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# FRBSF WEEKLY LETTER

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## Financial Developments in Korea

Over the past 25 years, Korea has had one of the world's fastest growing economies, with real output growth averaging more than nine percent a year. Although this success has stimulated considerable interest in Korea's trade and development policies, relatively less is known about Korea's policies toward the financial sector. Korea's experience with the financial sector is of particular interest because it illustrates the potential costs of highly interventionist government policies in financial markets, as well as how problems caused by such policies may be overcome. The development of Korea's financial sector also is of interest to foreign investors, who are scheduled to gain greater access to Korean financial markets in the next few years. This *Letter* reviews developments in Korea's financial sector since the mid-1970s.

### Financial intervention

Until the early 1980s, Korea's financial sector was severely restricted. Most funds were channeled through the government-owned banking sector. Government regulations dictated deposit and loan rates that effectively subsidized priority sectors, and credit guidelines placed rigid limits on the allocation of financial resources. These policies were a key component of a government plan in the 1970s to foster the growth of chemical and other heavy industries through easy credit to these sectors.

Such policies discouraged financial development, however. Financial markets became segmented into a regulated sector and a rapidly-growing, unregulated curb market. Even with the rise of the curb market, investment options remained limited. Thus, although rising inflation in the late 1970s prompted savers to turn from the regulated sector, where they earned below-market rates of interest, to the much riskier curb market, the limited alternatives of negative real returns (after adjusting for inflation) or very high risk probably helped to discourage private saving. Insufficient private saving, in turn, spurred the rapid growth in Korea's external debt as a way to finance rising investment spending in this period.

Over time, financial policies also contributed to inefficient resource allocation. Because of selective credit policies and segmented financial markets, viable projects by small- and medium-sized enterprises could not find financing, while massive, and in many cases unprofitable, heavy-industry ventures went forward.

Financial policies also distorted balance sheets. Industrial conglomerates became excessively leveraged, which increased their vulnerability to business cycles and made them heavily dependent on government support. By 1980, the debt-equity ratio of the manufacturing sector in Korea had risen to nearly five, compared to four in Japan, two in Taiwan and one in the U.S. The banking sector also became vulnerable, as funds to support designated industries dominated loan portfolios.

The disadvantages of government financial policies became apparent in the late 1970s as inflation began to rise. Rapidly rising inflation impaired the competitiveness of Korean firms, contributing to slower growth, and to large increases in external deficits and indebtedness. The resulting stagflation, which culminated in a drought-induced recession in 1980, prompted a reassessment of economic policies in the early 1980s. As a result, the government instituted a remarkably successful disinflation program, implemented by curtailing credit and investment spending. Inflation fell from 29 percent in 1980 to seven percent by 1982, while high output growth rates were maintained.

In addition, a shift in attitude occurred in favor of reduced government intervention in the economy and greater reliance on market forces. In financial markets, this policy shift has meant that distortions in the cost and allocation of credit have diminished, and markets have become deeper and more integrated.

### Reduced distortions

Distortions favoring large borrowers were significantly reduced in the early 1980s as a result of several developments. First, disinflation helped

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to narrow differentials in loan rates. Second, the government phased out preferential interest rates on bank loans to priority sectors and began limiting bank lending to large conglomerates, thereby enabling smaller firms to obtain bank credit.

A third development that helped eliminate distortions in financial markets was the rapid growth of Korea's capital markets, which provided an alternative source of funds and reduced the importance of the banking sector. By limiting the growth of bank credit in the early 1980s, the government's disinflationary policy encouraged lenders and borrowers to turn to non-bank financial institutions (NBFIs) and to the bond, commercial paper, and (more recently) equity instruments intermediated by NBFIs. (Funds did not shift to the curb market because disinflation limited the interest-rate spread that favored the curb market over the regulated market, and a series of scandals in 1982 increased the perceived risk of investing in the curb market.)

To facilitate growth in capital markets, the government lowered barriers to entry for NBFIs (partially in the early 1980s, and fully in December 1988). More recently, it privatized Korea's stock exchange, relaxed restrictions on securities firms, and undertook measures to encourage firms to go public or to raise funds in domestic capital markets in order to reduce their dependence on bank debt.

Another reason for the rapid growth in Korea's capital markets is that until very recently, commercial banks remained subject to a variety of restrictions. Although banks were privatized in the early 1980s, restrictions on loan rates and on longer-term deposits were not liberalized until December 1988. Banks also were constrained by government involvement in credit decisions, regulations dictating the pace of repayment of bank loans, and the requirement that banks hold large amounts of monetary stabilization bonds which pay below-market rates of interest. The resulting lack of development of the banking sector is reflected in the absence of an effective interbank market or short-term money markets in Korea.

## **Depth and integration**

The growing importance of comparatively less regulated capital markets and the curtailment of biases in the cost and allocation of bank credit have led to deeper and more fully integrated

financial markets, despite the absence of short-term financial markets in Korea. Financial deepening is evident in the increasing use of financial assets in the economy; the ratio of broad money to GNP rose from 39 percent in 1975 to 94 percent in 1987.

The remarkable growth in the stock market is another indicator of the growing depth of financial markets. In 1988, for the very first time, financing through the securities market exceeded financing through bank borrowing, and the total market value of stocks rose to Won 64.5 trillion (US \$88 billion), compared to around Won 3.3 trillion in 1982. The rapid increase in stock market values reflects a doubling in the number of shareholders in 1988, increased liquidity, and government measures to dampen real estate speculation that have shifted funds (and speculation) to equity markets. At the end of July 1988, the Korean stock market was the 13th largest equity market in the world, and after Taiwan, the second largest in the developing world.

Increased financial market integration is suggested by more equal access to borrowing in different sectors, and more equal costs of borrowing—a sharp contrast to the highly segmented financial markets of the 1970s. A 1986 study by Cho and Cole at the Harvard Institute for International Development indicates that small and medium firms have enjoyed slightly better access to credit than large firms since 1982, while heavy industries now have about the same access as light industries do.

Furthermore, in the 1980s, the gap between bank loan rates and the (higher) lending rates in other credit markets fell, leading to smaller variations in the average cost of credit for different classes of borrowers. These developments apparently helped to equalize the average rate of return on capital across different sectors in the 1980s, suggesting the efficiency of resource allocation may have improved.

## **Reduced dependence on bank loans**

In line with the deepening and growing integration of Korean financial markets, bank and corporate balance sheets have undergone significant restructuring in recent years. To a large extent, government policies deliberately have encouraged this. For example, as noted above, the government began limiting bank lending to

large conglomerates in the early 1980s. More aggressive measures were taken in 1987 and 1988, when the government instructed heavily indebted companies to accelerate the repayment of their bank loans by raising funds in capital markets. When it was appropriate, companies were encouraged to "go public." Companies failing to meet repayment targets were restricted from replacing maturing borrowings.

Corporate loan repayments in 1987 and 1988 represented around two percent of the total loans and discounts outstanding of deposit money banks in each of those two years, and totalled Won 1,620 billion (about US \$2 billion). Funds were raised primarily through new stock issues or the issuance of convertible bonds. Partly as a result, debt-equity ratios in the manufacturing sector have declined from a peak of 4.9 in 1980 to around 3.4 in 1986 and 1987.

These measures also have changed the direction of bank lending and produced a significant restructuring of bank balance sheets. The share of the top 30 corporate groups in total bank borrowing fell from 25 percent in 1986 to around 19 percent in the first half of 1988. (The share in total borrowing of the five biggest conglomerates also fell from 15 percent to 11 percent over the period.) In part, this decline in lending to large firms reflects a reshuffling of bank portfolios, as banks have participated in the acquisition of new corporate stock and bond issues.

### **Reinvigorating the banking sector**

The financial policy mistakes of the 1970s imposed a very high cost on the banking sector. In 1987, bank loans to 78 bankrupt companies totalled Won 6,800 billion (about US\$ 8.3 billion at then prevailing exchange rates), or nearly 16 percent of total loans and discounts held by deposit money banks. Of this amount, Won 986 billion were written off as bad debts owed by four of the largest business groups, which were dissolved. And interest and principal totalling Won 5,830 billion were rescheduled for periods as long as 30 years.

Nevertheless, bank share values have soared over the past two years. One reason is that the

government (albeit with increasing reluctance) has played a major role in bailouts to bankrupt companies, to the benefit of some bank creditors. Another reason is stronger bank financial conditions; the net profits of the banking sector increased 140 percent in 1988 to Won 237 billion (US \$348 million). In addition, banks are strengthening their capital positions through billions of dollars in new rights offerings.

### **The door opens**

The development of Korea's financial markets and the strengthening position of financial institutions is paving the way for the gradual liberalization of international capital flows over the next few years. At present, foreigners are allowed to invest in Korean firms only through authorized investment funds or through the purchase of convertible (to equity) Eurobond issues, but restrictions are being relaxed to the issuance of a wider variety of overseas securities by Korean funds. Starting this year, moreover, foreign investors will be able to sell and trade in the domestic market the shares they acquire through conversion of Eurobond issues. And in 1991, the proceeds from selling these converted shares may be used to buy certain Korean stocks in the domestic securities market.

By 1992, assuming sufficient maturity in financial markets, foreign investors will be allowed to buy any stock listed in domestic markets, subject to investment limits per issue, per person, and on total volume. The access of foreign securities companies to Korean capital markets also is being improved, and by 1991, branch offices and joint ventures involving such companies will be allowed on a restricted and reciprocal basis.

If fully implemented, these changes will serve to integrate Korean financial markets with international capital markets and in the process, further stimulate financial development in Korea. Given the continued strong performance of the Korean economy, financial liberalization also should provide attractive investment opportunities to foreigners.

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