KOREA'S EXPERIENCES IN REFORMING THE FINANCIAL SECTOR TOWARD A MARKET-BASED SYSTEM AND LESSONS FOR VIETNAM

By

THANH Ngo Dang

THESIS

Submitted to
KDI School of Public Policy and Management
in partial fulfillment of the requirements
for the degree of

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ABSTRACT

KOREA'S EXPERIENCES IN REFORMING THE FINANCIAL SECTOR TOWARD A MARKET-BASED SYSTEM AND LESSONS FOR VIETNAM

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Basically, the Korea's financial sector has gone through three development period under two different types of financial systems. During these three periods, in theory, two financial systems were applied into the Korea's financial sector: the relationship-based (or state-led) system (from 1960s to late 1980s) and the market-based system (after late 1980s till now). But in fact, due to the differences in applying the market style into Korea, we can see in the second system's time, there was obviously two periods, the period of 'gradualism' and the period of 'Big Bang' with the turning point is in 1997. Therefore, it is better to define the history of Korea's financial development into three periods. The first period started from early 1960s (after the military coup which brought Park Chung Hee to the position of President) to the late 1980s, in which Korea's economy was under the relationship-based system; the second period lasted from late 1980s to 1997 when the financial crisis occurred due to wrong policies

under 'gradualism' and bad effects of the first period; and the last period started from 1997 up to now when Korea take 'Big Bang' approach to cure its illness after the failure in 1997.

Researching the evolution of Korea's financial system during the three periods as a whole process is important to collect experiences for under-developing country such as Vietnam to improve its financial system. Even though the conditions of Vietnam and Korea are different, but still, the logic behind each policy that the Korean government used in the past will be a big help to Vietnam as well as finding out the reasons of the failures that Korea did not avoid. In this aspect, this thesis will focus on showing the important of the relationship-based system in the first period, in which the Korea's financial market was under-developed and did not function well as a perfect market, then the close, long term relationship between the government, financial institutions and chaebols can create good effects for developing heavy and chemical industries (HCIs) and for promoting exports. These HCIs and exports developments were in deed the cause of the 'Korean miracle'. Despite the success of this period, the relationship-based system also brought some bad effects such as moral hazard, debts, etc. Combined with the misguiding of the Korean government in applying the liberalization policy in the second period, these bad effects were multiplied and brought chaos to the economy. That was why and how the financial crisis of 1997 occurred in Korea. Started from 1997, under the 'Big Bang' manner, the Korea's financial system has gained some improvements. But still, there are a lot of problems need to be solved. Accordingly, for the Vietnam's financial system, the liberalization process should be done under 'gradualism' approach due to its economic and political conditions.

Dedicated to my family

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TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

INTRODUCTION

1. Purpose of the thesis

Korea is now well-known all over the World with its “Han river miracle” in the period of 1960s -1980s and later became one of four Asian Dragons. Contributed to this success, the Korea’s financial sector has had a very important role. In the period 1960s -1980s, the financial system of Korea (and the whole economic system) was a relationship-based system, which means, in theory, will be the factor to pull the development back. But in reality, the miracle development was happened at that time. So, how to explain that fact? More over, nowadays, while Korea is transforming toward a market-based system another question rises up, that is “why it need to transform and how to transform?”. To answer these questions, a research about the Korea’s financial sector from 1960s up to now is needed. And if we can answer these questions, we can apply its experiences into developing the financial system of less-developed countries such as Vietnam.

So far, the purposes of this thesis are focus on:

+ To research more clearly and deeply about the financial system of Korea before the crisis 1997.

+ To research more clearly and deeply about the financial system of Korea after 1997 and current situation.

+ To research more clearly and deeply about the reforming process from a relationship-based system to a market-based system of Korea’s financial sector.

+ To apply these experiences into Vietnamese financial sector.

2. The Methods and Strategies

The thesis will use the combination of various methods like describing, analysis, logic, comparison, statistics, etc. in which:

- Using time-series analysis to understand the process and trend of Korea’s financial sector’ development.

- Using describing to explain the changes in tables and graphs and the reason of these changes.

- Using comparison to compare between Korea and Vietnam.

- Etc.

3. Chapter headings

Introduction

Chapter I. Korea’s financial sector before the “take-off”

I.1. Korea’s economy after the Korean War

I.2. Financial sector and the requirements for “take-off”

Chapter II. The relationship-based system (period 1960s - 1980s)

Chapter I

KOREA'S FINANCIAL SECTOR BEFORE THE 'TAKE-OFF'

I.1. Korea's economy after the Korean War

At the end of Korean War, South Korea (hereafter Korea) was destroyed heavily. The loss of life and physical destruction were enormous. In 1953, the South was literally in ruins. The war had destroyed a quarter of the real wealth of South Korea and killed over 5% of the civilian population. The situation was further exacerbated by an influx of 3 million refugees immigrated from the North. Life was grim with most Koreans living at or below subsistence. Economic recovery was slow; the GNP for 1953 was at the level of 47.9 billion won in current market price; per capita GNP was at $67 at current price (or $757 in 1990 constant dollars); average growth of per capita GNP in the 1953-1961 period was merely 1% per year; and the economy was kept from collapse only through massive economic assistance by the United States. In 1953, total consumption expenditure accounted for 91 percent of GNP, implying an average saving ratio of 9 percent of GNP (this ratio was high this year because of the large increase in agricultural inventories caused by a bumper rice crop). Gross domestic investment in 1953 was about 15 percent in which gross fixed investment, excluding changes in stocks, was only 7 percent of GNP, barely enough to cover depreciation costs of the existing capital stock. Ninety percent of imports were consumer goods, and constituted emergency relief for the population. Little attention was paid to long-term economic development during this period. The bulk of government investment during this period was on social development: Of total government expenditures, 8.8% went into research and education, 5.6% into health and welfare, 8.7% into current transfers to households and 2.8% into roads, waterways, fire protection, water supply and sanitation as compared with a total of only 14% for capital formation.

The primary policies of the period were aimed at ensuring the population's survival, reconstructing economic and social infrastructure, rebuilding industrial facilities and stabilizing prices. However, government tax revenue fell short of the expenditures needed so it had to rely on U.S aid funds such as the International Cooperation Administration (ICA) and Public Law 480 for the reconstruction projects[1]. With that little helps, the government tried to use the fiscal policy (1957) to stabilize prices and the direct control of money and credit supply to channel the funds throughout the economy. For the fiscal policies, beside of setting the annual money supply (M1), the government also cut down its expenditures, reduced borrowings for the special account of grain management, and strengthened efforts to increase tax

[1] Pyung-Joo Kim (1997), "Financial policies and institutional innovation", pp.191, in Dong Se Cha, Kwang Suk Kim and Dwight H.Perkins et al.

revenue. In the financial sector, the rate of increase in bank loans was limited to the rate of increase in savings deposits. As a result, the growth rate in the money supply was reduced from 29.7% in 1956 to 9.0% in 1959 and 4.3% in 1960; and the wholesale price showed only a modest annual increase rate of 5.8% from 1957 to 1960, and even recorded a decline of 6.1% in 1958[1]. For money and credit control, the loan priority system was introduced in October 1953 (and was maintained until 1960) to classify industries into three types A, B, and C, according to their significance to the national economy. Different firms in different types of industries will be treated differently, for example, only type A firms can get rediscount loans from central bank. Along with this system, the existing loan ceiling system was also strengthened. While limitations were previously applied to the increase rate of loan amounts, the ceilings began to be applied to the loan amounts themselves according to the type of project in 1954. This ceiling system was sooner replied by the ceiling of central bank rediscount in 1955, but the BOK still continued to give guidance to financial institutions regarding loan ceilings until March 1959.

I.2. Financial sector and the need of government control

To strengthen such a weak economy, the main policy of the Korean government in the financial market was to privatize the commercial banks and reduce

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[1] Pyung-Joo Kim, 1997, pp. 191.

government control over commercial banks. A significant development in the banking system was the introduction of regional banks. The first regional bank was the Bank of Seoul (established in 1959 and operated in Seoul and Kyung-gi areas). Another important financial development to support the reconstruction in industry and agriculture was the reduction of government direct authority over the commercial banks. In 1954, the government started to divest its holdings of shares in the commercial banks - an early state of privatization. This action of government to auction off its controlling power over commercial banks was completed in 1957. Even though this move was unsuccessful (because of large business groups emerged as the owners of these commercial banks which created conflicts of interests between the owners and managers and customers), but there were some improvements. First, it helped the government to restrict the overexpansion of commercial banks credit easier.(WHY???) Second, it reduced the burden of KRB by developing the role of special banks, at that time was Korea Agriculture Bank (KAB), in funding the reconstruction of the economy. As in Table 1, the share of loans for commercial banks was decreased (obviously after 1957, the year in which ownership was transferred from government to private); the share of loans for special bank increased; and the share for KRB after increased a bit then began to fall back.

Table 1. Share of total loans for banking institutions, 1955-1960

(Unit: percent)

Year	Commercial Banks	KAB	KRB	Total
1955	45	15	40	100
1956	43	14	43	100
1957	30	25	45	100
1958	29	31	40	100
1959	29	28	43	100
1960	29	32	39	100

Source: Cole and Park, 1983

The non-bank financial market also had some developments. By September 1953, four securities companies were established, dealt mainly in government bonds. The securities exchange market, which was closed down in 1946 by the U.S military government, was reopened in February 1956 with the listing of stocks of thirteen companies and government bonds of three types. For the insurance market, the non-life insurance companies grew significantly during the late 1950s as they were acquired by large business groups. The life insurance market remained stagnant due to the chronic inflation.

At the same time, the government also tried to create its own banks to manage the investment funds. In 1954, the Korean Reconstruction Bank (KRB), which later became Korea Development Bank (KDB), was established with the primary objective of granting medium and long-term loans to industries. Its missions were to take over some assets, liabilities and facilities of the Korea Industrial Bank

(KIB), which strongly emphasized on the short-term loans during the inter-war and the Korean War periods. The short-term loans were very helpful and successful in the time of war, but for now, what Korean needed was to encourage the private savings and invested more on reconstruction, which required medium and long-term capital. So far, after KRB controlled KIB, it shifted the policy back to longer-term loans. Theoretically, the KRB was under direct control of the Ministry of Finance, but in reality, KRB proved to be heavily dependent upon the Bank of Korea (BOK), especially for funds. The fact was, with the poor Korean economy after war, the saving ratio was very low, the inflation was high, and the high ceiling on interest rates, etc. created a strong barrier to prevent KRB to sell its long-term debt instruments to the public to fund itself, and therefore, the KRB ended up borrowing heavily from the BOK. By the end of 1955, roughly two-third of loans that the KRB provide to the public was come from the BOK[1].

In spite of these improvements, in late 1950s, it was obviously that the saving ratio was low and Korea had to depend mostly on foreign aids. So far, with this limited amount of capital, it was hard for the market to decide how to distribute these funds, and there was a need for a stronger influence from the government.

[1] David C. Cole and Yung Chul Park (1983), "Financial Development in Korea 1945-1978", Harvard University Press, pg. 52.

Chapter II

THE RELATIONSHIP-BASED SYSTEM

(period 1960s-1980s)

II.1. The governmental control over banking sector and the export-led policy (1961-1971)

II.1.1. The nationalization of banking system

After the military coup in 1961, economic development became national top priority and reorganizing the financial system was highly required to finance such development. In this situation, President Park Chung-Hee decided to create a strong banking system.

Firstly, the government reorganized the agricultural financing and marketing institutions by combining the agricultural cooperatives and the KAB into one entity known as the National Agricultural Cooperatives Federation (NACF). NACF was responsible for providing credits to farmers, refinance a sizable amount of the existing debts of farmers to private money lenders, etc. Through these activities, the government could reduce the dependence of farmers on the curb market and thereby reduce the importance of curb market.

Secondly, in August 1961, the Medium Industry Bank (MIB) was established to provide more and easier loans to medium and small enterprises. With the help of MIB, small farmers and small businessman can get loans for their investment, which in turn created a rapid expansion of loans during the early 1960s. After 5 months, at the end of 1961, the share of these two banks (NACF and MIB) in total bank credits jumped from 32 to 38 percent while the share of commercial banks dropped from 29 to 24 percent[1].

In October 1961, President Park, who was affected a lot by Japanese economic system, nationalized all commercial banks by repossessing the shares held by large stock holders. In following, the Bank of Korea Act also was revised in May 1962 with intention to bring the government - not the central bank - to the highest position to be responsible for monetary and financial policies. 'The Board's membership was expanded to nine, adding two more appointed members while eliminating the alternative membership. The power of the Minister of Finance (MOF) increased so as to make request that the Board reconsider a resolution that had already passed... The central bank was also subject to an audit by the finance minister at least once a year and its annual budget had to be approved by cabinet'[2]. This was a completion from previous period when MOF only had part of its authority over the central bank, and now, it totally owned the BOK. 'As a result, the BOK was relegated

1 Cole and Park., 1983, pp. 57.

2 Pyung-Joo Kim, 1997, pp. 196.

to the status of a virtual rubber stamp for MOF decisions and served as a ready source of government debt financing when necessary'[1]. Examples of these Acts were reinforced restriction on loans without collateral, restriction on asset management, office tenures of board members and auditors, and new punitive provisions for bank officials, etc. Through them, the government took banking operations including annual budgeting and the appointment of high-ranking bank officers under its tight controls. This action helped the government 'seized control over the entire financial system, gaining an extraordinary leverage over the private sector' (You, 1995). The result was, in 1970, more than 56% of assets of top 10 banks in Korea were owned by the government.

Table 2. The government ownership over top 10 banks of the country in 1970

(Unit: percent)

Korea	Malaysia	Singapore	Taiwan
56.64	20.0	12.85	50.43

Source: La Porta, 2002

II.1.2. The allocation of capital supporting exports activities

Starting from 1961, President Park decided to turn Korea from an inward-looking country to an export-oriented industrialization country. The goal of this

[1] Byung Sun Choi (1993), "Financial policy and big business in Korea: The perils of financial regulation" in Stephan Haggard, Chung H. Lee and Sylvia Maxfield (ed.), "The politic of finance in

outward-looking development strategy was to make maximum use of Korean comparative advantage in labor-intensive manufactured goods for exports. One of the important policy actions taken by the government to promote the export-oriented industrialization was to take the exchange-rate reform in 1964-1965.

Through reform of the exchange rate system in two steps, the government devalued the won and adopted the system of a unitary floating rate that was supposed to allow flexibility in the exchange rate reflecting demand and supply conditions on the market. An excessive intervention by the monetary authorities in the exchange market, however, resulted in transforming the system of a unitary floating rate into a crawling peg. Nevertheless, the nominal exchange rate was allowed to fluctuate so that a roughly constant level of purchasing power parity (PPP) adjusted, real exchange rate might be maintained beginning in 1965.

Table 3. Exchange rates in the 1953-1965 period *(won/dollar)*

Year	Exchange rate adjusted by PPI	Actual exchange rate
1953	6.1	18
1954	8.4	18
1955	11.6	50
1956	60.9	50
1957	84.7	50
1958	97.6	50
1959	90.9	50
1960	92.9	65
1961	106.9	130

developing countries”, Cornell University Press, London.

1962	124.4	130
1963	135.7	130
1964	175.3	256.3
1965	272.6	272.6

Source: Re-quoted from Kwang Suk Kim and Joon-Kyung Kim

(Dong Se Cha, Kwang Suk Kim and Dwight H.Perkins et al., 1997)

The exchange rate reform, and the concurrent implementation of comprehensive export promotion following it, was able to create an institutionalization system of incentives consistent with the export oriented industrialization strategy. However, the government did not only rely on this system alone. It had three major administrative instruments to support that strategy. One was the government export targeting system, under which annual export targets were usually set by major commodity group and by destination, and export performance was monitored against these targets. The second was the support of the government owned, Korea Trade Promotion Corporation (KOTRA) for overseas marketing activities of Korean exporters through a continuous expansion of its overseas network. The last was the Monthly Export Promotion Conference (later renamed the Monthly Trade Promotion Conference) which essentially served to disseminate the government emphasis on export promotion and also to quickly resolve problems encountered by exporters through the final decision of the president. Through KOTRA, firms working in export-related areas can borrow loans from banks at lower interest rates.

Table 4. Interest Rates for Deposits and Loans (1961-1970)

(Unit: percent)

	1 year saving rate	General loan interest	Export loan interest
1961	15.0	17.5	13.9
1962	15.0	15.7	9.1
1963	15.0	15.7	8.0
1964	15.0	16.0	8.0
1965	30.0	26.0	6.5
1966	30.0	26.0	6.5
1967	30.0	26.0	6.0
1968	26.0	25.2	6.0
1969	24.0	24.0	6.0
1970	22.8	24.0	6.0

Source: Re-quoted from Kim, 2004

Along with the interest rates policy, the Park Chung Hee's government also tried to sponsor the export-related firms through Central Bank's discount window. This policy was indeed a rediscount policy to firms who already received letters of credit (L/C). If a firm could get its hands over a L/C, then it means it could get an exporting contract and became a 'potential exporter'. Thus, financed these kind of firms was beneficial to the economy. Therefore, such firm could use the L/C as a mortage to borrow from the BOK with lower rediscount interest rates - compare to normal firms. This rediscount loans from the BOK were also applied to pre-shipment exports, imports of raw materials and intermediate goods for exporter use, and to the purchase of export content from local suppliers[1].

[1] Kim Joon Kyung (2006), 'Capital accumulation and resource mobilization' et al.

Table 5. Export loans of DMBs in the period 1961-1972

(unit: percent)

Type of loans	1961-1965	1966-1972
Export loans of DMBs/Total loans of DMBs	4.5	7.6
Export loans of DMBs/Total policy loans of DMBs	n.a	n.a
Export loans of BOK/Total loans of DMBs	n.a	66.3

Source: Cho and Kim, 1997 (pp.38)

Along with creating the incentives for firms in exporting, the government also tried to help these firms to get capital needed for their investments. In 1962, the government legislated the Act for Payment Guarantee of Loans in which the BOK (and subsequently the Korea Exchange Bank (KEB)) issued a guarantee to the foreign lenders when they lend their capital to Korean businessmen. The Korean borrower therefore was backed up by both BOK and KEB that, in the worse scenario that he cannot repay his debt then the BOK will pay for him. This Act became significant in 1963 when the KDB acceptances went up from 2.2 billion (in 1962) to 18.1 billion won and after that the guarantee amount of the whole banking system increased rapidly, around 80 percent per year.

Table 6. Loans guaranteed by banks, 1960-1971

(Unit: billion won)

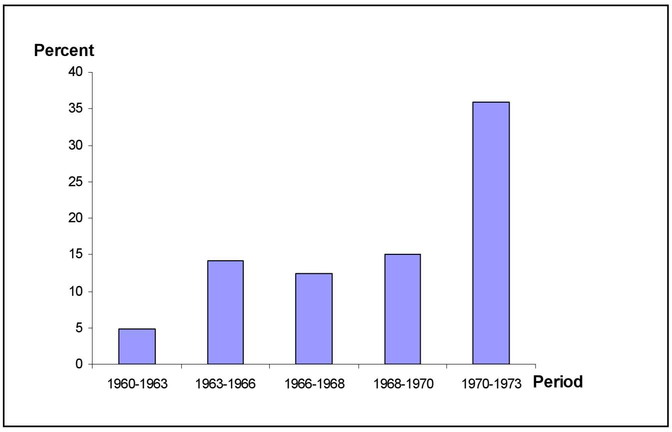
Year	Commercial banks	Special banks	KDB	Total loans guaranteed	Annual Growth (%)
1960	0.4	0.0	0.2	0.6	n.a
1961	1.4	0.0	0.2	1.6	166.67
1962	2.8	0.0	2.2	5.0	212.50

1963	3.7	0.0	18.1	21.8	336.00
1964	9.9	0.0	38.3	48.2	121.10
1965	11.8	1.4	62.1	75.3	56.22
1966	40.2	1.4	103.0	144.6	92.03
1967	50.3	2.7	143.0	196.0	35.55
1968	126.1	3.3	175.0	304.4	55.31
1969	225.1	4.0	300.0	529.1	73.82
1970	319.3	6.0	424.0	749.3	41.62
1971	435.5	13.2	600.0	1,048.7	39.96

Source: Cole and Park, 1983

In general, due to two strong impacts both from private sector (indirectly through KOTRA) and government (exchange rate reform and Act for payment guarantee of loans) then the development of exports can contribute more than 16 percent to GDP growth in the 1960-1970 period.

Figure 1. Contribution of exports to GDP growth in Manufacturing, 1960-1973



Source: Re-quoted from Choong Yong Ahn, 2004

II.2. Strengthening selective credit policy for the HCI drive (1972-1979)

In the first and second Five year economic development plan (1962-1966 and 1967-1971), the Korean government more or less focused on import-substitute light industries to build a ‘strong nation’. But from the third and fourth periods (1972-1976 and 1977-1981), the selective industry policy of the Korean government tended to focus on heavy and chemical industrial (HCI) plan. In 1973, the government announced the HCI plan that envisioned a total investment of approximately $9.6 billion for construction of six industries - iron and steel, electronics, petrol-chemical products, automobile, ship building, and machinery - during the period 1973-1981 (Lee, 1991). The HCI project was declared in the HCI promotion council 1973 to be a key strategy that would increase Korea’s per capita GNP to $1,000 and exports to $10 billion by 1981 (in 1972, GNP per capita of Korea was $318 and exports was $1.6 billion only).

Table 7. Some main HCI projects during the 1972-1979 period

Sector	Project	Size	Building period
Steel and iron	POSCO	1,030,000 mT	1970-1973
Machinery	Heavy machinery factory		1973-1974
Shipbuilding	Hyundai shipyard	300,000 mT 05 ships	1972-1973
Chemical	Ulsan petrochemical complex	100,000 mT	1968-1974
Electronics	Gumi electronics complex construction		1971-1981

Note: mT = metric tons = 1,000 kg

Source: Suk Chae Lee, 1991

The motivation of this changing in strategy was due to three reasons. First, it was that the development of HCIs was considered inevitable for the purpose of constructing a domestic defense industry which was essential for enhancing the nation's self defense capability. Second, the nation's industrial policy emphasized the construction of HCIs, since Korea had to face the increasing in trade barriers of advance countries against its labor intensive goods while the domestic wage-rental ratio was rising rapidly. Lastly, the development of HCIs was considered important for improving the country's balance of payments, since the past strategy emphasized light industries which cause the increasing in imports of both capital and intermediate goods, and thus was ineffective in reducing the current account deficit. In order to mobilize the necessary resources (capital, technology, entrepreneurship, etc.) to the HCI sector, the government had to use various measures such as increased preferential long-term loans for HCIs; provided tax incentives to enterprises working in HCI sector; improved the engineering and technical schools as well as broad access to these schools to improve human capital for HCI development; established several new research institutes to promote research and development (R&D) in the HCI fields; etc. (Kwang Suk Kim & Joon-Kyung Kim., 1997). As an example for the increasing of manpower of Korea in HCI related sector, from 1977 to 1991, Korea won nine times in a row in the International Vocational Training Competition (Joon-Kyung Kim, lecture note).

But, as the HCI plan was affected strongly by the development of private enterprises, thus, financial policies towards these enterprises had to change. To secure an adequate flow of financial resources into HCIs and to lessen the risks involved, the government had to control the entire credit system and give preferential access at greatly subsidized rates to targeted industries. To do so, it established a special fund called the National Investment Funds (NIF). In fact, NIF was a combination of domestic fund from private financial intermediaries (such as commercial banks and insurance companies) and the government fund (such as Civil Servants' Pension Fund and Veteran's Pension Fund) with the contribution proportions as follow: commercial banks had to send to NIF 10-30 percents of the net increase in their saving deposits, insurance companies had to contribute 40-50 percents of their premiums, and pension funds had to contribute 90 percents of their reserved. In the period of 1974-1984, in average NIF got its fund contributed up to 17 percent from public funds, 64 percent from banks and 18 percent from insurance companies (Cho and Kim, 1997).

Table 8. Financing sources of NIF from 1974 to 1981

(Unit: billion won)

Sources	1974	1975	1976	1977	1978	1979	1980	1981
National Saving Association	8.8	11.3	12.1	17.0	26.4	39.0	41.8	48.0
Public funds	11.5	16.8	25.4	45.3	54.6	64.4	91.4	75.5
Postal savings and National Life Insurance	10.0	15.0	18.5	-2.1	0	0	0	-24.3
Banking institutions	36.9	53.5	102.4	100.4	200.0	257.2	102.5	277.4
Insurance companies	2.6	7.4	12.2	18.1	24.1	16.3	24.0	20.7

Balance from previous years and redemption	1.0	3.0	18.4	33.1	143.6	163.6	147.1	276.0
Total	70.8	107.0	189.0	211.8	448.7	540.5	406.8	673.4

Source: Suk Chae Lee., 1991

With the existence of NIF, HCI-related companies were easier to get capital for their investment with lower borrowing cost than other sectors.

Table 9. Borrowing cost in the period of 1973-1981

Sector	Borrowing cost (%)
HCI	12.1
Light industries	14.9
Other	17.3

Source: Cho and Kim, 1997 (pp 115)

These measures above were quite successful in attracting capital funds for HCI sector. If the investment for HCI firms in the early 1970s was accounted for about 57 percent of total manufacturing investment, then in the later half of that decade, it went up to 64 percent (meanwhile, investment for light industries dropped from 43 percent to 36 percent during the same period). And the final results were the continuous increasing in the share of HCIs in total manufacturing value-added (from 26 percent in 1961 to 55 percent by 1979) and the increasing in the share of HCI exports (from 10 percent of total manufacturing exports in early 1970s to 43 percent by 1979) (Kwang Suk Kim & Joon-Kyung Kim, pp.22-23).

II.3. The role of the state in reforming financial institutions

II.3.1. Establishing new banking institutions

A number of new government banking institutions were established in 1967, and the doors were opened to creation of new private banking ventures. The KEB was constituted as a separate entity out of the personnel, facilities, and financial resources of the foreign-exchange and foreign-operations departments of the BOK. The KEB's stock was wholly owned by the BOK, and it has functioned largely as an extension of the BOK since its inception. Thus, the change was mainly one of form rather than substance.

Much the same can be said for the Korea Trust Bank (KTB), which represented a consolidation in 1967 of the trust departments of the five national banks. Trust accounts in Korea are fairly close substitutes for time deposits. The KTB held substantial amounts of demand deposits from its inception. Thus, it functioned much like a commercial bank and was treated as such by both the central bank and the financial authorities before it was merged with the Seoul Bank in 1976 to become the Bank of Seoul and Trust Company.

The Korea Housing Bank (KHB) was also created in 1967 to finance housing funds for low income families. "It was to extend loans for construction and purchase of houses, and to firms producing housing construction materials"[1]. The Housing Bank has raised roughly a third of its funds through the sale of debentures and 55 percent of its funds through demand and time deposits. Depositors receive preferential treatment in the granting of loans, which provides an incentive in addition to the interest rate for holding its deposits.

Of greater significance was the government's action in 1967 which authorizing the chartering of "local banks" to conduct commercial banking business, principally in the provinces. One objective of the government was to achieve greater dispersion of banking services and see that the banks would concentrate on meeting the needs of local enterprises. The local banks engage in branch banking, with their head offices in the provincial capitals and branches in the same province. Initially they were prohibited from engaging in foreign-exchange operations, but, as they became better established, this prohibition was relaxed.

Also the local banks were authorized to charge interest rates on loans up to 2.5 percentage points higher than the national commercial banks, and to pay higher interest rates on time deposits. These banks are privately owned and less closely regulated and controlled than the government-owned banks. They are examples of the kind of banks that Bloomfield and Jensen and subsequent foreign advisors, such as

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[1] Cole and Park (1983), pp. 66

Edward Shaw and Homer Jones, advocated for Korea. While they have grown quite rapidly, their share of total bank deposits had reached only 9.8 percent by 1978; and the remaining 90 percent of deposits, and an even higher percentage of total loans, were still administered by government-owned or government-controlled banks.

A final institutional innovation of 1967 was the granting of permission to a limited number of foreign banks to open branch offices in Korea. In the first year, five banks (three American and two Japanese) established branches, and, by the end of 1974, four more were permitted. Since then, the number of foreign bank branches has risen rapidly, reflecting a growing volume of external transactions. At the end of 1978, there were thirty branches and fifteen foreign bank representative offices.

The kinds of activities in which these branches can participate are quite circumscribed, and their share of total bank deposits reached only 1.1 percent by 1978. They rely mainly on funds borrowed from their head offices to make loans in foreign currency, especially to importers.

II.3.2. Improving transparency and efficiency in the market

Economists as well as governors realize that the rapid growth of the financial market may lead to emerging problems due to institutional interdependency (see Kim & Lee for more details). Thus, a government intervention to create such a fairness for the market was necessary. In this manner, in 1977, the Securities and Exchange

Commission (along with its executive body - the Securities Supervisory Board), were established "to remedy structural weaknesses remaining in the capital market and, thereby, to maintain fairness in transactions and protect the investors"[1]. Beside the control of SEC and SSB, the government also increased its supervision and guidance toward the operations of securities companies. It required these firms to audit through certified public accountants to improve transparency in the market. More over, an improved system of margin transactions and subscription to new equity issues has been established.

To expand the development of the securities market, the SEC introduced a registration system as a further development of the government's policy of inducing corporations to go public. This registration is required for for unlisted corporations wishing to list their securities on the market or to merge with a listed firm, and for other designated firms.

Transactions outside the Exchange existed in small scale and in a decentralized manner at negotiable prices. For these transactions, the government used close supervision and supportive measures to secure the fairness. But, as of late-1970s, this market in Korea was not yet developed.

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[1] Cole & Park (1983).

II.3.3. The capital market's intervention

The Korean capital market, which grew rapidly since mid-1960s, still lacked depth, breadth, and resiliency. Therefore, government intervention was needed to protect investors from the failures of the immature market.

First, the limit of price change within a trading day was introduced supposedly to protect investors from abrupt price changes. Then, changing credit availability for margin transactions and urging institutional investors to buy or sell specific stocks in a stabilizing manner were used to stabilize the stock market. Open market operation also became an useful tool of the government to control the market. At the end of 1977, about 54 percent of the total listed shares were held by the government and public entities. The ratio held by individuals decreased from 59 percent at the end of 1974 to 46 percent three years later.

II.3.4. The effectiveness of the relationship-based government

Combine all the conditions of the Korea's economy in the period of 1960-1970, we can clearly say that this was an underdeveloped market: inexperience investors did not know where to invest, customers did not know how to maximize their utilities, producers could not answer the three 'Wh' questions for producing, etc. In other words, in this market, a transaction was hardly 'contractually allocated', or the function to allocating resources effectively of the market could not be done (low contractability). Thereby, the actions of the government in nationalize the banking system, promoting transparency, reforming financial institutions, etc. were needed and brought efficiency to the market. Along with that, the limit of funds as well as the inefficient of the price signal (due to the weak market) and the lack of opportunity for invest also made it difficult for individual investors to choose profitable investments. This fact brought Korea into the situation of low capital relative to opportunities. In this condition, the government interventions in choosing 'national industries' or allocating funds for exports and HCI firms were to bring effectiveness to the usage of limited capital. Therefore, under these condition, the relationship-based system was successful in bring efficiency into the Korea's financial market and it explains why this market could grow in the 1960-1970 period to make such a 'Korean miracle' (Rajan & Zingales, 1999).

This figure explained how the relationship-based system is well suited for development for Korea in the 1960s.

	Low capital/opportunity	High capital/opportunity
High contractability	Both	Arm's length
Low contractability	Relationship-based	Neither

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Chapter III

THE REFORMING TOWARD A MARKET-BASED SYSTEM AND THE FINANCIAL CRISIS 1997

III.1. The early market-based system before 1997

The patchy and gradual nature of liberalization in the 1980s was followed by much deeper and speedier liberalization in the 1990s, especially during the Kim Young Sam administration (1993-1998). Under the US pressure trade liberalization began to affect even such “sacred” areas as agriculture, finance and automobile industry from the late 1980s. The launching of the WTO in 1995 accelerated this move toward dismantling the last pockets of protected industries.

Financial liberalization proceeded quickly since 1993. Measures included interest rate deregulation, abolition of policy loans, greater managerial autonomy of the banks, relaxation of entry barriers to the financial industry, and liberalization of capital account transactions. All these liberalization measures, however, did not prevent the financial crisis of 1997-98. What was the reason?

First, liberalization policy was distorted by influences from those who had vested interests in keeping the old system of control and protection such as the bureaucrats and, especially, the chaebol. An important instance was the financial liberalization of the early 1980s, when chaebol groups acquired shares in the commercial banks and ownership of many NBFIs. While the NBFIs were given considerable leeway, the natural reluctance of the bureaucracy to relinquish its power meant that the government never allowed true autonomy of bank management. Out of this two major problems in the financial system arose. The deregulated NBFI sector's share of finance became inordinately large as they grew at the expense of the banking sector, and, with many NBFIs under the control of various chaebol groups, a basic principle of sound finance – separation of industrial capital from financial capital - was violated. Chaebol groups now used affiliated financial institutions to feed their expansionary ambitions.

Chaebol's distortion influence was also responsible for the mismanaged financial liberalization in the 1990s. It was the driving force behind the capital account liberalization measures of the 1990s that would allow them to borrow freely cheaper funds from abroad. They also pushed for more deregulation in domestic finance as they increased their control over the NBFIs. Even as the chaebol championed the cause of liberalization and deregulation in order to gain greater freedom of business, they strove to keep their unfair advantages stemming from their dominant market position and privileged access to finance.

Second, growing political interference distorted liberalization process. The infamous case of Hanbo Steel Co. is a good example. Offering generous sums of political contributions to the nation's most powerful politicians, Hanbo's founder-chairman Chung Tae-soo managed to secure a total of 5.7 trillion won (about U.S. $7 billion) in bank loans before his empire crumbled under the weight of snowballing debts. This was not an exceptional case, as many chaebol groups accumulated unmanageable amount of debts in similar ways.

Another notorious instance of politicization of economic decisions is the Samsung Motor case. The government had been denying Samsung from entry into the auto industry for fear of over-capacity and excessive competition, but suddenly granted entry in 1995 after Samsung's successful manipulation of the public opinion in Pusan, the political hometown of President Kim Young Sam. The Samsung auto project, even without the industry-level over-capacity problem, was nonsense, as its plant was to be built on reclaimed land that needed massive fortifying as a move to give political benefits to the President in return for allowing the entry.

Third, the financial liberalization was mismanaged partly because of the misguided ideology of neo-liberalism in the Kim Young Sam government that adopted segyehwa as its guiding principle. Especially problematic was the financial liberalization and the capital account liberalization without installing proper safeguards. Thinking that they should 'let the market decide', bureaucrats neglected prudential regulations and financial supervision that became, in fact, all the more important as a result of liberalization. NBFIs were especially poorly supervised. The consequence was a rapid accumulation of foreign debt, particularly the short-term debt, and a growing list of highly risky financial investments. In the end, the mismanagement of financial liberalization culminated in the catastrophic exchange crisis of 1997.

III.1.1. The paradigmatic shift from state-led developmentalism to liberal market economy in the period of 1980s-1990s

At the end of 1970s, Korea's economy had to face many problems. First it was the bad effect from the World' second oil shock which led to the Korea's term of trade deterioration. Second, it was the high inflation in the economy at the level of more than 20% and the boom of housing and land's price (nearly 50% increased in 1978 compare to 1977), which made real interest rates negative and hampered the financial sector. More over, the HCI and exports promotion policy in the 1960-1970 period now created some side effects: overcapacity in investing, low profitability in some HCI-related firms, moral hazard problem, etc. Recognized the seriousness of these problems, the Korean government decided to liberal the financial system through deregulation.

Financial deregulation began with the privatization of nationwide commercial banks and the abolition of various restrictions on bank management in the early 1980s. Then, the interest rates was also liberalized to eliminate the differences between general loans and policy loans (it was accomplished in June 1982). Along with that, the government also tried to reduce the directed credit, open the capital market and exchange market follow the "Third-stage blueprint for the liberalization and opening of the financial sector" (June 1993).

Figure 2. Third-Stage Blueprint for the Liberalization and Opening of the Financial Sector *(announced June 1993)*

Phase I (1993)

1. Liberalize all bank and non-bank lending rates(except for policy loans) and long-term deposits over two-year maturity.
2. Issue Monetary Stabilization Bond and government bonds at close-to-market interest rates.
3. Operate M2 targets flexibly.
4. Liberalize call markets.
5. Widen the daily won-dollar trading margin from 0.8% to 1.0%.
6. Switch to the notification system for foreign direct investment into Korea.

Phase II (1994-1995)

1. Liberalize all lending rates and rates for short-term marketable instruments.
2. Establish indirect monetary controls.
3. Deregulate loans to large conglomerates.
4. Develop short-term financial markets.
5. Further widen the daily won-dollar trading margin.
6. Further ease requirements for underlying documentation prior to foreign exchange transactions.
7. Expand limits on foreign investments in the stock market.
8. Allow the foreign participation in primary markets for some bonds.
9. Ease requirements for opening branches of foreign securities companies.

Phase III (1996-1997)

1. Liberalize all deposit rates except for demand deposit (allow MMC, MMF).
2. Utilize open market operations as main monetary policy tool.
3. Operate the Loans Management System as a prudential regulation.
4. Introduce free floating exchange rate system.
5. Eliminate requirements for underlying documentation for the usual foreign exchange transactions.
6. Allow foreign borrowing through commercial loans.
7. Allow foreign financial institutions to hold stocks of domestic banks.

Source: Re-quoted from Won-Am Park and Gongpil Choi (2002)

a) Interest Rate Liberalization

Piecemeal attempts to deregulate interest rates can be found since 1981 when commercial paper (CP) was introduced in Korea without any restriction over issuance rates. Still, there was no significant advance toward interest rate liberalization until December 1988 when most of the lending rates of banks and non-bank financial institutions were liberalized. Even though the government effectively resumed interest regulations in 1989, when the interest rate became unstable as a result of high inflation, most people regard the official declaration of interest liberalization in 1988 as the first step in this reform measure.

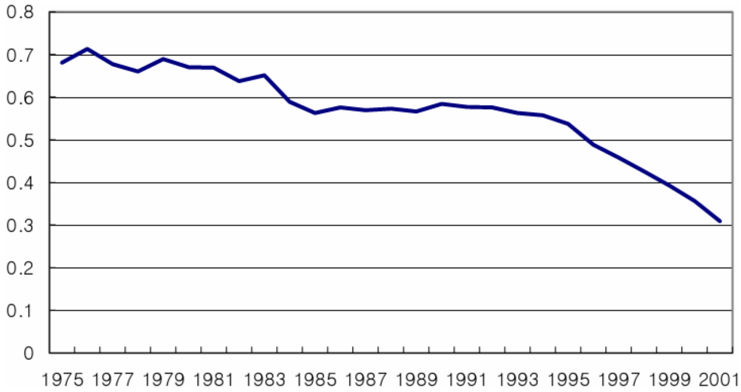
In August of 1991, the government announced a more detailed plan for interest liberalization, “The Four-Stage Interest Rate Deregulation Plan” in order to promote competition and enhance efficiency in resource allocation. In accordance with this agenda, the government implemented the first stage in November 1991. As a result, those interest rates that were already close to market rates were deregulated. Included in the plan were lending rates for bank overdrafts, discounts on commercial bills, trade bills, and CPs, deposit rates for CDs, large-amount of CPs, and repurchase agreements (RPs). In the second round of the liberalization in November 1993, all lending interest rates and the deposit interest rate for more than two years of maturity were deregulated, and the bond rate was also liberalized. The third and fourth rounds of the liberalization were enforced in July 1994 and July 1997 respectively and interest rates for the rest of financial products were deregulated..

b) Reduction in Reserve Requirements and Directed Credit

Together with interest rate liberalization, various efforts were made to improve autonomous asset management of banks. Notably, reserve requirements and directed credit were lowered in the 1990s. Until the late 1980s, the BOK relied mainly on reserve requirements in controlling its money supply and so the required reserve ratio fluctuated according to policy stances of the BOK. For example, the required reserve ratio was substantially lowered from an average of 23 percent at the end of 1979 to 3.5 percent in 1981. However, the BOK raised the reserves-to-deposit ratio to as high as 11.5 percent in late 1980s in order to absorb the increased liquidity caused by large current account surplus at that time. Sustained reduction in reserve requirements was undertaken only in 1996 as reserve requirements for demand and time deposits were reduced to 9 percent in April 1996, 7 percent in November 1996. In February 1997, reserve requirements were further reduced to 5 percent of demand deposit and 2 percent of time deposit.

Directed credit refers to the loans that are completely or partially financed through borrowings from the government or the central bank. Consequently, the allocation of directed credit is heavily regulated. In Korea, the proportion of directed credit in total credit decreased continuously, even if there were not discrete changes in the policy on directed credit.

Figure 3. Reduction in Directed Credit ***(Proportion to the Total)***



Source: Monthly Financial Statistics Bulletin, Bank of Korea.

As Figure 3 indicates, the proportion of directed credit was higher than 60 percent for the years before 1984, but decreased to less than 60 percent in years between 1985 and 1994 and to less than 40 percent after 1995. This trend can be regarded as representing enhanced independence of financial intermediaries in their operations.

c) The privatization of state-owned banks or the 'chaebolization' of banking system

As we can see, prior to 1980, the Korean government owned commercial banks and not only exercised strong influence in appointment of top managers, but also supervised the budget, organization and business activities of banks. But under the special project of Kim Jae-ik, the government began actively divesting its stake in other government-owned banks based on the premise that establishing a market-based ownership and governance structure should be the first step to improve efficiency of financial markets. As a result, all of the government-owned commercial banks were privatized in the 1980s, starting with Hanil Bank in June 1981, then Bank of Seoul, Korea First Bank in 1982, etc. And over the 1990s most of the government-owned special purpose banks (such as Korea Exchange Bank) were transformed into commercial banks and privatized subsequently[1].

After privatization of the banks over the period from 1981 to 1983, an individual was allowed to take minority stakes in banks of up to 4%. The primary reason for this restriction was to prevent the chaebols from owning and controlling the banks. But, despite the privatization of the commercial banks, the government continued to influence bank operations ranging from credit allocation policies to the selection of top management. On the surface, the influence of the government seems to be ruled out. Yet, in practice, the government overrules out the board of non-standing directors of these banks in appoints and dismisses the presidents of banks[2]. In the end, the banking sector after liberalization became half government half

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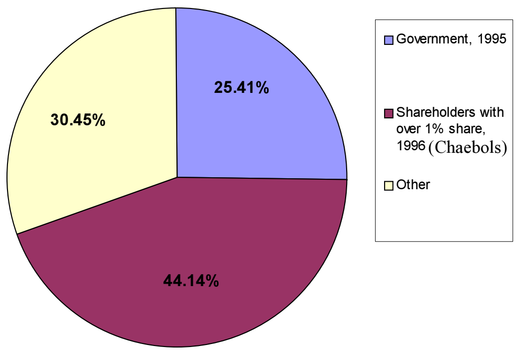
[1] Choongso Kim & Inseok Shin (2002). *Economic Liberalization of Korea for an Advanced Market Economy.* Korea Development Institute.

[2] Jaewook An, Sang Kun Bae and Ronald Ratti (2005). *Ownership Restrictions and Economic Performance: The Case of Korean Banks.* Oxford Bulletin of Economics and Statistics.

chaebol-owned.

Figure 4. Ownership structure of Top 10 banks of Korea



Source: Rafael La Porta (2002), Kim-Kim-Kim (2000)

d) Foreign Exchange Market Liberalization

Liberalization of foreign exchange market typically involves a great variety of measures and, thus, it is hard to document all aspects of it. At large there were two dimensions: lifting of direct intervention in market operation and deregulation of foreign exchange transactions by Korean nationals such as foreign exchange borrowings.

In case of Korea, the former can be traced by the change in exchange rate system, since degrees of intervention seem to have declined step by step whenever new exchange rate system was adopted. In the 1970s Korea maintained a de facto dollar-peg system although the system was officially named the unified floating exchange rate system. The nominal anchor approach was changed to a real target approach with the introduction of Multiple Currency Basket Peg System in February 1980. In the wake of realignment of major currencies in the mid-1980s, Korea's current account showed large surpluses, and the international financial institutions and the U.S. Treasury accused the Korean government of manipulating its exchange rate. This led to an adoption of Market Average Exchange Rate System in March 1990, under which the won-dollar exchange rate was determined in the market within a band that was initially set at 0.4 percent above and below the rate of the previous day. The band was gradually widened overtime and eliminated in December 1997, immediately after the currency crisis.

As to foreign exchange transactions, until 1997 the Korean government heavily regulated any form of transactions by taking the positive system under Foreign Exchange Management Act. Under the system only those transactions that were explicitly permitted could be undertaken. During the 1990s, the Korean government began liberalizing foreign currency borrowings slowly. While cross border trade by individuals was left closed, certain transactions were allowed for corporations as a part of capital account liberalization. Thus, overseas bond issuance by financial institutions and corporations was deregulated in 1991, subject to discretionary quantity control by the government. Also foreign borrowings by corporations were allowed in 1995, again with restrictions on the use of funds attached and government approval required.

Liberalization of trade-related short-term financing was made relatively free with fewer restrictions attached: regulations on deferred import payments and receipt of advance payments for exports were lifted step by step with little restrictions throughout the early 1990s. Relative to individuals and corporations, banks were given more freedom in transactions with foreign agents, although the allowed transactions were limited to overseas bond issuing and foreign borrowings. For banks, there were no formal restrictions on foreign borrowings, although it is known that the government imposed informal quantity controls. But the restrictions were lifted in 1994.

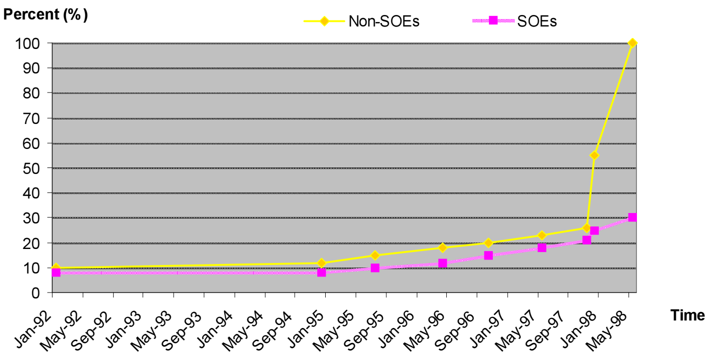
e) Capital Market Opening

Like the liberalization of foreign exchange market, capital market liberalization is also a complicated process. In this study, we focus particularly on the opening of stock and bond markets as an indicator of capital market liberalization.

Capital market liberalization in Korea was initiated in December 1988, when the government announced a plan for "gradual globalization of the capital market." Subsequently, the stock market was first opened in January 1992, by allowing foreign investors to purchase up to 10 percent of the volume of each stock item. The limit on this share was relaxed continuously during the 1990s, until it was completely lifted in

May 1998.

Figure 5. Trend in the expansion of Limits on Equity Investment by Foreigners



Source: Financial Supervisory Service, Press Release, Jan. 2000.

The opening of the bond market came later in July 1994, when foreigners were allowed to purchase non-guaranteed corporate bonds of small and medium sized firms. In December 1997, all regulations on the purchase of corporate bonds and government bonds were abolished. Subsequently, foreign investment on the bond of non-listed companies was allowed in July 1998. Opening of the money market, such as the markets for CPs and CDs, proceeded in steps and was completed in May 1998.

III.1.2. The rise of chaebols over NBFIs and its negative consequences

a) Chaebols and NBFIs

Along with the 'chaebolization' of the banking system, in non-banking sector, chaebols also tried to gain control over NBFIs so they can mobilize the capital for their own benefits. As government eliminated the asset restriction and reduced the reporting requirements for NBFIs (under the strong pressure of liberalization), chaebols were able to increase their power over NBFIs. Once they acquired NBFIs, they lobbied for the dismantling of business restrictions on NBFIs so that they could offer new financial instruments (Cho, 2003). Therefore, chaebols could 'exploited their affiliated NBFIs as financing arms to support and provide beneficial preference to other subsidiaries within their group in various ways including: direct provision of funds, priority underwriting of securities issued by related subsidiaries, provision of preferential financial services and information on competing firms, management of related firms' shares and their prices, exercise of control of other firms via stock holding, and other forms of unfair inter-group transactions' (Kim, 2004).

Table 10. Number of NBFIs owned by Top 70 chaebols *(as of end of 1997)*

(Unit: number of firms)

NBFIs	Top 5 Chaebols	Top 6-30 Chaebols	Top 31~70 Chaebols	Total
Merchant Bank (29)	3	7	4	14
Securities (26)	6	5	1	12
Investment Trust (24)	4	6	0	10
Life Insurance (31)	2	4	8	14
Fire & Marine Insurance (13)	2	3	0	5
Installment Credit (26)	2	7	3	12
Mutual Saving & Finance (219)	1	5	12	18
Venture Investment (56)	3	4	6	13
Credit Card (7)	3	1	0	4
Finance Factoring (46)	3	4	5	12
Total (477)	**29**	**46**	**39**	**114**

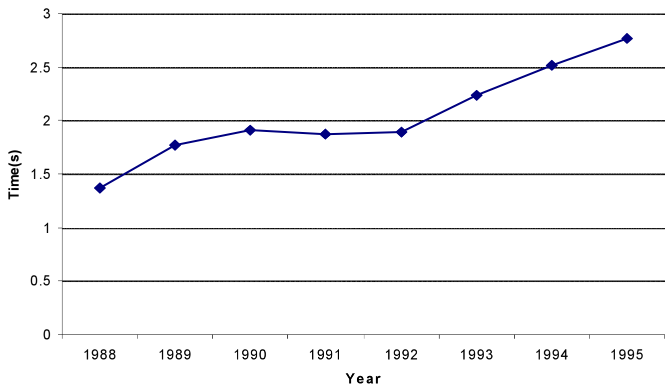
Note: *Number in ( ) shows total financial institutions at each sector*

Source: Kim (2004)

With the help of the so-called 'affiliates' NBFIs, the chaebols now had more accessing power to the funds they needed. Chaebols became more and more dependent to loans borrowed from NBFIs than loans borrowed from commercial banks. As of the end of 1995, the loans that chaebols borrowed from NBFIs were around 2.8 times higher than borrowed from banks.

Figure 6. Ratio of loans by NBFIs over loans by commercial banks

(for Top 30 Chaebols)



Source: The Bank Supervisory Authority of Korea.

b) The negative consequences

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

One consequence of the unbalanced financial deregulation and lack of control over chaebol was a rapid debt-financed growth of investment accompanied with low profitability of investment in the 1990s. In fact, compared with Japan and Taiwan, Korea had the highest growth rates of investment and asset and the lowest profitability, especially noteworthy is a sudden increase in investment in the mid-1990s.

Table 11. Comparison of Profitability and Growth of Investment & Asset values in Korea, Taiwan, and Japan (%)

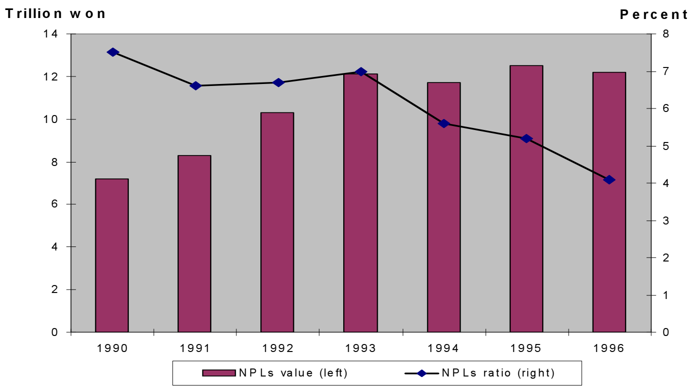
		1988	1989	1990	1991	1992	1993	1994	1995	1996
Profitability	Korea	4.1	2.5	2.3	1.8	1.5	1.7	2.7	3.6	1.0
	Taiwan	5.0	3.8	4.5	4.0	3.4	2.9	4.9	5.1	
	Japan	5.5	5.8	5.3	4.0	2.9	2.3	2.9		
Growth of Fixed Capital Investment	Korea	26.8	16.5	25.7	11.6	-14.0	-4.0	56.2	43.5	
	Japan	30.4	16.8	19.2	8.0	-20.0	-22.0	-8.4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

Source: Re-quoted from Lee-Lee-Lee (2000)

Another important aspect of this expansion by chaebol, apart from their low profitability, is that it was done at the expense of profitability for banks and other financial institutions. According to official report of the government, after the deregulation in August 1993, the commercial banks were showing good signs of developing in reducing the NPLs ratio from 7.5% in 1990 down to 4.1% in 1996. This meant that the banking system of Korea at that time was healthy, so why the crisis still occurred if the NPLs was that small? The answer lied on the 'real' NPLs ratio that the government didn't know (or didn't want to report?) which related to the Interest Payment Coverage Ratio (IPCR) of firms - mostly chaebols - which borrow from these banks.

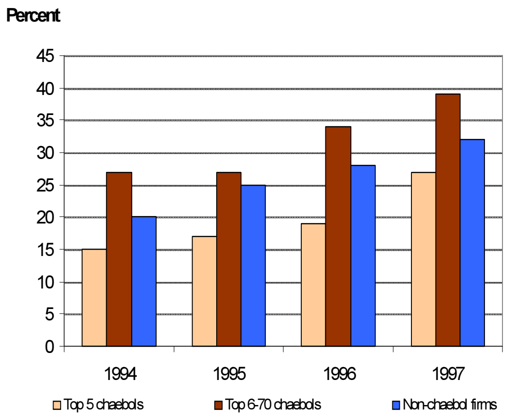
The IPCR shows that a company can pay it interest for borrowing loans or not, therefore if a company has IPCR smaller than 1 then it may not pay that cost, and this loan can be counted as potential NPLs. Prior to 1997, it was obvious that more and more chaebols (particularly among top 6-70 chaebols) and non-chaebol firms were facing difficulty in paying the interest.

Figure 7. Official NPLs of Korean banks



Source: Kataoka (1999) and Shin (1998)

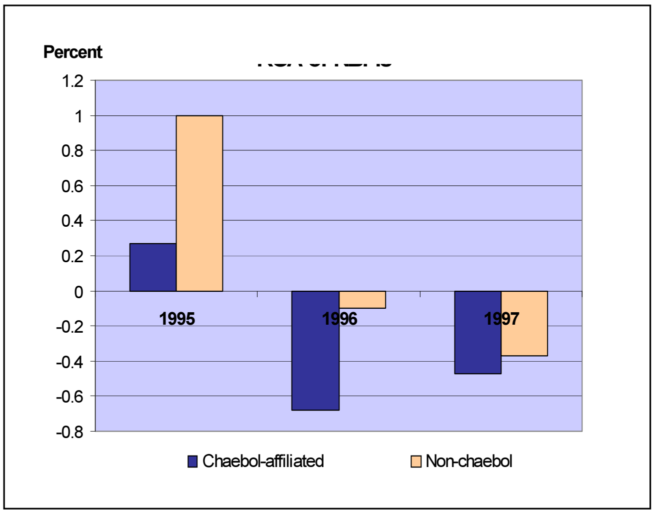
Figure 8. Share of firms with IPCR<1



Source: Kim (2004)

Moreover, NBFIs under the affected from chaebols turned out to be inefficient because they acted not as profit seeking institutes but as tools of chaebols only. Further hypothesis research of Kim (2004) already proofed that fact by showing that the rate of returns (ROA) of chaebol-affiliated NBFIs always lower than non-chaebol independent NBFIs.

Figure 9. ROA of NBFIs



Source: Kim (1999)

III.2. The 1997 financial crisis

The first overt signs of trouble in Korea were evident in 1996, when the current account deficit widened from 2% of GNP in 1995 to 5% in 1996, the rate of growth of exports slowed down from a phenomenal 31% to a merely high 15._At the same time, foreign debt rose from 78 billion dollars (62% of exports) in 1995 to 100 billion dollars (76% of exports) in 1996, most of it short term. The slowdown in exports was due in part to: a loss of competitiveness arising from the relative appreciation of Korea's currency because of the drastic decline of the yen; a recession in Japan and Europe; and a precipitous drop in the world prices of computer chips, ships, automobiles and garments, which affected over 50% of Korea's total exports. Exporters of these products were therefore losing money on their exports. Together with increases in domestic wages and high domestic interest rates, these losses put a squeeze on corporate profits, which let to a surge in corporate failures. In January of 1997, despite a massive rescue attempt, Hanbo steel, the 14th largest chaebol in terms of assets and 17th largest in terms of sales, went into bankruptcy. This was followed by the failure of the Sammi group, another steel producer. Next came two major affiliates of the Jinro group, the 19th largest chaebol, which defaulted on their debts in April. They were succeeded by the Dainong retail chain and by the Ssangyong business group, the sixth largest. In July 1997, Kia motors, the third largest Korean auto maker, went into default. The stock market responded by a precipitous decline; by mid-November, it had dropped 50% from its mid-1997 high.

Table 12. Number of bankruptcy cases during 1995-2001

	1995	1996	1997	1998	1999	2000	2001
Corporate organization	79	52	132	148	37	39	32
Composition	13	9	322	728	140	135	58
Bankruptcy	12	18	38	467	733	736	450
Total	**104**	**79**	**492**	**1,343**	**910**	**910**	**540**

Source: Nam (2006)

Rapid increases in NPLs of banks and merchant banking corporations have destabilized the financial market and quickly translated into a currency crisis. Strong depreciation pressures on the Korean won began to develop in the foreign exchange market in September 1997. The government and the BOK, in trying to defend the won, were selling the US dollar and purchasing won in the exchange market, which led to the widen of daily fluctuation bandwidth of the won from 2.5 percent to 10 percent in November 1997. As a result, the won went into a freefall on November 19th. As Korea's financial troubles mounted, on November 21, 1997, the government asked the IMF and other international agencies for standby loans and reached an agreement with the IMF on the Financial Aid Package on December 3, 1997 (it was the largest international financial rescue package to date). Nevertheless, Korea's bonds were downgraded by Moody's and Standard & Poor's from A1 status to junk-bond status on December 11, when the IMF forced disclosure of the true state of Korea's usable external reserves and it became apparent that they were inadequate to cover the debt coming due before the end of the year. The down-grading of Korean bonds made them ineligible for portfolio-investment by international banks. The banks not only could not renew maturing loans, but started withdrawing funds from Korea to the tune of a billion a day. The swing in foreign lending from plus $100 billion between January and October of 1997 to minus $20 billion by the end of the year was catastrophic. With IMF and US help, talks on debt rollover with international commercial banks were started on December 29-30 1997. On January 17th US secretary of the Treasury stated that Korea had stabilized, but the President elected, Kim Dae Jung, warned that in adjustment under IMF conditions "the worst is yet to come". On January 29th of 1998, agreement between Korea and international commercial lenders was reached on a rollover of $60 billion of its debt, on favorable terms: the maturity of its debt was extended to between one and three years, at between 2.25 and 2.75 percentage points above the six month London Inter-bank Rate, with 80 percent of loans between two and three year's maturity, and the banks received government guarantees on $24 billion of the debt. Nevertheless the crisis worsened. After a landmark agreement with the union to allow firing of workers was reached, as part of IMF adjustment conditions, a general strike called for February 11th was cancelled. In February, one third of its merchant banks were closed, but deposits were guaranteed. Problem loans (loans that are difficult to collect) at banks were 6% of all loans and non-performing loans, on which payments were overdue by more than three months, were between 15 and 20 percent. The debt-default-ratio (the percentage of promissory notes that are overdue in payments) was 62% in February, higher than in January (53%) and in December of 1997 (1.5%), with over 10,000 firms defaulting on payments since December 1997.

Industrial output in February 1998 was 1.9 percentage points lower than a year ago; during February in 1998, the rate of growth of output was negative. Since then, the crisis has abated and been replaced by a depression and Korea has been engaged in fundamental restructuring of its financial and corporate sectors.

The origins of the present Korean financial crisis are complex. Several elements have combined to generate it: vulnerabilities to external shocks, both inherent and strategy-induced; institutional inadequacies, both domestic and global; domestic policy mistakes; and exogenous shocks originating in the external environment. Individually, none of these would have been sufficient to generate the financial meltdown experienced by Korea between October 1997 and mid-March 1998. In the absence of substantial capital-market liberalization, the policy mistakes and domestic institutional inadequacies in Korea would merely have resulted in a recession, as they did during the previous corporate financial crises of 1972, 1980-81, and 1992. In the absence of exogenous shocks stemming from prolonged recession in Japan and Europe and contagion from financial crises in other East Asian countries the mistaken real appreciation of the won and consequent slowdown in exports and economic growth, which made Korea more vulnerable to shocks, would not have taken place. And, if the financial crisis had not been as severe, once it got going, Korea would not have had to submit to the overly stringent and partially mistakenly conceived IMF conditionality which, despite being accompanied by the largest financial-rescue package in IMF history to date, did not succeed in stemming the crisis and will slow down Korea's recovery and increase its pain. It took the combination of these factors to produce the magnitude of financial and economic disaster of 1997-98.

Chapter IV

THE NEW REFORM OF KOREA'S FINANCIAL SECTOR AFTER 1997 AND LESSONS FOR VIETNAM

IV.1. The new reform of Korea's market-based financial system after 1997

IV.1.1. Strategies and institutional framework of the new reform

a) Strategies

- 'Big Bang' approach: The word 'Big Bang' came from the 'Big Bang theory' in which Professor Stephen Hawkins explained how the World was created from a tremendously dense and hot state through a sudden bang in the universe. Later on, it was used in many aspects, include economics. In economics, there are also more than one definition of 'Big Bang' approach, such as the reform or transition which uses injection of new capital or close down institutions (while in 'gradualism' approaches these two methods will not occur); or a radical change in a banking and financial system, which accelerates market-led financial sector reform; or simply a sudden deregulation of the financial markets; etc. But allover, the real objective of big bang is liberalization of the financial sector and financial market opening.

Under the affects of IMF and Marshall's theory, the Korean government used

‘Big Bang’ approach to fix the problem of the financial crisis 1997. The first reason was, some economists believed that the ‘gradualism’ method before 1997 was the cause of the crisis, because in that period the deregulation changes were too slow (gradualism) compare to the liberalization speed of the market. And the second reason was IMF wanted to bring Korea to a higher level of liberalization as soon as possible to avoid the demerits of the crisis. Therefore, from June 1998, the ‘Big Bang’ approach, or what so-called ‘public fund based-government driven restructuring’, was started.

- Partial bail-out: With the development of chaebols under the policy ‘too big to fail’, it was a disaster if the government closed them down (under ‘Big Bang’ approach). Therefore, it was needed to save some big financial institutions with the partial bail-out policy in balancing between costs (the systemic risk of moral hazard occurs from bail-out policy) and benefits (the social beneficial by saving employees, shareholders and creditors of these institutions).

b) Institutional framework

- Strengthen the accounting standard: Accounting standard is directly related to the transparency of the balance sheet of financial institutions, one important factor to support the ‘Big Bang’ approach. In this regard, the government introduced reforming regulations of the accounting standard for financial institutions. The first step was made in June of 1998 as standards of asset classification standard and provision requirements were aligned to the best international practices. The asset classification standard was further strengthened in 1999 to obliged banks to consider future performance in classifying loans. Another important step in improving the accounting standard was the introduction of the mark-to-market valuation of securities, replacing the lower-of-cost-or-market method. Moreover regarding off-balance sheet transactions, the disclosure requirement of the International Accounting Standards was imposed on financial institutions.

- Introduction of Prompt Corrective Action (PCA): The PCA program was introduced in 1997 to provide the policy maker with the authority of dictating recapitalization to failing institutions.

- Create new controlling agent: In April 1998, one single agency which governing all the supervisory institutions, the Financial Supervisory Commission (FSC), was launched. And in January 1999, the three existing financial supervisory institutions (Office of Bank Supervisory, Securities Supervisory Board and Insurance Supervisory Board) were consolidated under FSC as the Financial Supervisory Service (FSS).

- Empowerment of the Korea Deposit Insurance Corporation (KDIC) and Korea Asset Management Corporation (KAMCO): The KDIC was established in

1996 as the managing agency of the deposit insurance fund and the KAMCO was founded in 1962 as a public enterprise specializing in resolving bad assets of financial institutions. But in the crisis 1997, due to the lack of resources and control from the government, the two institutions didn't have much effect in resolving the demerits of the crisis. Under 'Big Bang', the government decided to enhance the function of them to fully protect all depositors (for KDIC) and to purchase NPLs to help financial institutions in problems (KAMCO).

IV.1.2. Progress and results of the new reform

- The reduction of financial institutions: Under 'Big Bang', financial institutions with high NPLs ratio were closed down or merged. The total number of these close or merged institutions was around 750 (comparing between the end of 1997 and the end of 2004), in which mostly was banks, merchant bank corporations, mutual saving banks and credit unions (Table 13).

Table 13. Financial Institutions Closed or Merged (1997-2004)

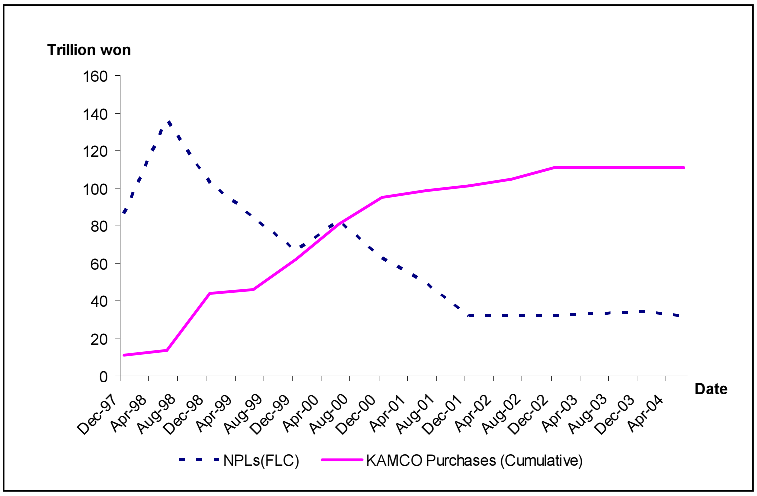
	Total No. of Institutions (end-1997) (A)	Type of Resolution					New Entry	Total No. of Institutions (end-2004)
		License Revoked	Merger	Others[1)]	Subtotal (B)	Ratio(%) (B/A)		
Banks	33	5	10	-	15	45.5	1	19
Merchant Bank Corporations	30	22	7	-	29	96.7	1	2
Securities Companies	36	5	4	3	12	33.3	18	42
Insurance Companies	50	10	6	3	19	38.0	19	50
Investment Trust Companies	30	6	2	-	8	26.7	25	47
Mutual Savings Banks	231	102	27	1	130	56.3	12	113
Credit Unions	1,666	2	108	499	609	36.6	9	1,066
Leasing Companies	25	10	2	1	13	52.0	6	18
Total	2,101	160	166	507	835	39.7	91	1,357

[1)] *Includes dissolution and asset transfers to bridge institutions*

Source: Kim (2006)

- Decreasing of NPLs ratio: Starting from November 1997, the government allowed the Korea Asset Management Corporation (KAMCO) to buy NPLs from banks planning mergers or carrying out self-rehabilitation plans. KAMCO purchased NPLs from all financial institutions near at the fair market price, or with heavy discount rate applied. As the purchasing of KAMCO increased, the NPLs decreased.

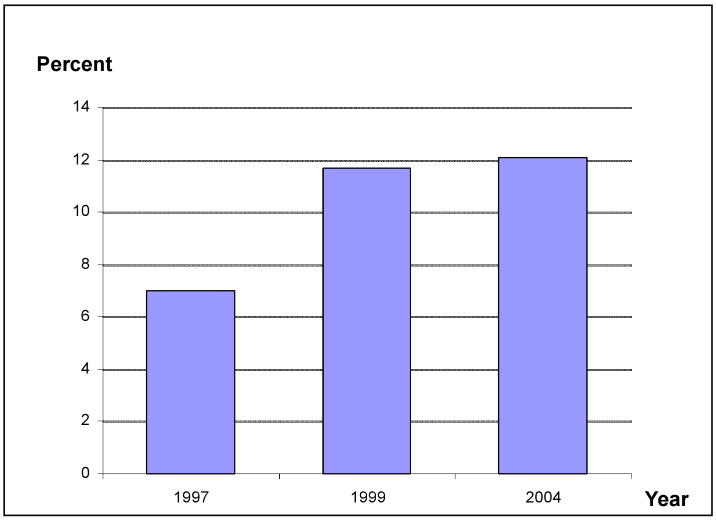
Figure 10. KAMCO purchases and NPLs ratio



Source: Financial Supervision Commission and KAMCO

- Increasing of bank's capital adequacy: The BIS (Bank for International Settlements) standard for Korea's banking system was introduced in 1992 which required all commercial banks in Korea had to maintain this ratio at the level of 7.25% (1993) and after that is 8% (1995). Before and in the crisis 1997, this BIS ratio of Korean banks was at safety level of 7 percent, but in fact, the true BIS was only about 5 percent (see Inseok Shin & Joon-ho Hahm, 1998, for more details), which was a threaten for the banking system. Anyway, under the new reform, the BIS ratio was increased to a soundness level of 12.1 percent in 2004.

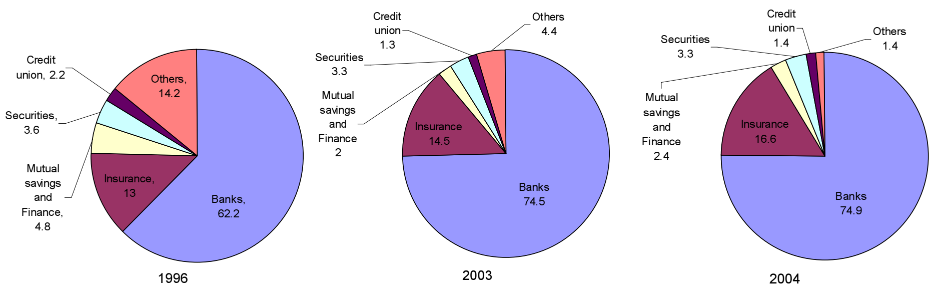
Figure 11. The BIS ratio of Korean banking system



Source: Financial Supervision Commission

- Strengthen banking sector: Due to the financial security offered by deposit insurance scheme, the banking sector has been recovered fast and has grown back. From 1996 to 2004, the share of assets of banks in total assets of all financial institutions rose from 62.2 percent to 74.9 percent.

Figure 12. Share of assets of financial institutions



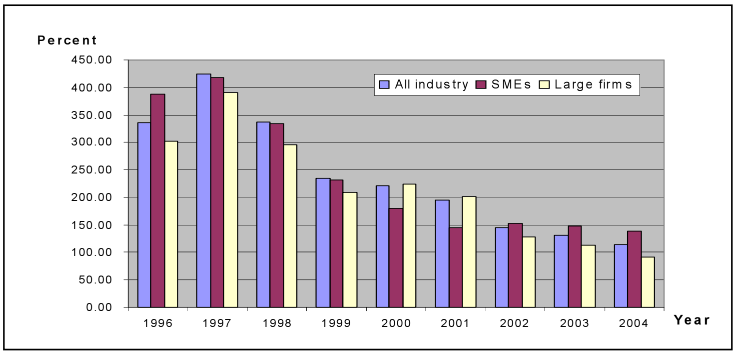
Source: Bank of Korea

IV.1.3. Impacts of the new reform and problems need to solve

<u>a) The impacts</u>

- Firms started to focus on strengthen their financial soundness through the reduction of borrowing. One big problem for firms in the financial crisis was that they cannot repay their debts. By reducing the borrowing cost, firms can improve their debt/equity ratios from 424.6 percent in 1997 down to 113.99 percent in 2004 (Figure 13). Compared to other OECD countries, this ratios was even lower than in U.S, Japan and Germany (at the end of 2004, the debt/equity ratios of U.S was 141 percent; and at the end of 2002, the debt/equity ratios of Japan was 162 and of Germany was 241, while in Korea it was 144.66 percent).

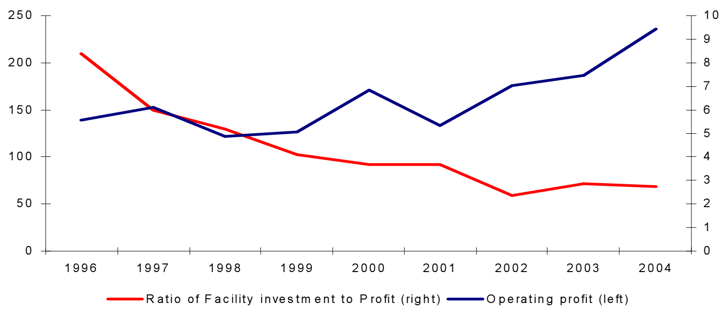
Figure 13. Debt/equity ratios of Korean firms



Source: Kim(2006)

- Firms' ratio of facility investment to operating profit has been steadily decreasing. Because of 'Big Bang' policy, firms now realize that efficiency is the most important, and increasing facilities investment means increasing cost, which can be a burden to their operating activities (in reality, more investment also means more borrowing). Therefore, even though their profits started to rise under the affection of the new reform, firms still very careful when invest into facilities.

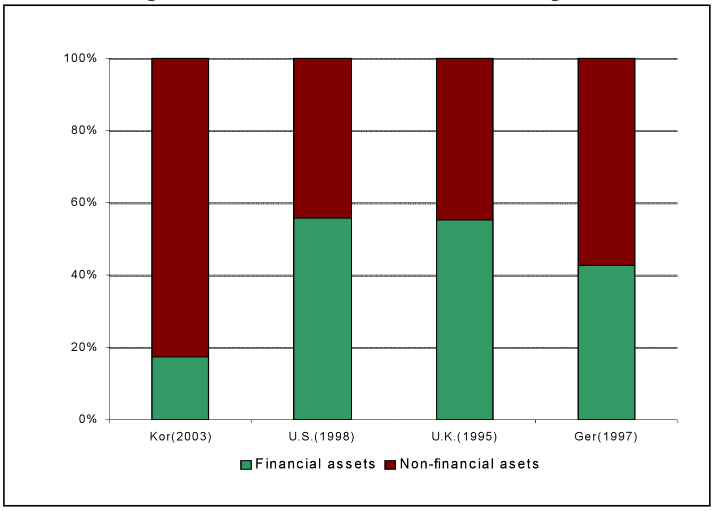
Figure 14. Ratio of facility investment to operating profit of listed firms



Source: WiseFn

- Households prefer to hold real estates rather than financial assets. After the financial crisis, people still afraid of financial assets such as CP, corporation bonds, stocks, etc. Meanwhile, holding real estates brings higher return with lower risk. Compared to financial assets, the rate of return (ROR) of an apartment or a house is higher while their standard deviation is lower. For example, in the period of 1997-2004, the mean of ROR for holding an apartment was 36.1 while the mean of ROR for holding equity was only about 8.9, four times smaller. And, the standard deviation of the apartment's ROR was 18.6; compared to the equity's ROR standard deviation of 46.1 is relatively low. This fact led to a rushing in buying real estate assets (which also negatively created a booming period of houses and apartments price) and changed the assets composition of Korean households.

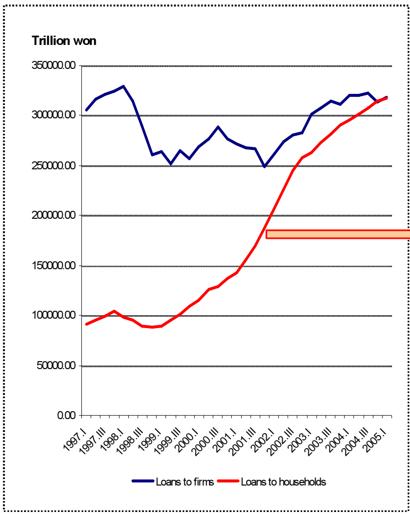
Figure 15. Assets composition of Korean households compare to other countries

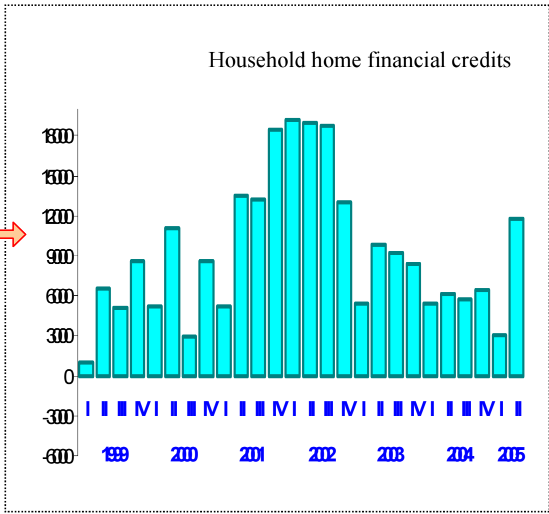


Source: Park and Huh (2005)

- Financial institutions tend to focus on consumer loans, mainly household home financial credits. After the crisis, financial institutions found out the risks of lending to business sector, thus, they started to turn to consumer sector, focusing on households. Meanwhile, with 'Big Bang' and its effects, the Korean economy was recovering and households had more and more needs of funds to sponsor their buying, mostly in real estates aspect (as mentioned above). That was the reason why loans to households were increasing rapidly from 1999.

Figure 16. Outstanding loans of financial institutions to households



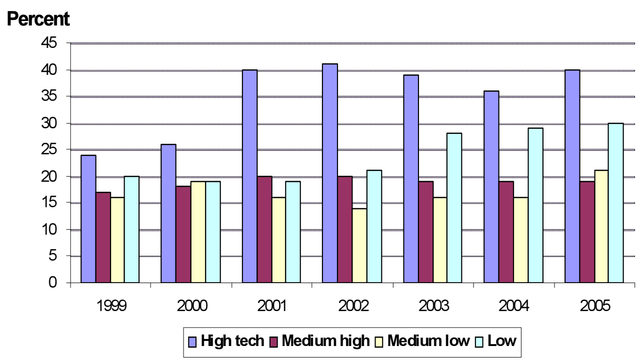


Source: Bank of Korea

b) Some problems appears

- Even though there were many changes in firms operation soundness, but the operating profits of most SMEs still have not improved in both low-tech and high-tech manufacturing sector (Figure 17). Moreover, the number of firms with IPCR<1 are still big enough so that the potential NPLs can increase at any time (Table 14). This requires the government to tighten their management over business sector.

Figure 17. Share of SMEs with negative operating profits



Source: Kim and Lee (2007)

Table 14. Share of firms (externally-audited) with IPCR<1

	IPCR < 1		
	2004	2 Consecutive Years (2003 and 2004)	3 Consecutive Years (2002, 2003 and 2004)
Large Firms	121 (17.4%)	68 (9.8%)	35 (5.0%)
SMEs	2,206 (24.3%)	1,012 (11.1%)	542 (6.0%)

Source: Kim and Lee (2007)

- One side effect of liberalization and competition is the development of financial conglomerates longings with the merger and acquisition (M&A) process. Large financial institutions now become larger by buying smaller institutions in debt after the crisis. This fact can lead to monopoly situation which damages the liberal market. Moreover, the financial conglomerates nowadays have complicated intra-relations, which will be a burden if the crisis occurs again.

Table 15. Financial Conglomeration by Types in banking, insurance, securities, and investment trust companies

(Unit: trillion won, %)

			1996				2003			
			No. of Inst.		Assets		No. of Inst.		Assets	
			No.	%	amount	%	No.	%	amount	%
Total	FC	FSC	0	0	0	0	14	11.4	262.7	27.2
		P-S	20	19.6	256.9	43.9	15	12.2	369.0	38.1
		Mixed	40	39.2	73.2	12.5	34	27.6	185.3	19.2
		Subtotal	60	58.8	[illegible]	56.4	63	51.2	8[illegible]	[illegible]4.5
	Non-FC		42	41.2	255.0	43.6	60	48.8	150.4	15.5
	Total		102	100	584.9	100	123	100	967.5	100

Source: Kim and Hahm (2006)

- The credit guarantees policy still remains too long after the financial market was stabilized leads to the facts that, this policy even protects the 'zombie' SMEs in the economy. This situation creates another problem to Korean financial market - the evergreen accounting problem.

IV. 2. Lessons for Vietnam's financial sector transitions

IV.2.1. The reform of Vietnam's financial market since 1990s

Before the year of 1986, due to childish understanding about communist society, Vietnam created its economy without concerning market principles. Thus, the financial market did not really exist:

- There was no monetary market and capital market;

- The banking system had no commercial banks, and the central bank did all activities alone ("mono-bank" system);

- The banking system worked under direct control of the government through government order, without concerning the market order.

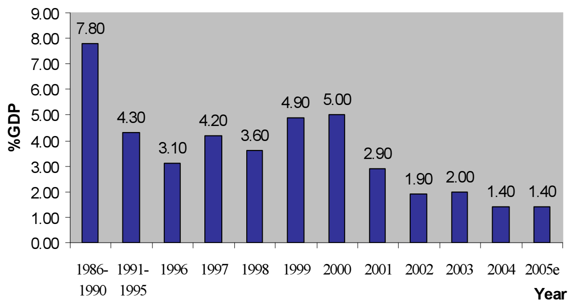
The Vietnam Government has significantly relaxed regulation policy since the Vietnam Communist Party (VCP) formally endorsed a program of "renovation", also known as "Doi Moi", at its Sixth National Congress in 1986. Central planning was relaxed, prices were freed, public sector spending declined, and restraints were loosened on business activity. Agricultural co-operatives were disbanded; farmers were given land-use rights and - in a similar way to China's transitional period - were allowed to market whatever output was left after they had fulfilled state contracts. The results of "Doi Moi" instantly affect to the state's budget; and after that are many other areas, include financial sector.

Based on the financial liberalization model of Mc Kinnon (1973), the steps toward a new financial market are following this order: budget deficit reduction, banking system reforming, freeing exchange rates, and liberalization securities market. Therefore, it is important to take a look at what Vietnam has achieved at these four sectors.

a/ State budget

As long as "Doi Moi" was launched, the budget over-deficit was improved sharply. The budget deficit higher than 7% in the pre-1986 period was reduced to 4.3% in 1991-1995 periods and continued to reduce into acceptable rate in the present days.

Figure 18. Budget deficit over GDP



Source: *Ministry of Finance-Vietnam and World Bank.*

b/ Banking system

The transition to a market economy required a fundamental change in approach to the role of money and credit, and in 1988, major reforms were implemented to bring the 'mono-bank' system to an end. The reforms created a separate State Bank of Viet Nam with full central banking responsibilities, and formed two new commercial banks from the industrial and commercial loan department and the agriculture credit department of the old state bank.

The enactment of the two Ordinances in May 1990 (Ordinance on State Bank and Ordinance on Banks, Credit Cooperatives, and Financial Companies) has resulted in the formulation of the two-tier banking system. Under this system, the commercial banks exercise the monetary transactions and provide banking services, the State Bank of Vietnam exercise the state regulatory function of a central bank. So far, the legal framework in banking is basically completed with the enactment of the Law on State Bank and Law on Credit Institutions in December 1997. The previous measures and the current laws on banking not only recognize and protect business operation by the state-owned commercial banks (SOCBs), but also encourage the development of non-state banks, foreign credit institutions in Vietnam, on the basis of equal treatment between different credit institutions, regardless of ownership, to create a sound competitive environment, transparency, and publicity in banking operation.

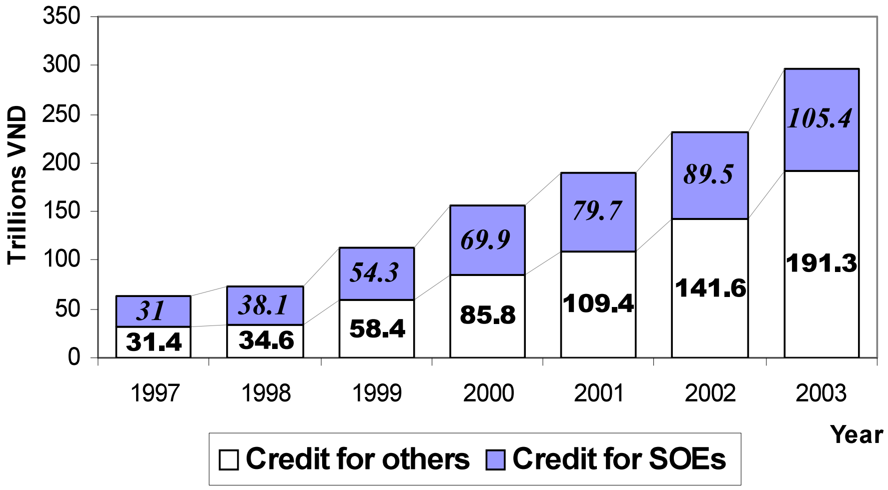
International standards on supervision and inspection such as CAMELS and BASEL were gradually institutionalized and introduced. Inspection and supervision were reformed in both content and form, with more distant supervision and banking auditing (internal and independent) to support the supervision and inspection, to detect, prevent, and timely deal with violations of laws and prudential regulations of banking.

For commercial banks, in the recent years, the autonomy and accountability of the commercial banks for their business have been institutionalized and enhance in practice. The commercial banks have the right to decide on the deposit and lending interest rate, to select the method of loan security. No institution or individual can intervene illegally into the operation of the commercial banks. Directed credit or policy-oriented lending is gradually separated from the commercial credit. The international principles and standards for commercial banking (e.g. accounting and auditing, risk management, credit analysis, investment, foreign exchange, loan classification and provisioning, etc.) have been gradually introduced to Vietnam. Banking products and services become more diverse. Some commercial banks have built their e-banking system and automatic transaction system (VCB-online, connect 24, ATM, e-account, home banking, credit card, TCB FAST ACCESS, etc.). By strongly introducing modern technology, especially IT, the banks are providing more features to their customers, including the substantial improvement in the depth and quality of the banking payment system. Such a remarkable progress of the banking payment system was further marked by the participation to the SWIFT system (in March 1995) and the introduction of the inter-bank electronic payment system (in May 2002) that allows banks to develop the wholesale and retail banking through Vietnam, and to connect to the international payment system. Currently, the payment system of Vietnam reaches the average level of the region; money transfers and payment through banks in the country now takes only a few second, instead of hours, or even days as before. Enabling legislation introduced in 1990 facilitated the establishment of commercial joint stock banks (Commercial Banks Decree Law of 1990), and legislation introduced in 1991 paved the way for establishment of foreign bank branches and representative offices and joint venture banks.

The Commercial Banks Decree Law also established a basis for regulating credit cooperatives - prompted in part by a collapse of many urban credit cooperatives in 1990. In 1994, regulations were introduced allowing the formation of People's credit funds. The People's Credit Funds (PCFs) were established under the guidance of the State Bank of Vietnam. These are credit cooperatives which play an important role in providing financial services to people in the rural areas. The PCF system has developed rapidly with the establishments of nearly one thousand PCFs within a short period of five years. The total capital of PCFs has increased from VND 84 billion in 1994 to VND 5,853 billion in 2004.

As of now, the banking system has an important role in providing capital for the development of the economy. It provides capital not only for State-Owned Enterprises (SOEs) but also other sectors (such as private companies, personal, etc.). In 2005, the total amount that banking system provided for the economic is more than 450 trillions VND (approximately US$28 billions).

Figure 19. Credit to the economy by Deposit money banks (DMBs)



Source: *IMF country report No. 02/05 and No. 06/52*

While in 1991 the banking system in Vietnam consisted of only 4 SOCBs and 1 joint-venture bank, by 2007 there are 5 SOCBs, 1 Policy Bank, 1 Development Bank, 36 Commercial Banks, 5 Joint-venture Banks, and 31 representative offices of foreign credit institutions, financial companies, financial leasing companies. In which, the Commercial Banks have the most effectiveness with average assets' growth rate of 48-50 percent; borrowing growth rate of 45-60 percent; lending growth rate of 35-50 percent; and high ratio of earning with low NPLs of 1-1.2 percent[1].

c/ Monetary, interest rate and foreign exchange rate

- Monetary policy: Instead of being dependent on the fiscal policy as it was the case before 1990, the monetary policy has become a typical macroeconomic instrument with an overall objective of controlling inflation and promoting economic growth. Currently, the making and influencing monetary policy by the State Bank are based on market principle; market factors are respected and taken as basis for the State Bank to make decision on adjustment to achieve macroeconomic objectives. The process of reforming the monetary was done step by step, under control and linked to the reform of monetary policy instruments and reform in the institutional structure. Since 2000 such indirect monetary policy instruments as open market operations, rediscounting, SWAP arrangement for foreign exchange have been replacing direct monetary control and administrative measures.

- Interest rate: Basically these rates have been liberalized. The State Bank only influences the interest rate and exchange rage through the money market and monetary policy instruments. Therefore, interest rates and exchange rates currently

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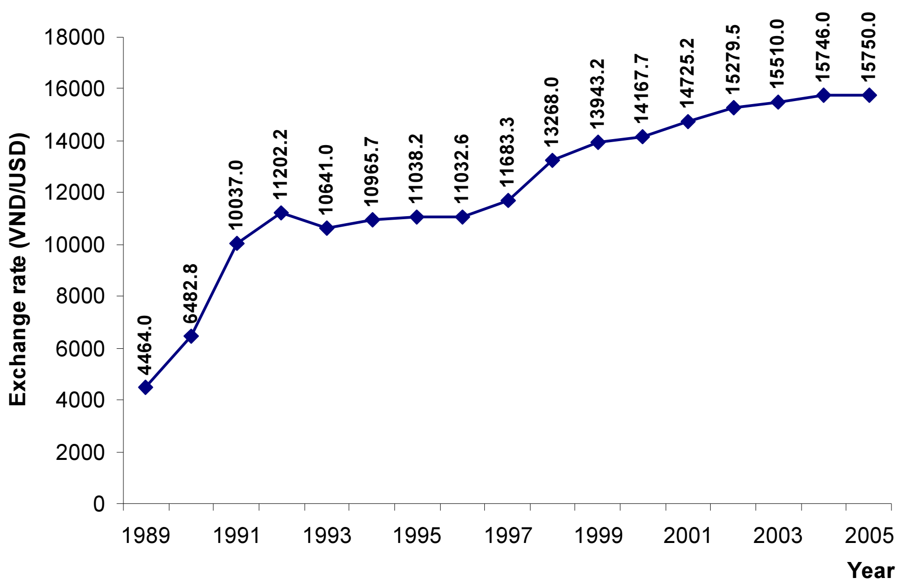
[1] Vietnam Economics News (1/2007). The economy of Vietnam and the World 2006-2007.

reflect more closely the value of Vietnam dong, and follow the development of the international and domestic money market. Interest rates were gradually liberalized in sequencing and with caution. First of all, the real positive interest rate principle was introduced since 1992. Deposit interest rates were liberalized in 1996, and lending interest rates were determined through negotiation since June 2002.

- Foreign exchange rate: After "Doi Moi", Vietnam opened its economy to other countries. That means, from this time, Vietnam Dong was allowed to exchange with other currencies. From time to time, the exchange rate policies of Vietnam experienced 3 periods: period of floating exchange rate (1989-1993), period of fixed exchange rate (1994-1997) and controlled-floating exchange rate (1998-present).

Figure 20. Foreign exchange rate changes from 1989 up to now

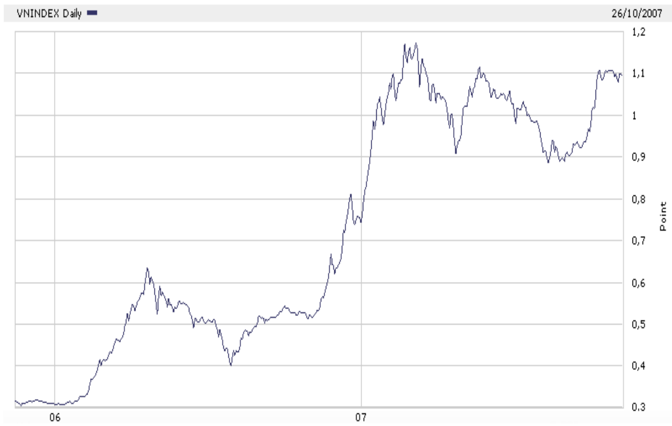


Source: *Key Indicators 2003 (ADB) and CIA World Factbook* *d/ Securities market*

The opening of the Ho Chi Minh City Securities Trading Centre (HSTC) in July 2000 marked a milestone in Vietnam's efforts in its economic reforms and reaffirmed Vietnam's determinations in developing the market economy.

After 7 years of operating the stock market, Vietnam has reached many achievements in the initial stage, generalized as follows: Successfully organizing and operating the Ho Chi Minh City Stock Exchange (HoSE); ensuring principles of the SE; gradually creating more goods for the SE, strengthening the management of listed firms and clarifying information on the SE; expanding operations of intermediary organizations on the market and improving service quality; building domestic and foreign investor system; etc. Up to now, there are 113 companies and 2 funds listing on HoSE. The number of security trading accounts had remarkably increased to 300,000 accounts at the end of 2006 comparing with 5,000 in 2000. OTC market has also developed. Vietnam's total market capitalization in 2006 increased by 20 folds, equivalent to 22.7 per cent of the country's GDP in 2006. This is a record which surprised even international investors. The number of stock investors has also increased sharply. By the end of 2006, the number of trading accounts reached 100,000, three times higher compared to that in late 2005 and 30 times higher compared to the figure six years ago when the market was first launched. Especially, of this total, 17,000 accounts belong to foreign investors, including those of international stature such as JP Morgan, Merryll Lynch and Citigroup. In the first eight months of 2007, 28 foreign organizations and 537 foreign individuals have opened securities transaction account in Vietnam, which makes the total amount of foreign capital that has been injected into Vietnam's securities market archives 4.8 billion USD[1].

Figure 21. Time series of the VN-index (2006-2007)



Source: *Saigon Securities Incorporation (http://www.ssi.com.vn)*

IV.2.2. Vietnam's financial market has the same problems as Korea's

Despite the positive developments achieved through the past years, Vietnam's financial sector remains quite shallow with the ratio of broad money (M2) to GDP stabilizing at around 26.5 percent in 2005 (down from 30.4 percent in 2004)[2]. Structural rigidities, limited competition and perceptions of fragility associated with

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[1] http://www.vietstock.com.vn/tianyonen/Index.aspx?ArticleID=50839&ChannelID=113

[2] IMF Country Report No. 06/52.

high exposure to poorly performing SOEs continue to erode public confidence in the financial system.

Dominating problems in the sector are serious weaknesses in the banking system, which are in turn linked to the poor performances of the state enterprise sector. Aspects of the vulnerability of the banking system include the following[1]:

- Large foreign exchange exposure, with about 32% of total bank credit being extended in foreign currencies (of which nearly 60% is extended to SOEs).

- A growing and under-reported problem with non-performing loans (in 2003, officially reported overdue loans amounted to 7% of total loans for state-owned banks and 5% for other banks)[2].

- A maturity mismatch - with most deposits being of maturity less than one year, while some 20% of loans have maturity over one year.

- Inadequate capitalization (the average capital asset ratio of the state-owned banks remained at 3.8% after a major recapitalization carried out in September 1998. This compares with a legal minimum of 5.6% and a desirable ratio of 10.3%).

Some of the important issues that need to be addressed to create a sound financial system capable of meeting the needs of a modernizing industrial economy include:

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[1] IMF Country Report No. 06/52.

[2] IMF Country Report No. 03/382.

- The large element of non-performing loans on the books of the state-owned commercial banks (SOCBs) and their dominance of the banking system. SOCBs account for over 80% of the systems assets and deposits and they are in serious need of recapitalization.

- High transactions cost, due to the fragmented and rudimentary nature of the payments clearing system.

- The reliance on direct controls to achieve monetary targets, which work against the pursuit of efficiency and deposit mobilization by banks. This is linked to:

+ The lack of depth and width of financial markets and the absence of a legal framework for the operation of bills of exchange;

+ The biases against longer term project lending in favor of short term trade finance, created by the existing level of non-performing loans in SOCBs and the underdeveloped state of the legal system and property rights in the economy, that erode the viability of security and collateral pledges;

+ The uncertain nature of enterprises' access to foreign exchange - the lack of free convertibility on the current account means that banks are cautious about offering foreign currency loans to local firms, because they cannot be sure that debtors will be able to acquire foreign currency to meet obligations over the life of a loan;

+ The heavy reliance of the joint stock banks on SOEs as a source of deposits and for lending. The operation of some of these banks is closer to that of a "credit club" than a genuine deposit mobilization and intermediation function, and there is a risk that "capture" of banks will work against the channeling of savings to the most viable projects;

+ The absence of significant non-bank lending. There have been some limited resources to bond issues, but without injections of equity capital into enterprises the scope for extensive use of this source of financing is limited. Development of a stock market is largely going to be driven by a decision to proceed with equitization of SOEs. The current private corporate sector is too small to support a stock market, and only with a larger scale equitization process would the preconditions for a market be created.

IV.2.3. Suggestions for the development of Vietnam's financial sector

- 'Big Bang' is suited for post-crisis situation as in Korea, but for Vietnam, it is best to follow 'gradualism' way. Because, one small failure in 'Big Bang' is not only lead to a big problem in the economy but bigger problem for the society and politic. In reforming the financial institutions, it is required to take care of institutional interdependency. Institutions in a society do not function in isolation because the interdependency among them makes the functionality of a particular institution depend on other institutions. Therefore, whether it is for establishing de novo a new institution or for changing some of the existing institutions, the reform may fail to create an effectively functioning institution if either (1) the institutions that are complementary to it are absent or (2) the new or reformed institution is not compatible with some of the existing institutions. In the first case, the absence of complementary institutions would makes it difficult or impossible for the new or reformed institutions to function; while in the second case, the presence of incompatible institutions would limit their effectiveness. Due to that fact, it is needed to make any reform (not only financial reform) step by step, each institutional reform after another institution changed or created; or, in theory, it is best to reform all institutions at once. Obviously, reforming all the interdependent institutions in a 'Big Bang' manner in Vietnamese conditions will be accounted impossible. Therefore, 'gradualism', or step by step reform in which institutions can be created/changed interdependently may take decades, but it is the better choice for Vietnam.

- Solving the NPLs problem as soon as possible in regarding with the potential NPLs - the IPCR. As mentioned above, even though Korea now is having a safety level of NPLs, but still, it is facing a high risk of another crisis due to the large number of firms with IPCR smaller than 1. Take that into account, Vietnam will have to deal with the IPCR directly, not only the NPLs itself, to prevent any risky situation.

With the current status of the SOEs - high investment and borrowing but low profit, Vietnam needs to speed up the SOEs' equitization process to improve the soundness of these firms.

- Strengthen the banking sector and build up a modern securities market to attract indirect investments from both Vietnamese and foreigner investors. Banking in Vietnam is still fairly basic, consisting of mostly short-term deposits and short-term lending. The economy needs a stable system and more importantly, a modern banking system to support a modern economy. At present, Vietnam must concentrate on reforming the banking sector, but it must also focus on developing the capital markets (as in institutional interdependency), particularly the bond and stock markets. The presence of capital markets would provide an alternative venue for the allocation and distribution of capital and ease the credit burden of the banking sector. The booming of Vietnamese stock market in 2006 was a good sign of development, but as many economists alert, the government needs to take more control in the stock market, especially the OTC market, to prevent the 'bust'.

- Step by step build up some financial groups under the supervision of the government to create more power to compete with foreign financial institutions in the new condition of joining WTO. Building financial groups is a must, but the question for the government is how to control and prevent these groups from monopoly power and chaebol-like influences in the economy.

CONCLUSION

From all the finding above about the Korean financial sector's evolution from a relationship-based system toward a market-based system, it is clearly to say that the Korean financial market has got a great transition during these past years. Obviously, this improvement of the financial system had a big role in the development of the Korean economy, which bring Korea to the number 10^{th} country (in GDP) in the World nowadays. Despite that merit, still there are many problems occur within the financial system itself and within the Korean economy, in which the financial crisis of 1997 was a proof. From then on, the financial evolution of Korea moved to a different level of liberalization under the effects of the 'Big Bang' policy. Even under 'Big Bang', there is a lot of things ahead need to be solved, in which the most important is that Korea has to solve the problem of what kinds of relationship should be established between banks and corporations after the government ends its role in the future.

Due to the experiences learnt from the development of the Korea's financial market, the way for transition the Vietnam's financial market will be different to Korea's. It is because of the differences in starting conditions, the World and area's conditions, etc. and even the political conditions. The starting point of Vietnam nowadays are not comply with Korea after the crisis 1997 but similar to Korea in the 1960s (with strong relationship-based system, low investment opportunities, etc.) Therefore, 'gradualism' will be a better policy which can help Vietnam in bringing best outcomes for the financial system's evolution, especially after Vietnam joined the WTO.

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