity market has now matured
and also grown in breath and depth with the growing links with foreign financial markets
in the wake of a substantial liberalization of external current and capital accounts, there is
no raison d'etre left for the old-vintage government regulation of the financial system.

Financial Reform Sequencing

The financial reform announced by the Korean government towards the
end of 1993, has been substantial in content and comprehensive in scope with a well
defined time-frame and clearly delineated proposed action. There have been four major
areas of reforms. These are: (i) liberalization of all interest rates; (ii) reforms of policy
loans; (iii) management of monetary policy and credit controls; and (iv) external capital account. There have been other areas of reform such as management of banks and their autonomy, bank supervision, etc., (Park 1993; Bank of Korea, 1994) but they are left out in this paper in order to focus on its central theme.

**Interest Rate Deregulation**
The reform plans addresses three areas of interest rate liberalization: rates on commercial loans, deposits, and short-term corporate bonds, government bond and bank debenture. The government has proposed a rapid liberalization of interest rates on commercial loans of bank and NBFIs, reflecting more or less their credit standing. Deposit rates are to be liberalized gradually, beginning with interest rates on long-term deposits, to be followed by deregulation of interest rates on short-term deposits. The sequencing of interest rate deregulation is presented in Charts 1.

**Reform of Policy Loans**
The approach taken to policy loan reform is to freeze ceilings on these loans and to conduct a step-wise reduction in ceilings, leading to a termination of all policy loans by 1997. In addition, the interest rate subsidy on these loans, to be reduced and the rediscount policy of the BOK in regard to these loans is to be revised to remove the automaticity. The reform program is also directed at discontinuation of preferential rates for certain sectors (e.g., manufacturing) and the termination of the ratio of mandatory loans. The phasing of the reform is presented in Chart 2.

**Management of Monetary Policy and Credit Control**
The BOK is to implement monetary policy through indirect monetary instruments such as open market operations rather than direct credit controls in discrete steps. First, the system for issuance of treasury and other public sector securities is to be improved; the BOK is to develop the treasury bill market as the primary market for open market operations. Second, BOK’s lending operations are to be toned up through the abolition of automatic lending and rediscount system. Finally, the required reserve ratio (RRs) is to be lowered to increase the competitiveness of banks. Sequencing order of this reform is in Chart 2.

**Liberalization of Capital Accounts**
Some simple measures to develop the foreign exchange market and to prevent short-term speculative capital inflows are proposed. With respect to the foreign exchange market, the goal is to allow the Won exchange rate to be market determined and be freely floating by 1997. However, the interim measures are designed to increase the band within which the Won can fluctuate. While measures have been devised for foreign direct investment in both directions and outflows of portfolio investment, the opening of the capital account to portfolio investment in fixed income
securities is left to later stages, after the full liberalization of the domestic financial market and interest rates have been completed. How all these are to be sequenced is shown in Chart 2.

**Basis of Sequencing of Reforms**

Despite profusion of academic literature, there is hardly any agreement about sequencing in regard to various elements of financial reform. There is no theory of sequencing as such and in countries which followed financial reform, no unique pattern sequencing is observed. A diversity of experiences in regard to sequences of various components of financial reform vary from country to country and in the same country from one period to the other (McKinnon, 1982; Bisat, Johnston and Sundararajan 1992; Villanueva and Mirakhor, 1990). Korea has determined the sequencing of its latest full financial liberalization in terms of its own institutional situation, overall economic strategy and the accumulated experiences from operating earlier government guided deregulation.

Following is the rationale for time frame and sequencing of the major elements of financial liberalization in Korea. First, the period of reform is compressed for two reasons: (i) the momentum of deregulation is likely to be lost if the period of change is spread over a longer time span; (ii) interface between the globalization of financial markets and the almost developed Korean economy is strengthened by a more rapid adjustment. Second, a complete deregulation of lending rates on loans of financial intermediaries is telescoped because, the current effective lending rates being already high will not increase much after deregulation and thus overall cost to the economy and the corporate sector will remain within bound. Third, deregulation of interest rates on deposits (except demand deposits) is spread over a longer period on the ground that a removal of interest rates on deposits at one go may lead to excessive competition among banks for increasing their market shares. Since the banks are substantially high, a sharp increase in their funding cost without the ability to adjust the return on the existing loan portfolio of policy loans, creates a potential risk of bank failures. Therefore, a gradual deregulation of deposit rates with a clear timetable for eliminating the ceiling is assured to provide enough time for banks to prepare themselves to cope with the new competitive environment.

First, the capital account liberalization is scheduled to come last. In general, two preconditions need to be met before the capital account is fully liberalized. First, macroeconomics stability is essential as opening the capital account without increases opportunity for currency substitution, which, in turn increases inflation rate in terms of domestic currency (Hanson, 1994). When this occurs, the domestic currency money base shrinks while the foreign component of the base increases. Second, it is necessary that the domestic banking system must not be overburdened with rules, and regulations on interest rates or loan portfolio composition, thereby making it competitive relative to foreign banks operating in the country. Besides, the domestic banks must have independent management and sound portfolios - no large proportion of non-performing
Chart 1. GOK Blueprint of Financial Reform

<table>
<thead>
<tr>
<th>Phase</th>
<th>Loans of Financial Institutions</th>
<th>Deposits</th>
<th>Bonds</th>
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<tbody>
<tr>
<td>Phase 1</td>
<td>(i) Deregulate interest rates on all loans of more than two years of banks and non-banks, except for policy loans.</td>
<td>(i) Liberalize interest rates on all long-term deposits.</td>
<td>(i) Liberalization of interest rates for issuance of MSBs and T-Bills. (ii) Auction based method for MSBs. (iii) Deregulations of interest rate on corporate bonds of less than two years. (iv) Flexibility in regulation of issue of corporate debentures. (v) Establishment of credit guarantee institutions at the regional levels. (vi) Control of the supply of and demand for capital issues to be reduced.</td>
</tr>
<tr>
<td>1993</td>
<td>(ii) Liberalization of interest rates for issuance of policy loans.</td>
<td>(i) Liberalize interest rates on all long-term deposits.</td>
<td>(i) Liberalization of interest rates for issuance of MSBs and T-Bills. (ii) Auction based method for MSBs. (iii) Deregulations of interest rate on corporate bonds of less than two years. (iv) Flexibility in regulation of issue of corporate debentures. (v) Establishment of credit guarantee institutions at the regional levels. (vi) Control of the supply of and demand for capital issues to be reduced.</td>
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<tr>
<td></td>
<td>(iii) Liberalization of interest rates for issuance of corporate bonds of less than two years.</td>
<td>(i) Liberalize interest rates on all long-term deposits.</td>
<td>(i) Liberalization of interest rates for issuance of MSBs and T-Bills. (ii) Auction based method for MSBs. (iii) Deregulations of interest rate on corporate bonds of less than two years. (iv) Flexibility in regulation of issue of corporate debentures. (v) Establishment of credit guarantee institutions at the regional levels. (vi) Control of the supply of and demand for capital issues to be reduced.</td>
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<td>(iv) Flexibility in regulation of issue of corporate bonds of less than two years.</td>
<td>(i) Liberalize interest rates on all long-term deposits.</td>
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</tr>
<tr>
<td>Phase 2</td>
<td>Policy Loan (i) Liberalize interest rates on policy loans; terms and conditions for loans undertaken by commercial banks to be determined by market conditions. Commercial Loans (ii) Lending rates offered by financial institutions to reflect credit standing of borrower.</td>
<td>(i) Liberalize interest rates on short-term deposits, excluding demand deposits.</td>
<td>(i) Introduction of competitive bidding for treasury bonds. (ii) Discontinue low interest rate and mandatory allocation of treasury and other public sector bonds. (iii) Increased issuance of T-Bills after streamlining issuance of MSBs.</td>
</tr>
<tr>
<td>1994</td>
<td></td>
<td></td>
<td>(i) Introduction of competitive bidding for treasury bonds. (ii) Discontinue low interest rate and mandatory allocation of treasury and other public sector bonds. (iii) Increased issuance of T-Bills after streamlining issuance of MSBs.</td>
</tr>
<tr>
<td>Phase 3</td>
<td>(i) Continue reduction of interest rate subsidy on policy loans. (ii) Expand the scope of deregulation of short-term market-type products.</td>
<td>(i) Liberalize interest rates on short-term deposits, excluding demand deposits.</td>
<td>(i) Increased issuance of T-Bills after streamlining issuance of MSBs.</td>
</tr>
<tr>
<td>1994-95</td>
<td></td>
<td></td>
<td>(i) Increased issuance of T-Bills after streamlining issuance of MSBs.</td>
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**NOTES:** There is a slight difference in the time under consideration for the four phases between the World Bank Report and the GOK Plan. For example, in the GOK Plan, Phase 1 is 1993, Phase 2, 1994-95; and Phase 3, 1996-97. However, in these tables we have adhered to categorizing the measures by dates rather than phases (i.e. the reform schedule is time bound). In some cases, the GOK Plan translation does not provide us with a specific date for a specific action. In these cases, we have inferred the appropriate date for the action based on our judgement of the logical pattern of reforms.
Chart 2. GOK Blueprint of Financial Reform

<table>
<thead>
<tr>
<th>Phase</th>
<th>BOK, Monetary Policy and Policy Loans</th>
<th>External Capital Account</th>
</tr>
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<tbody>
<tr>
<td>Phase 1 1993</td>
<td>(i) Improvement of system for issuance of treasury and other public sector bonds. (ii) Establish limit on Policy Loans. (iii) Reduction of limited personal policy loan assistance (iv) Setting up of “Policy Loan Coordinating Committee”. (v) Enlargement of scope of securities subject to RP operations of BOK and expansion of Rps to NBFIs. (vi) Flexible target - M2 - for monetary policy.</td>
<td>(i) Relax Domestic concentration of foreign exchange obligations management. (ii) Increase band for exchange rate fluctuation between banks to 1%</td>
</tr>
<tr>
<td>Phase 2 1994</td>
<td>(i) Abolish policy loans which provide income supports. (ii) Transfer policy finance to specialized financial institutions or to the government budget. (iii) Decrease volume of loans and rediscounts; however, government or BOK will redeem non-performing credits with special loans. (iv) Support for the creation of credit guarantee institutions at the regional levels.</td>
<td></td>
</tr>
<tr>
<td>Phase 3 1994-95</td>
<td>(i) Increased issuance of T-Bills. (ii) Deregulation of interest rates on loans subject to BOK discounts. (iii) Deregulate rediscount rate for policy loans; reduce or terminate policy finance by commercial banks and/or privatize specialized banks. (iv) Phased reduction and adjustment of policy loans of general banks. (v) Activation of short-term financial markets.</td>
<td>(i) Liberalize the holding of foreign exchange by residents abroad. (ii) Move towards liberalization of Won.</td>
</tr>
<tr>
<td>Phase 4 1996-97</td>
<td>(i) No policy loans. (ii) Terminate ratio of mandatory loans to SMEs and regions. (iii) Full implementation of open market operations.</td>
<td>(i) Exchange rate to reflect market conditions. (ii) Permit indirect investment by foreigners in listed bonds.</td>
</tr>
</tbody>
</table>
loans. Of the two preconditions, Korea has more than adequately met the first of maintaining macroeconomics stability. The second condition will take some more time to be met when the interest rate liberalization and divesting the banking system of its non-performing loans are achieved, which will be at the tail-end of the deregulation plan.2

This sequencing order for capital account liberalization is also dictated by the experience of Japan and other OECD countries. The capital account controls in these countries were strongly influenced by the objectives of balance of payments, exchange rate variations, and the exigencies of monetary management. They tailored the removal of capital controls to the improvement of the balance of payments. They also synchronized the phasing out controls with the movement of capital flows, particularly of a short-term nature so as not to disturb domestic economic balances. As a result, capital account deregulation occurred over a longer period of time and in small doses.

Assessment of Financial Reforms

On the eve of the introduction of a deregulation plan, there was a great deal of skepticism amongst the policy makers about the success of deregulation and perhaps justifiably, so in the circumstances when the economy was on the downturn and the export growth had slackened. As it turned out, the Korean economy proved not only its inherent resilience but in fact appears to have positively benefited from the increased efficiency of the banking system. The actual outcome seems to have even exceeded what was projected in Government’s forecast as contained in the Government’s New Five Year Economic Plan (NFYEP). The growth rate of GDP steadily increased in 1993 from 4 percent in the first quarter to 6.4 percent in the last quarter, yielding an overall rate of growth of 5.5 percent for the whole of 1994, is projected at 8.8 percent. The saving rate has been well maintained at around 35 percent of GDP in 1993, while gross capital formation rate reversed its earlier declining trend and increased by about 8 percent in the second half of 1993. Consistent with these trends in GDP and investment, export growth was maintained at 11 percent. And all this, was achieved without aggravation of inflationary pressures. Only adverse change was in regard to the current account of balance of payments, which turned into deficit to the tune of about 2 percent of GDP, because of the need to import high-tech capital goods for upgrading the technological base of the economy. These helpful developments in macroeconomy may certainly encourage the Korean policy-makers to redouble their efforts to speed up the process of financial deregulation in coming years.

Interest rate deregulation is proceeding apace. The rates on all loans of banks and non-banks are freed, loans so freed from interest rate restrictions, account for as much as almost 70% of the total loans of commercial banks. There is a greater certainty than before that during the remaining period of the deregulation, banks will be given full freedom to set interest rates on all bank loans in response to market conditions.

2 The financial crisis in Mexico in December 1994 has dramatized issues related to sequencing of capital accounts liberalization.
Likewise the rates on deposits except those on deposits of less than two year maturity have been deregulated; such deposits broadly account for about 40 percent of total bank deposits. Though rates on deposits of less than two year maturity will be deregulated at the final stage i.e. 1997, a gradual transition to that is being made from mid-July 1994 by shortening the maturities of commercial paper (CP), RPs and CDs which can be considered as close substitutes for short-term deposits. For instance, the minimum maturity of CDs and CPs is reduced to 60 days from 90 days earlier. It is the intention of the authorities to advance implementation of the remaining interest rate deregulation measures scheduled for third and fourth stages to early 1995. The prospective macroeconomic conditions in Korea, which look good on present indications will no doubt contribute to the acceleration of interest rate deregulation. There was a widely shared feeling among banks and the policy makers before unleashing the reform that the interest rate liberalization in Korean conditions where the demand for credit was believed to be interest-inelastic, would lead to sky-rocketing of interest rates and thus cause financial distress (World Bank, 1993 (b)). However, these forebodings, it is clear, were misplaced in the wake of financial deregulation experience so far. In fact the liberalized interest rates and loan rates, have all declined after the deregulation plan was put in operation. As a result of this the window guidance from the MOF has abated to a large extent. This conclusively proves that Korea is not any different from other economies similarly placed in regard to behavior of the participants in the financial markets, economic motivation and responses to market signals.

The progress in regard to deregulation of interest rates in corporate bond market and the auctioning of monetary stabilization bonds (MSBs) including other government paper is also promising. The GOK has substantially relaxed the capital issue control, leaving decisions about the amount of issue of bonds to the Association of the securities dealers. There is still a semblance of window guidance, though indirectly, in so far as the MOF influences the decisions of the Association. Perhaps this is unavoidable at the initial stages and with the accumulation of experiences of operating in unregulated environment, the decisions of the Association will be made in future more autonomously and independently. Corporate bonds are still issued with bank guarantees though there is some evidence that the proportion of nonguaranteed bonds is steadily increasing. It is estimated that 50 percent of corporate bonds are guaranteed by banks. While such guarantee-linked bonds may be considered a device to increase investors' confidence, they do not permit proper risk assessment of bonds, which can be undertaken only by qualified rating agencies. There are currently three credit agencies in Korea. However, the present infrastructure is not sufficiently developed to enable efficient functioning of the credit rating corporations as the companies issuing bonds do not observe transparent and standardized accounting procedures or disclose full financial information. If the authorities could fill this gap through appropriate regulations or incentives, the rating agencies would emerge in course of time, thereby obviating a need for obtaining bank guarantees.

The BOK has now announced a decision to permit foreign investors beginning from July 1994 to purchase in primary market convertible corporate bonds
(CBs) and long-term government securities (three to five years). Purchase by foreign investors of corporate bonds is limited only to those issued by small-scale industries. The Korean companies are free to decide the size and conditions of issue of CBs issuance on the basis of a resolution of their boards of directors rather than that passed by their share holders. The government is considering to introduce self-registration system under which companies can issue CBs several times within a total issuance limit without their having to secure approval for every issue. Foreign purchases are restricted however to 30 percent of the total bond issue of any one company and to not more than 5 percent for a single investor. Perhaps these are transitional restrictions, which may well be phased out, once the capital account is fully liberalized in 1997.

The government is contemplating to allow international organizations such as the World Bank and the Asian Development Bank to issue Won-denominated bonds in domestic market. Foreign investors will also be given access to the bond-market through bond-type beneficiary certificates. These measures will no doubt force the pace of bond and capital market development with a full scope for unrestricted activity.

The authorities have done will in placing the issue of MSBs and RPs on auction basis from early 1994. Approximately 80% of MSBs and 70% of RPs are auctioned and a differential between auction rate and market rate on these instruments has narrowed to barely 0.3%. However, the auction is partially managed. Sixty three primary dealers, consisting of banks, securities companies, investment trust companies, investment and finance companies are allowed to participate in auction. Only MSBs with maturity of 364 days is auctioned and the auction cut-off rate is arbitrarily determined, not leaving it to be fully determined by market-forces. Therefore, the rate that emerges can hardly be called a market indicator. While the present auction system is good as a first step, it is likely to be refined and developed further so that it can fully reflect the market conditions.

The most significant policy measure from the point of view of developing an efficient financial system, taken by the authorities is in regard to policy loans. First of all, the BOK substantially revised its rediscount and loan system since March 1994, thereby changing the way in which policy loans are supported. Previously, the BOK had extended loans automatically in amounts corresponding to a proportion in which banks had provided loans to small and medium enterprises and the export sector. This link between the BOK's credit and bank's policy loans is now broken. The BOK will stipulate henceforth individual credit ceiling to each bank within the overall ceiling for the entire banking system set by the Monetary Board every quarter according to a predetermined criteria relating to performance of commercial bills discounted and foreign trade loans. Second, loans to small and medium firms involving subsidy estimated to be around Won 500 billion are transferred from the BOK to the Government. Loans to agriculture, fishing and livestock will be gradually taken out of the BOK, to be eventually financed by the government. Three, the remaining policy loans will be shifted from the commercial bank's portfolio to the specialized banks, which will finance them through their deposits or issue of bonds. A subsidy involved in these loans, will be tapered off once all the interest rates
are deregulated. These moves would no doubt strengthen, in course of time, the financial system of Korea and enhance the efficiency of the BOK's monetary policy.

However, the problem of non-performing assets (NPA) of the banking system, that have resulted mainly from the past policy loans remains formidable. The present official estimate of NPAs is around Won 2.9 trillion - which constitutes about 4% of the loan portfolio of all commercial banks or 19 percent of their capital. The amount of NPAs has increased over the last two years and more importantly they are concentrated in four banks whose share in total NPAs is about 87.7 percent. However, there are strong reasons to believe that amount of NPAs is grossly underestimated as they are calculated on the basis of existing norms which are outdated. One estimate made in a private study based on the information from the BOK but a different criteria derived from the internationally accepted standards places NPAs at about Won 9.1 trillion or 13.46% of the outstanding bank loans, (Donbang Peregrene, April 1994). The authorities being seriously concerned about this problem have urged on banks to increase the provisioning to write off NPAs, which however, will take few years. It should be recognized that unless this takes place, it will be difficult to fully liberalize the financial system according to a time-frame of the blueprint, as borne out by the experiences of other countries (Cho and Khatkhate, 1989; Chandavarkar 1992; Atiyas, Caprio, Jr., and Hanson, 1994, Galbis, 1993).

There is a clear evidence that competition amongst banks and between banks and non-banks has become keen in recent months, partly induced by the deregulation of interest rates and by new stance of the BOK to create a level-playing field through removing certain advantages which investment finance companies enjoyed over commercial banks. Thus, the net interest margin of commercial banks has declined from 2.24% in 1992 to 1.91% towards the end - 1993 and this trend seems to be continuing. The reduced maturity of CDs and CPs issued by banks will increase competition amongst banks and nonbanks, by making such paper issued by nonbanks less attractive. Furthermore, the nonbanks will find it more difficult than before to discount low grade bills from companies, because of the new regulations requiring companies to seek credit ratings from at least two reputable agencies. Commercial banks also seem to compete more vigorously with the curb market since introduction of the real name financial transactions from August 1993. There are indications that the curb market shriveled greatly as there was a flight of funds from that market to banks, thereby attenuating credit market segmentation.

The government and the BOK have admittedly taken other policy initiatives such as increasing the scope of operations of financial institutions, broadening the ownership structure of financial institutions, enhancing autonomy of banks, which were not specifically included in the deregulation blueprint. Significant among these initiatives are relaxation of restrictions on the operations of financial institutions and introduction of committee system for recommending bank presidents. These are all the salutary changes, which will help to tone up the management of the financial system and make it an effective instrument of development.
While the tangible aspects of the financial deregulation are quite impressive, it is its intangible facets which will ensure sustainability and transparency of the financial sector reform. Though the deregulation process has gathered momentum, in the last six months, it seems to have changed the mind-set of the government bureaucracy, the bankers and the business community. Observing that financial liberalization neither caused macroeconomic instability nor dampened GDP growth and export prospects, the bureaucracy and the politicians have now less reservations about forcing the pace of reform. The bankers feel less inhibited to take autonomous decisions in lending and pricing of loans and in the process are challenged to be innovative and risk-takers; the business and industry have become more aware of the virtue of competitive environment created by reforms, in which efficiency of production has its own rewards. It is this change in work culture, and mental attitudes which promise a more rapid and substantial progress in implementation of the remaining financial liberalization program.

VI. SUMMING UP

The Korean experience, in pursuit of financial liberalization strategy and policy, seen in juxtaposition to that of several other countries is apt to lead to wrong perception of the Korean reforms, if its nuances and subtleties are not properly comprehended. Those who are intellectually wedded to the interventionist policies are likely to see a ray of hope in the Korean experience to justify the dirigistic approach to financial development. Asmden and Euh (1993) for instance, used what Korea did, to attack the policy of removing financial repression as counterproductive. They argue that the Korean example suggests—“modernizing its financial sector principally by creating institution or remodeling old ones, not by relying exclusively on market forces to achieve desired goals”. As an illustration, they cite the development of stock market in Korea and channeling more credit by banks under the directed program to small- and medium-size firms. However, they do not ask why it is that several other countries in Asia, Latin America and Africa which do what Korea did and on a larger scale failed miserably. There are thus other reasons for Korea’s success achieved through government intervention, which are deeply rooted in the Korean history as well as its psychological and institutional make-up (Kohli, 1994).

An insight into Korea’s success is provided by Lee’s observation that -- "the experience of South Korea demonstrates that a developing country adopt a system of market-economy but can accelerate the pace of its economic development by establishing non-market institutions if they are complementary to the market system and appropriate to its culture and history” (Lee, 1992). Thus the rewards from government intervention came not because new institutions were set up; the new institutions followed the course, which the market forces would have dictated. The financial institutions, even when credit was subsidized and preferential did not ignore the discipline which the market would have enforced. Nor did the big businesses indulge in rent seeking activities, as often happens under the interventionist regime since the quasi-internal capital market had a built-in
safeguard against it. Thus, the Korean policy makers may have followed a non-market approach to the financial reform but it was reinforced, though indirectly by the competitive forces, normally generated by the markets. When the conditions were ripe Korea took the bold step as in 1993 to divest its financial policy of its dirigistic elements and finally discarded it.
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