

2012 Modularization of Korea's Development Experience:
**Institutionalization of the Informal
Credit Market and Financial
Inclusion in Korea**

2013

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Supervised by	Financial Services Commission, Republic of Korea
Prepared by	KDI School of Public Policy and Management
Author	Joon-Kyung Kim, KDI School of Public Policy and Management, Professor KS Kim, KDI School of Public Policy and Management, Researcher
Advisory	Sang Ho Lee, National Credit Union Federation of Korea, Former Chairman Yang Chul Shin, Korean Federation of Community Credit Cooperatives, Former Director
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2012 Modularization of Korea's Development Experience

Institutionalization of the Informal Credit Market and Financial Inclusion in Korea



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Preface

The study of Korea's economic and social transformation offers a unique opportunity to better understand the factors that drive development. Within one generation, Korea has transformed itself from a poor agrarian society to a modern industrial nation, a feat never seen before. What makes Korea's experience so unique is that its rapid economic development was relatively broad-based, meaning that the fruits of Korea's rapid growth were shared by many. The challenge of course is unlocking the secrets behind Korea's rapid and broad-based development, which can offer invaluable insights and lessons and knowledge that can be shared with the rest of the international community.

Recognizing this, the Korean Ministry of Strategy and Finance (MOSF) and the Korea Development Institute (KDI) launched the Knowledge Sharing Program (KSP) in 2004 to share Korea's development experience and to assist its developing country partners. The body of work presented in this volume is part of a greater initiative launched in 2010 to systematically research and document Korea's development experience and to deliver standardized content as case studies. The goal of this undertaking is to offer a deeper and wider understanding of Korea's development experience with the hope that Korea's past can offer lessons for developing countries in search of sustainable and broad-based development. This is a continuation of a multi-year undertaking to study and document Korea's development experience, and it builds on the 40 case studies completed in 2011. Here, we present 41 new studies that explore various development-oriented themes such as industrialization, energy, human resource development, government administration, Information and Communication Technology (ICT), agricultural development, land development, and environment.

In presenting these new studies, I would like to take this opportunity to express my gratitude to all those involved in this great undertaking. It was through their hard work and commitment that made this possible. Foremost, I would like to thank the Ministry of Strategy and Finance for their encouragement and full support of this project. I especially would like to thank the KSP Executive Committee, composed of related ministries/departments, and the various Korean research institutes, for their involvement and the invaluable role they played in bringing this project together. I would also like to thank all the former public officials and senior practitioners for lending their time, keen insights and expertise in preparation of the case studies.

Indeed, the successful completion of the case studies was made possible by the dedication of the researchers from the public sector and academia involved in conducting the studies, which I believe will go a long way in advancing knowledge on not only Korea's own development but also development in general. Lastly, I would like to express my gratitude to Professor Joon-Kyung Kim and Professor Dong-Young Kim for his stewardship of this enterprise, and to the Development Research Team for their hard work and dedication in successfully managing and completing this project.

As always, the views and opinions expressed by the authors in the body of work presented here do not necessary represent those of the KDI School of Public Policy and Management.

May 2013

Joohoon Kim

Acting President

KDI School of Public Policy and Management



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Summary

Over the last half century, the Republic of Korea (Korea) has experienced rapid, sustained economic growth, the social benefits of which have been relatively broad-based. Korea today also boasts a modern and deep financial system, and financial inclusion is high with nearly every Korean having access to basic financial services and products. With this in mind, better understanding of Korea's financial development is an important key to unlocking the secret behind Korea's economic miracle. In studying the development of Korea's financial system (financial deepening), we find that Korea's experience has been a long and winding road, a journey marked by a difficult struggle to govern the informal credit markets, which had at times dominated Korea's financial sector early in its development.

In explaining the prominence of the informal credit market, we find that the difference in interest rates between the formal and informal sectors, above all, was the biggest determinant of the informal market's role and size in Korea's financial system during much of the 1960s and until the early 1980s. Negative real interest rates due to high inflation and interest rates kept artificially low in the formal sector, drove huge amounts of money underground. Moreover, early policy missteps such as a failed financial coup d'état in 1962 only worsened the situation by damaging the trust between financial institutions and customers. Many attribute these distortions, and consequently, Korea's financial underdevelopment to "financial repression," a product of the government's nationalization of banks and regulation of interest rates.

It was only after a series of policy shifts and institutional reforms that the dominance of the informal credit market began to wane before being relegated all together. A partial liberalization of interest rates in 1965 which narrowed the gap between formal interest rates and black market rates marked the first major step in restoring the formal financial sector. The government's August 3 Emergency Economic Measure in 1972 bailed out troubled

firms at the brink of bankruptcy, partly a consequence of investment boom since the mid 1960s. This extraordinary policy action not only averted a major corporate debt crisis, but also effectively institutionalized the informal money lenders.

The 1980s marked a period of rapid change in Korea's financial sector, driven by the government's policy shift toward promoting macro stabilization and financial liberalization. Efforts to reign-in inflation, which resulted in positive real interest rates, led to the eventual decline of the informal sector. Its demise was accelerated by policy efforts to liberalize the financial sector with the entry of new banks and the introduction of new financial products. The institution of the real name financial system in the 1990s was the death knell that ended the informal financial market reign in Korea.

In the wake of the financial liberalization efforts of the 1980s and early 1990s, Korea's financial landscape changed dramatically. It spawned a new generation of non-banking financial institutions (NBFIs), merchant banks, many of which were owned by Korea's largest *chaebols*. The rapid expansion of merchant banks later had disastrous economic consequences, indirectly contributing to the 1997 Financial Crisis. A similar pattern of financial institutions trying to cope in a fast changing environment coupled with haphazard deregulation and inadequate financial supervision seem to also be contributing factors to the recent mutual savings bank crisis in 2011.

Lastly, the paper discusses the institution of cooperative financial institutions (CFIs) in Korea, an experience usually not seen in other developing countries. CFIs have a long history and share a special place in Korea's financial development. CFIs were first introduced during Japanese colonial rule. It was not until the 1960s with the establishment and rapid growth of home-grown credit unions and cooperatives that financial inclusion began to improve in Korea. Today, however, the industry is at a cross roads; Korean CFIs no longer operate like cooperatives. Moreover, a highly fragmented legal regulatory governing has resulted in an over-crowded CFI market and poor internal governance. The reform and reactivation of Korean CFIs poses a huge policy challenge. But it also offers an opportunity to address Korea's growing income inequality, and its polarizing effect on society, by facilitating access to finance for the poorest and for young entrepreneurs.

2012 Modularization of Korea's Development Experience
Institutionalization of the Informal Credit Market
and Financial Inclusion in Korea

Chapter 1

Introduction

Introduction

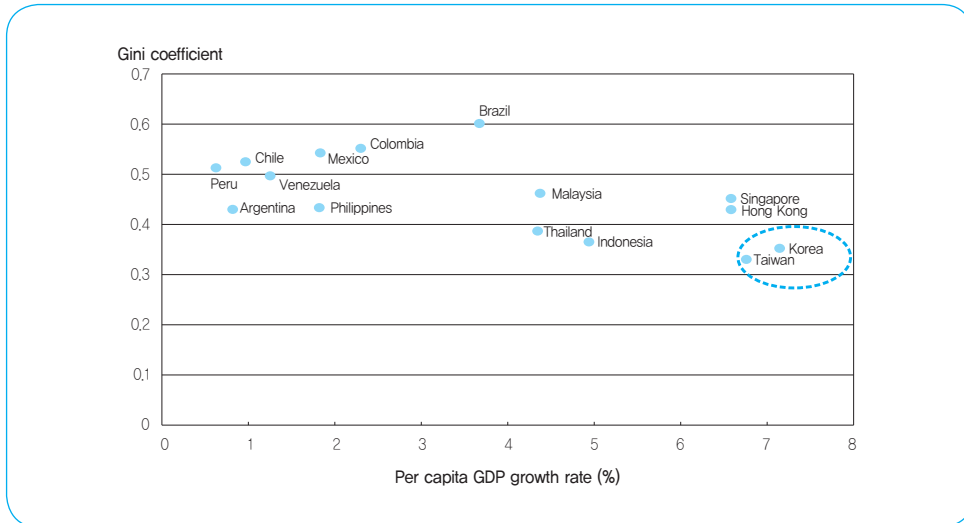
The development of the financial system (financial deepening) has long been associated with economic growth and development. Empirical studies have shown the strong correlation between financial development and growth, some even suggesting that financial deepening is vital to growth and development.¹ With a well-working financial system and institutions, resources can be allocated more efficiently and financial services can be made more accessible, which are considered crucial to ensuring sustainable but also broad-based economic development.

Today, the Republic of Korea (Korea) boasts a modern and well developed financial system, populated by a diverse range of financial institutions. Financial inclusion is high as nearly every Korean has access to basic financial services, as well as, more sophisticated products such as mortgages and specialized investment funds. Over the last 50 years, Korea has experienced rapid and sustained economic growth, transforming an economy that was once largely poor and agrarian to an industrialized nation. What makes Korea's rapid economic development even more unique is that the growth was relatively shared, meaning the social and economic benefits of growth were broad-based. Many have cited that Korea's rapid growth produced relatively low income inequality, demonstrated by a low Gini Coefficient and the highest average real per capita income growth rate at 7.2% on an annualized basis during 1965-1990, as seen in [Figure 1-1].²

1. See Levine (2005) for a review of the empirical literature on the link between financial development and long term economic growth.

2. Korea's broad-based development can also be attributed to government interventions such as Land Reform in 1950, adoption of compulsory primary education in 1948, and policy efforts to promote financial inclusion among low-income households.

Figure 1-1 | Gini Coefficient and Real Per Capita Income Growth (1965-90, Annual Average)



Source: East Asian Miracle (World Bank, 1993)

One of the keys to unlocking the secret behind Korea’s economic miracle will be better understanding the role and impact of financial deepening on the economy. To do this, it will be critical to better understand the development of Korea’s financial system.

Korea’s financial development has been a long and winding road, a journey that has been marked by financial crises and a difficult struggle to regulate the informal financial markets. Considering its dominance of the entire financial system at times, this paper examines Korea’s financial development in relation to the evolution and impact of the informal financial market, starting from Korea’s colonial period and ending with the recent mutual savings bank crisis. The paper also draws attention to important institutional reforms in finance that contributed to Korea’s financial deepening, and ultimately, its economic development.

Japan’s colonial rule of Korea (1910-1945) marks a dark period in Korean history. From an economic standpoint, Korea’s colonial past cannot be ignored. Though originally built to serve the Japanese, Korea’s colonial legacy left it remnants of a modern financial system and institutions from which to build. A certain degree of financial development and even financial inclusion did occur during this period, evidenced by the growth of cooperative financial institutions (CFIs) during this period, something that is usually not seen in other developing countries.

As in Korea's history, the period of 1945-1964 was a tumultuous time in Korea's economic and financial development. It was a period when the economy was ravaged by war and hyper-inflation, and the financial sector was dominated by the informal credit market. It also marked a period of trials and tribulations for the Korean government, which often resulted in misguided and failed policies. During this time, the government's management of the Korean economy seemed to take the economy from one extreme to another. The failed privatization of commercial banks showed that Korea was not ready to adopt market-oriented principles. At the same time, the damaging consequences of the Emergency Financial Measure in June 1962, a failed financial coup d'état, showed the dangers of the state intervening too much. Land reform in the early 1950s is seen as having had a positive and lasting impact on Korea's development. But its immediate impact did more harm than good by expanding the informal credit markets, since the Land Reform Act restricted the use of land as collateral. This left farmers to turn to the informal credit markets. It subsequently resulted in high and unsustainable debt levels in Korea's rural sector. In response, the government implemented a debt-relief program for rural households. The program was not big enough to have a considerable impact on rural household debt, but the study of the program provides a rare insight into the negative social effects of informal financial markets.

The period of 1965-1982 was a challenging time in Korea's financial development. Indeed, financial deepening remained stagnant during the 1970s. One view of why Korea's financial system did not develop during the period was that it was a highly repressed financial system. The government's nationalization of commercial banks and its regulation of interest rates amid high inflation resulted in negative interest rates, which led to the dominance of the informal market during this period.

The interest rate adjustment of 1965 was the biggest single event in Korea's financial history, in that the liberation of interest rates, which allowed bank rates to converge with the market rates, changed the trajectory of Korea's financial development. This resulted in money rushing into the formal banks. It was the first step in a long march toward institutionalizing the informal credit market in the financial sector (See [Figure 4-2]). The flow of money back to the formal financial market can also be seen as strengthening the government's control over finance since the banks were nationalized. The period of the 1960s also marked the beginning of the first Cooperative Financial Institutions (CFIs) movement in Korea. The first credit union was established in 1960 at Pusan, and spread quickly in urban cities and rural country-sides. The growth of credit unions was unique in that it was a private and grass-roots initiative.

In 1972, Korea faced its first financial crisis brought on by mounting debt in the corporate sector. To avert a debt crisis, the government implemented the August 3 Emergency Economic Measures (8.3 Measures) in 1972, helping to avert an economic crisis. The post-

crisis legal and regulatory reforms sought to institutionalize the informal credit market by formalizing informal money lenders as Non-Banking Financial Institutions (NBFIs). Informal lenders that mainly lent to large firms which needed short-term working capital were formalized as short-term finance companies (STFCs). Smaller money lenders that lent primarily to small businesses were formalized into mutual savings and finance companies (MSFCs). At the same time, the legislation of the Credit Union Act sought to promote financial inclusion mainly among households.

The late 1970s and early 1980s brought a period of macro-instability marred by high inflation. The government's continued repression of the financial system, especially commercial banks, led to an active informal credit market, which contributed to Korea's largest financial scandal involving banks and informal money lenders in May 1982. The period from 1983 to the mid-1990s marked the eventual decline of the informal credit markets. Korea had reigned in inflation and secured macro-stability, resulting in positive real interest rates. At the same time, the government's financial liberalization efforts that led to the introduction of new financial products particularly trust accounts for banks, and the deregulation of entry barrier for new commercial banks and NBFIs led to the flow of funds flooding back into the formal financial sector, further accelerating the decline of informal credit markets. The end of this period which brought the institution of the real name financial system in 1993 essentially marked, by and large, the demise of the informal credit market's role in Korea's financial system.

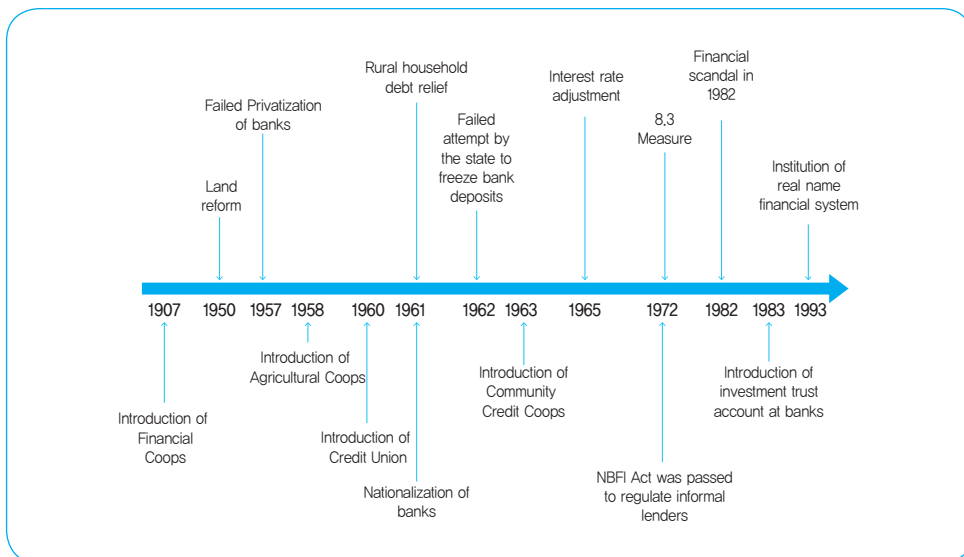
The latter half of the 1990s was a period of rapid change in Korea's financial landscape. It seemed that haphazard liberalization and deregulation had breathed new life into NBFIs including STFCs and MSFCs that were left scrambling to adapt to the new financial environment. The financial liberalization and regulatory changes of the 1990s spawned a new generation of NBFIs in the form of merchant banks, many of which were STFCs, during 1994-96. The proliferation and inadequate supervision of merchant banks, many owned by Korea's largest chaebols, would have disastrous consequences on Korea's economy by playing an indirect role in triggering the financial crisis in 1997. As in the STFCs, the MSFCs were marginalized, pushed aside by Korea's rapid financial development, as its obsolete business model left it trying to survive in the new financial order. As in the case of STFCs, new life had been breathed into the MSFCs, which became mutual savings banks following a series of deregulatory measures. Haphazard deregulation and inadequate financial supervision gave way to a high risk-high reward strategy that eventually consumed the entire mutual savings bank industry in a crisis in 2011.

Today Korea boasts a highly developed financial system where financial inclusion is relatively high. Just as in any country, financial inclusion for the low income still remains a social and economic policy challenge. In Korea, the issue of financial inclusion has taken

on greater significance, considering the steady growth of household debt and worsening wealth distribution. A closer examination of Korea's growing household debt across all income classes reveals that a considerably disproportionate amount of debt has gone to high income households which used them to finance real estate activities, much of it speculative. While higher income groups can afford to leverage themselves, lower income groups are over burdened with high levels of debt. This has fueled the recent growth of consumer loan finance companies (CLFCs) which offer loans largely to low income and financially constrained households at usurious rates. To promote social equality, the government has also introduced micro credit to facilitate financing for low income households and businesses.

The recent emergence of CLFCs and micro credit institutions begs the question of what has been the role of CFIs in the last 20 years, considering its long and unique history in Korea's financial development. The short answer to this question is that CFIs in Korea are no longer operating as CFIs. More specifically, Korean CFIs do not seem to be operating under the same basic principles that they were founded on and are reflective of CFIs, such as being member owned and controlled, being voluntary-based, and members sharing a common bond. Furthermore, the highly fragmented legal regulatory framework that govern the various CFIs, has led to inconsistent financial supervision which has weakened internal governance.

Figure 1-2 | Major Events in Korea's Financial Development



2012 Modularization of Korea's Development Experience
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Chapter 2

Early Period of Korea's Financial Development

1. Colonial Legacy (1910-1945)
2. Financial Underdevelopment (1945-1960)

Early Period of Korea's Financial Development

1. Colonial Legacy (1910-1945)

In 1910, the Korean peninsula was formally annexed by Japan, and remained under Japanese colonial rule until 1945. During this period, Korea experienced a fair amount of financial development with the introduction of a modern financial system. Korea's first central bank, the Bank of Chosun, was established in 1905. It remained so until 1950, when the bank was renamed as the Bank of Korea (BOK). The role of formal financial institutions grew over this period based on the number of branches and assets. Some measure of financial inclusion was also achieved, largely driven by the growth of non-banking financial institutions (NBFIs), particularly the rapid expansion of cooperative financial institutions (CFIs).

The main financial institutions in Korea's were the Industrial Development Bank and a handful of commercial banks. The Industrial Development Bank was the most dominant. It accounted for about 40% of total loans in 1940. The banks were mostly owned and managed by the Japanese, which were their main customers. For instance, the Industrial Development Bank largely financed new Japanese enterprises and investments in Korea. During this time, the Japanese had developed a fairly extensive industrial base in Korea. Later on, the banks helped to finance Japan's military efforts during the World War II. At the end of World War II, a total of 3,555 Japanese-owned plants and firms that were taken custody by the US military government, after Korea's liberation (See <Table 2-1>).

Table 2-1 | Number of Vested Firms Formerly Owned by Japanese (1945)

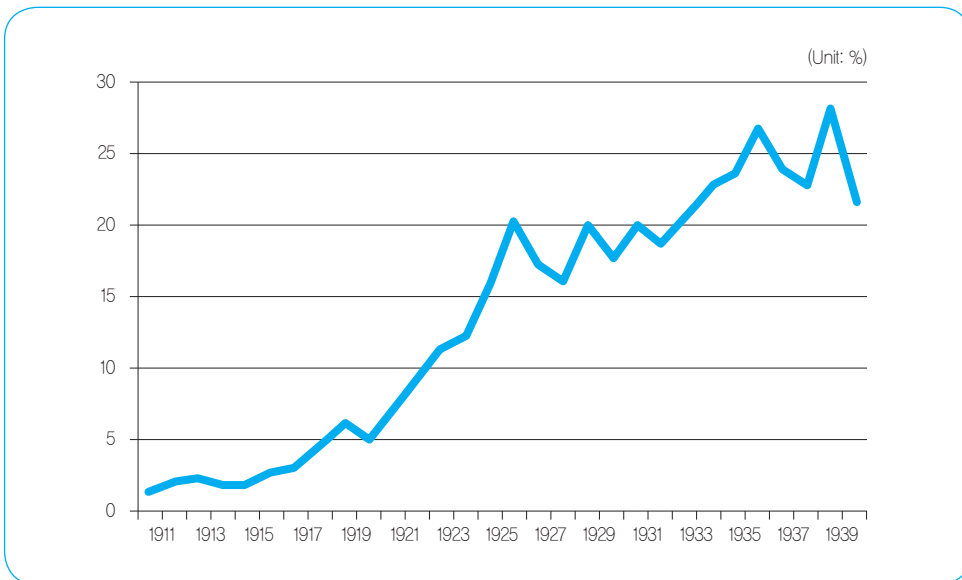
	Central	Seoul	Kyunggi	Choong-nam	Choong-buk	Chon-nam	Chon-buk	Kyung-nam	Kyung-buk	Kang-won	Jeju	Total
Manufac.	255	589	207	162	48	151	162	549	274	61	11	2,469 (70%)
Metal	10	13	10	3	1	1	1	32	3	2	-	76
Machine	12	121	30	20	3	22	21	99	40	3	-	371
Chemical	24	147	46	12	7	22	12	74	23	3	7	377
Electricity	13	22	2	3	-	1	-	4	6	-	-	51
Ceramics	3	10	17	11	8	9	8	33	9	-	-	103
Textile	75	60	23	12	20	11	3	68	36	11	-	307
Food	8	67	45	77	2	72	94	177	132	22	4	718
Wood	102	23	8	7	3	6	5	20	9	15	-	197
Printing	-	37	4	5	1	10	18	15	15	1	-	97
Mining	31	30	18	5	-	2	10	16	20	178	-	316 (9%)
Agri/fish	69	17	1	3	-	5	9	57	7	11	3	182 (5%)
Finance	-	11	-	6	-	-	-	-	6	-	-	23 (1%)
Others	56	349	56	42	70	46	47	88	28	15	4	801 (23%)
Total	403 (11%)	907 (26%)	260 (7%)	206 (6%)	59 (2%)	201 (6%)	220 (6%)	686 (19%)	334 (7%)	261 (7%)	18 (1)	3,555 (100%)

Source: Lee, Dae-Keun (2002), p 97

A remarkable part of Korea's financial development during the colonial period is the introduction and growth of cooperative financial institutions (CFIs). By 1940, these forms of NBFIs accounted for a noticeable part of Korea's financial sector, making up 20% of Korea's total loans. [Figure 2-1] shows the rapid growth of financial cooperatives based on their value added. The share of CFI's total value added in the financial sector jumped from 2% in 1911 to 28% in 1939. It should be pointed out that the size of the informal credit market steadily declined over this period based on the share of total value added of informal money lenders. As seen in [Figure 2-2], the total value added of informal money lenders as a share of the financial sector fell from 50% in 1911 to 18% in 1939. In contrary, the role of commercial banks seemed to have waded during this period based on its share of value added, which fell before flattening out in 1920s, as seen in [Figure 2-3].

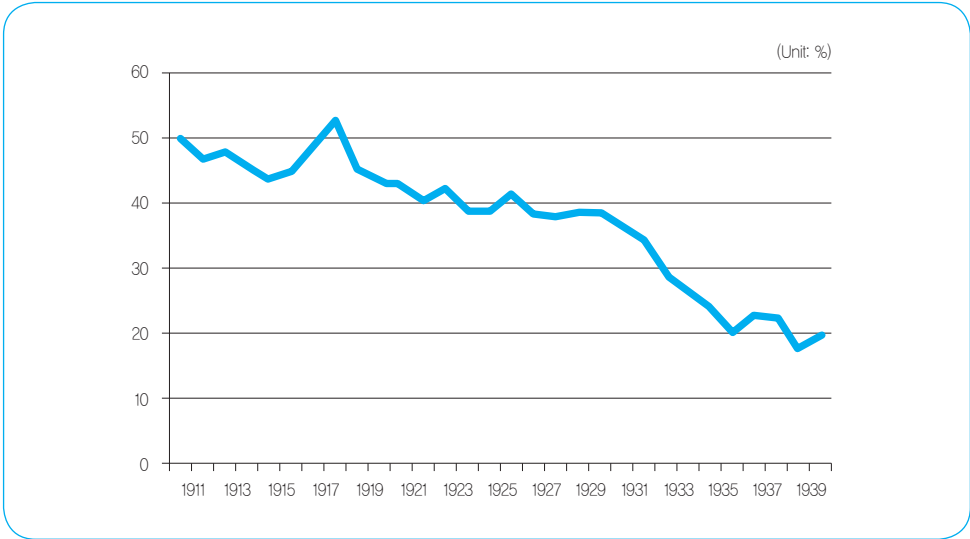
Korean CFIs were mainly located in urban areas before the 1930s. This changed in 1935, when the Japanese colonial government introduced non-financial cooperatives in rural villages to spur agricultural development as a response to worsening economic conditions suffered by farmers during the Great Depression. These non-financial cooperatives, called Agricultural Development *Kyes*, were basically formed to facilitate collective action and cooperation among farmers for non-financial activities such as the procurement of fertilizers and the distribution/sales of agricultural goods. These types of cooperatives were loosely affiliated with CFIs. By 1944, a total of 613 Financial Coops and 49,207 Agricultural Development *Kye* were operating in Korea.

Figure 2-1 | CFI's Share of Financial Sector based on Total Value Added, 1911-1940



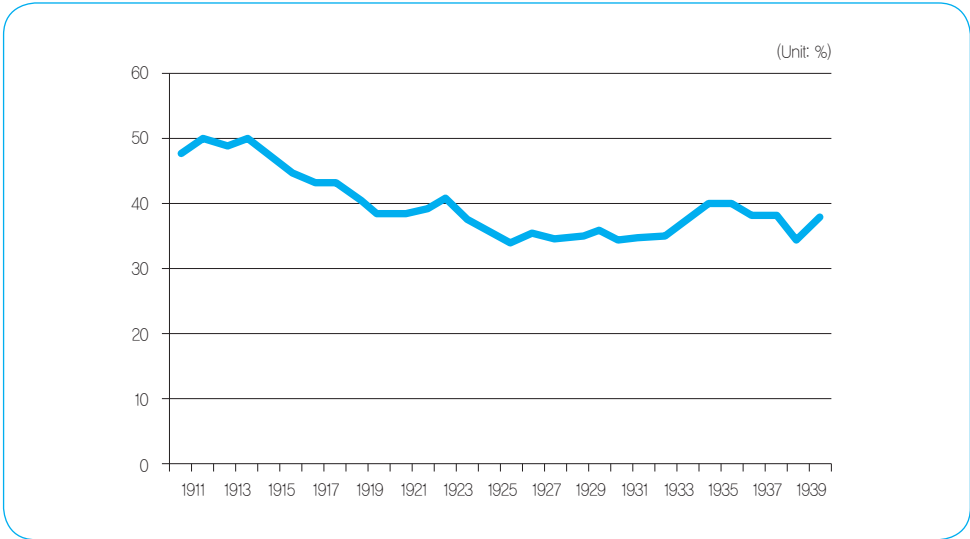
Source: Kim, Nak-nyun (2006)

Figure 2-2 | Informal Money Lender's Share of Financial Sector (*Mujin*) based on Total Value Added, 1911-1940



Source: Kim, Nak-nyun (2006)

Figure 2-3 | Bank's Share of Financial Sector Based on Total Value Added, 1911-1940



Source: Kim, Nak-nyun (2006)

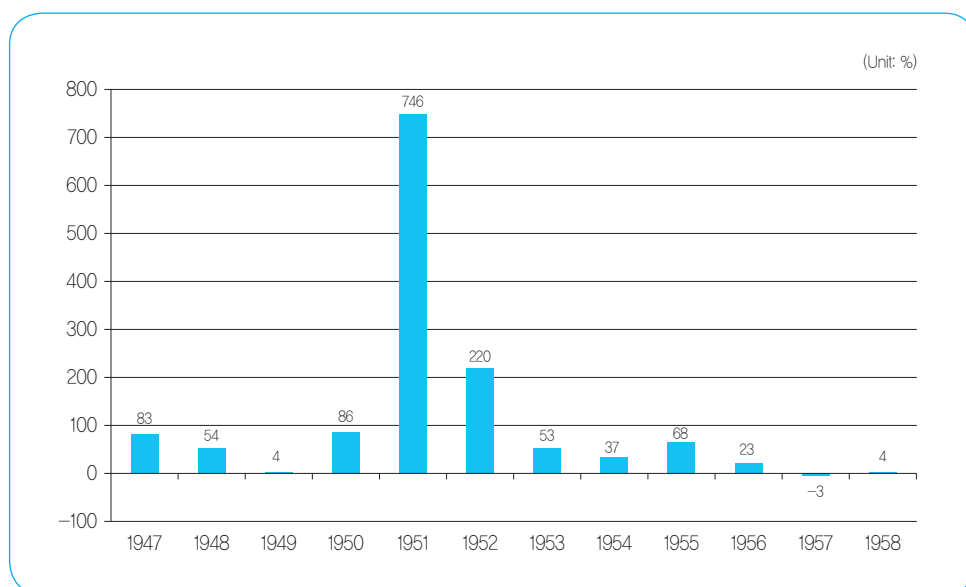
Figure 2-4 | Financial Cooperative in Suwon



2. Financial Underdevelopment (1945-1960)

In the 15 years after its liberation from Japanese colonial rule in 1945, following World War II, Korea suffered from a depressed economy, hyperinflation, and a civil war, any one of which could impoverish a country. The Japanese had the capital, technology, and managerial know-how, which in the wake of their departure left an economic vacuum. In the immediate years after liberation, the Korean economy suffered from chronic fiscal deficits and persistently high inflation as it struggled to build anew. Then, the Korean War broke out in 1950, bringing total chaos and destruction. Korea's economic collapse and rampant inflation in the years after the Korean War [Figure 2-5], followed by the failed privatization of the commercial banks in 1957, led to the growing prominence of the informal credit markets. As a matter of fact, financial inclusion worsened. As of 1959, 90% of samples in Seoul participated in *Kye*³ at one time or another (Cole and Park, 1983).

Figure 2-5 | Inflation Rate: 1947-1958 (Consumer Price Index)



Source: Lee, Dae-Keun (2002)

3. *Kye* is a traditional form of association where members took turns to access a large amount of money at one time. Basically, members contributed into a pot of money, which was disbursed to a member as single lump-sum payment based on a pre-determined sequence or lottery system. Each contributing member had an opportunity to collect the pot of money when their number was called. This rotating lotto was an important means of accessing credit for farmers.

During this tumultuous period of Korean history, two policy events stand out as having had a profound and lasting impact on Korea's economic and financial development. First, the redistribution of land to poor farmers via land reform changed Korea from being largely a semi-feudalistic agrarian society, dominated by landlords, to a land tenure system made of equally landed farmers. Second, the divestiture of "vested properties" (properties formerly owned by the Japanese and acquired by the US Military Government under the rules of war), including banks, after WWII, into the hands of Korean owners helped to shape the formation of Korea's industrial and financial sector. Ultimately, land reform, the divestiture of vested properties, and destruction of war, conspired to level the playing field by flattening the income distribution curve, resulting in a relatively high degree of equality or "equal distribution of poverty" not seen in many countries. However, the distribution of small parcels of land to individual farmers most likely did not have much of an impact on expanding financial inclusion, since the farmers were not allowed to mortgage their land or use their land as collateral to secure credit between 1950 and 1965. As will be discussed further, these developments in the financial sector actually had a worsening effect on Korea's financial development and inclusion in the subsequent years after land reform (1950-1965). The laws were later abolished in 1966 which allowed farmers to borrow against their land.

2.1. Corruption in the Divestiture of Japanese owned Banks

The US Military Government also took custody of physical assets or properties once owned by the Japanese including businesses, factories, buildings, equipment, inventory, homes, and other physical properties. The US took custody of 166,301 properties including 3,555 businesses, 70% of which were in manufacturing such as machinery, chemical, and light manufacturing. The vested properties also included banks such as Heungop Bank (or formerly known as Hanil Bank), Savings Bank (or formerly known as Korea First Bank), and Korea Commercial Bank. However, Cho-Heung Bank which was largely a Korean-owned bank was left alone and did not undergo ownership change. The properties were placed into custody under the American Office of the Property Custodian (AOPC).

After its liberation from Japanese colonial rule in 1945, Korea's financial system, which was essentially built to finance Japanese industries, collapsed. The banks had lost most of their management and customers including depositors and borrowers. Once the Japanese departed Korea, the only thing left were uncollectable loans and empty office buildings. Moreover, the Korean economy suffered hyperinflation due to the Korean War (1950-53) as the government printed money to fund war and reconstruction efforts. High inflation led to transactions being backed by commodities instead of currency, which lost its value. High inflation combined with regulations restricting on the use of land as collateral led to the rapid growth of the informal credit markets.

The US Military Government put high policy priority on divesting or transferring ownership of the properties including the banks into the hands of Koreans. In the fall of 1949, Arthur Bloomfield, an economist at the Federal Reserve Bank of New York, came to Korea to advise the Korean government on the creation of a new financial system. At its center, the new system had an independent central bank similar to the U.S. Federal Reserve System. In 1950, the Bank of Chosun, which was one of the industrial banks formerly owned by Japan, became the Bank of Korea. The Bank of Korea was established to primarily focus on implementing monetary policy and bank supervision. It was given autonomy and independence and a Monetary Board was created within the Bank of Korea to set monetary policy.⁴ The function of commercial and industrial banking was also separated.⁵

Arthur Bloomfield also recommended “getting most of the banks as rapidly as possible out of the government hands into the hands of private owners”. The privatization of banks, however, was not implemented quickly, even though legislation on the ownership transfer of vested properties was established in July 1949. It was not until 1957 that Korea took the first step toward privatization after continued pressure from the U.S.

After enactment of General Banking Act in August 1954, a committee, comprised of representatives from the Ministry of Finance, Bank of Korea, and Property Trustee, was established to facilitate the ownership transfer of banks. The committee established the procedures under which the banks would be sold. The conditions of sales were relatively stricter compared to the sale of manufacturing properties due to the specialized nature of the banking industry. A cap was placed to limit the ownership share of banks per individual investor. Also, investors were required to make one lump-sum payment for the shares. The government also set a price floor for the bank shares based on its own valuations. Once ownership of the shares was transferred, the investors were prohibited from selling the shares for two years (Samsung Office of the President, 1988, p142). After the procedures and conditions of the banks’ shares were established, a series of six auctions were held between November 1954 to early 1956. The first and second round of auctions failed to produce any sales as bidding investors did not find the prices attractive. The remaining

4. A similar type of central banking system was also introduced in several countries including Paraguay (1943-45), Ethiopia (1942-44), Guatemala (1945), Dominican Republic (1947), Honduras (1980), Ceylon (1950) on the advice of the US (Cho and Kim, 1995).

5. Arthur Bloomfield recommended that “*It has been our primary purpose to convert the present central bank into a more genuine central bank ... One draft of a new central bank statute, therefore, equips the Bank of Chosun with strong credit control powers (especially appropriate to the present inflationary setting), lays down rules for credit policy, and prohibits the Bank from engaging in commercial banking business with the public (except in connection with foreign trade and exchange) ... purpose has been to free the Bank as far as possible from political pressure and arbitrary interferences, which have plagued it all too frequently in the past, by putting the management and operations of the Bank under the control of a seven-man group representative of different interests, and by defining the nature of the Bank’s operations and allocating responsibility than before*”.

rounds did not attract any bidders. Unable to sell any of the banks, the Monetary Board at Bank of Korea recommended that the conditions of sales be loosened by easing the ownership restrictions and allowing payments of shares to be made in installments. As a result, the bank ownership shares were sold to private investors including Lee Byung-Chul (Samsung Group), Chung Jae-Ho (Samho Group) and Lee Han-Won (Daehan Jeboon). Lee Byung-Chul took over 83% of ownership control of Heungop Bank (former Hanil Bank), Chung Jae-Ho took 51% ownership control of Savings Bank (former Korea First Bank), and Lee Han-Won took 29% ownership control of Korea Commercial Bank. Besides the more relaxed conditions of sales, the fact that the investors were able to finance their investments through bank loans may have led to the concentration of ownership shares in the hands of a few investors (Kim, Joon-Kyung, 1999). In the end, many of the banks were acquired by a few large industrialists, who subsequently used the banks they owned to predominantly fund their own businesses. According to Ahn (1993, p272), over 50% of a bank's total loans were lent to companies owned by the major shareholders of the bank.

2.2. Consequences of Land Reform: Growth of Informal Credit Market

Korea only 70 years ago was largely an agrarian society where 75% of the population was in the agricultural sector; a fact largely forgotten because of Korea's rapid industrialization. After its liberation in 1945, land tenure in Korea was based on an ownership structure dominated by a handful of landlords owning most of the land on which farmers worked. According to Morrow and Sherper (1970), the top 4% owned or managed 50% of the arable land and most of the farming was done by hired labor or tenant farmers, who were mainly "share croppers living at subsistence levels".⁶ As a result, the unequal distribution of land, the dire economic situation of farmers, and growing population pressure worsened by the lack of arable land, led to widespread poverty and social instability, making Korea ripe for land reform (Morrow and Sherper, 1970).

The land reform program that was pushed by the US and implemented largely by the Korean government sought to achieve multiple objectives in redistributing the land, which was essentially based on the land-to-tiller's principle. A major political objective of land reform was "to lay a foundation for democratic rural society" by dismantling the oppressive tenant farming system to ease social unrest and improve the economic conditions of farmers. It also sought to raise agricultural productivity by providing incentives to farmers through the ownership of land and production, and raising the income of farmers and encouraging investment.

6. Most of the arable land was still in the hands of Korean landlords while Japanese owned about 13.4% of total arable land during its colonization according to historians.

The land distributed to the poor included land formerly owned by the Japanese under US custody and land owned by Korean landlords. A total of 245,554ha of arable land formerly owned by Japanese was redistributed which was 13.4% of all arable land. The distribution of Japanese land benefited an estimated 727,632 households which received an average of 0.337ha of land. This significantly changed the land tenure structure resulting in: “1) share increase in full-owner operators, 2) a reduction in part owner operators, 3) a consequent reduction in full tenancy, and 4) an indirect effect of accelerating the trend to smaller farms and a subsequent consolidation of very small farmers into medium sized farms”. The most immediate and prominent effect of land reform was reforming Korea’s traditional and oppressive tenant farming system. Tenant farming was legally abolished.⁷ This helped to stabilize the income of farmers who had to pay over half of their production as rent.

However, the immediate benefits of land reform were short lived. Farmers continued to experience difficult economic conditions. The income of farmers fell due to a drop in grain prices and productivity. The large influx of grains via US aid and the government’s policy of keeping grain prices low to minimize inflation led to a decline in grain prices. Also, farmers earned less income as they were less productive partly because individual farmers were cultivating on smaller plots of land (0.6ha on average) as a result of the land reform in 1948 and 1950. As such, rice production decreased from 14.7 million *Sok* in 1949 to 12.8 million *Sok* in 1956, indicating 13.3% decrease.⁸

Having less income but owning land, farmers relied more on credit, mostly from the informal credit market. In fact, farmers could only turn to the informal credit market because land could not be used as collateral to access credit in the formal market. Under the Land Reform Act, farmers were restricted from leasing or collateralizing their land to keep with the principle that the farmers had to own their land. However, many farm households became heavily reliant on informal loans, which charged high interest rates, or usury loans. Many of the farmers fell into deeper financial trouble, unable to repay their loans with high interest rates. The farmers would refinance by borrowing more before losing their land, or even worse, end up as indentured servants (Kim, Byung-Tae, 1957).

By the 1960s, total debt among farm households had reached unsustainable levels; in that, nearly 90% of farm households relied on informal credit markets, amassing large amounts of usury loans. According to a survey, the total amount of debt held by farm households was estimated to be 15.1 Billion Won in 1960. Among these households, over 73%, or possibly

7. According to Dwight Perkins (1969), the tenant farming system also lowered agricultural production in China.

8. Indeed, many farm household had run out of provisions for meals. Particularly, the season from February to May was a hardship period, so called “the season of *spring poverty*”. According to a survey in 1957, 15.4% of rural households had run out of provisions for meals.

even higher share, of households borrowed with loans that charged an interest rate of over 60% in 1961 (Lee, Myunghwi, 2010). In many cases, farm households also borrowed food and other commodities and repaid in kind, often at a 100% of what was initially borrowed.

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Chapter 3

Relief Program (1961-1970) for High Rural Household Debt

Relief Program (1961-1970) for High Rural Household Debt

The difficult financial and economic situation of farmers, who had amassed large amounts of informal usury loans, was the biggest political and policy issue in the late 1950s. The high level of debt among rural households was a serious financial problem but it also exposed the dominance of the unregulated or informal credit. The issue surfaced in 1958 when the ruling party (Freedom Party), led by Rhee Syngman, made a political pledge during parliamentary election campaigns to assist farmers in financial distress due to debt. The ruling party proposed policy measures aimed at providing farmers debt relief. The key features of the debt relief program included: 1) loans with a monthly interest rate of over 4%, defined as usury loans, could qualify under the debt relief program; 2) the full amount of loans outstanding had to be reported by both borrowers and lenders to the Agricultural Bank; 3) the goal of the program was to modify the loans by adjusting the repayment schedule with a longer maturity term and at lower interest rates. The Agricultural Bank was in charge of administrating the program, acting as the go-between for borrowers and lenders. The bank in fact was supposed to issue promissory notes to the lenders and to collect repayment from the borrowers. However, this proposal was shelved, largely because the government did not have the fiscal resources to finance a large debt relief program, especially considering that Korea at the time had to focus on war reconstruction efforts. Considering the government's limited fiscal capacity, it was believed that the program would have been far too small and would not have affected enough rural households to have a meaningful impact. The government did make an attempt at providing some debt relief just before the Presidential Election in March 1960. The national assembly led by the ruling party legislated a smaller debt relief program that provided small loans to debt-ridden farmers. A total of 53,328 small loans were allocated from 1 Billion Won that was earmarked (Lee, Myunghwi, 2010). However, this only worsened the situation.

It was not until the military government led by Park Chung-Hee came to power that a real attempt was made to address the fallout stemming from unsustainable levels of debt among rural households, most of which were informal usury loans. Most of the usury loans, nearly 51%, were used to pay for one-time large lump-sum expenses like funerals, weddings, education, etc. <Table 3-1> shows the main sources of usury loans which came from various segments of society. Professional moneylenders, individuals and *Kye* lottery winners accounted for 92% of all lenders (out of which professional money lenders was 41.3%, followed by individual lenders at 33.1%, and *Kye* lottery winners at 17.5%).

Table 3-1 | Sources of Usury Loans

(Unit: 100 Thousand Won, %)

	Classification	# of Cases	Amount	Share based on Amount
Sources of loans (Lenders)	Income from pensioners*	9,073	317	1.3
	Money lenders	255,356	10,304	41.3
	<i>Kye</i> lottery winner	128,221	4,357	17.5
	Salary of Indebted workers	35,725	1,307	5.2
	Individual	246,129	8,254	33.1
	Extended relatives	7,894	280	1.1
	Merchant	868	48	0.2
	War veterans	63	2	0
	Widows	23	2	0
	Public officials	451	21	0.1
	Others	1,212	42	0.2
	Total	685,015	24,934	100
Unidentified sources of loans		205,314	4,336	
Total		890,329	29,270	

* Pensioners included widows of soldiers and police officers

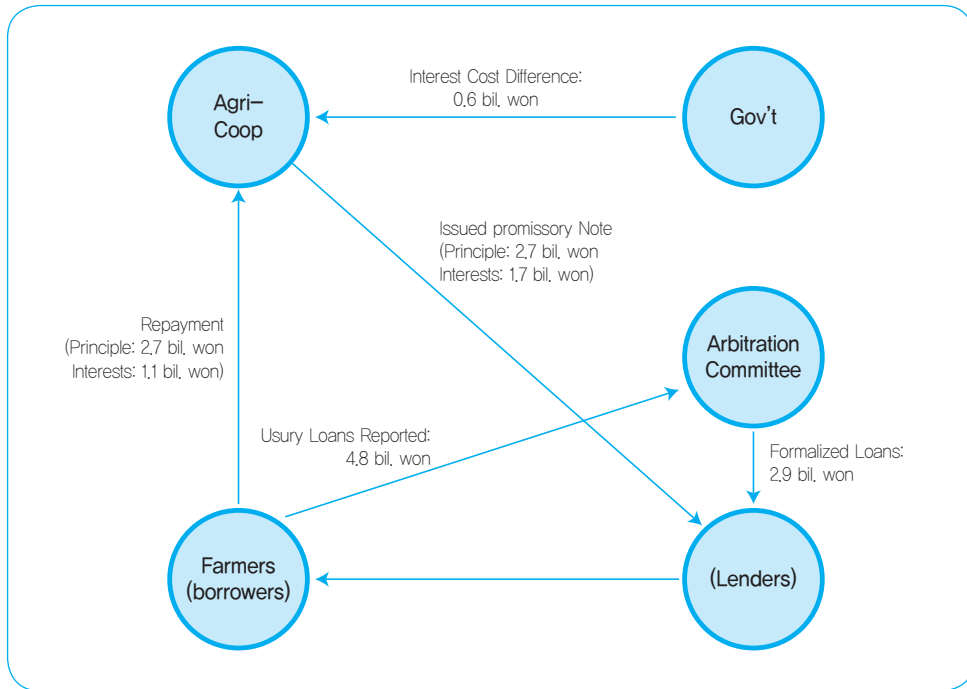
Source: National Agriculture Cooperative Federation (NACF), Agriculture Yearbook, 1962. Cited from Lee, Myunghwi (2010)

Ever since the Park Chung-Hee led government took power, the rural sector was a top political and economic priority for the government. It wanted to consolidate political support in the rural sector and to implement rural development policies aimed at reducing poverty and raising standards of living. On May 25, 1961, the military government rolled

out a debt relief program to ease the economic and financial difficulties of farmers and fishermen. The key features of the 1961 debt relief program included:

- 1) Loans totaling less than 15,000 Won with an annual interest rate of over 20% qualified under the debt relief program.
- 2) A four member arbitration committee composed of senior village members was formed to oversee the program in each village. The committee was in charge of identifying and recording the names of the lenders and borrowers involved. The committee also arbitrated cases of disagreements between lenders and borrowers.
- 3) All loans had to be reported by a specific deadline. Loans reported after the deadline risked having any financial claims being void. False reports or false financial claims were subject to criminal punishment including five year imprisonment or a financial penalty of no less than 50 Thousand Won.
- 4) For borrowers, usury loans were modified under the following terms and conditions: (1) borrowers were given a one year grace period on repayment; (2) borrowers had to repay the modified loans in installments over four years; and (3) interest rates were lowered to 12% annual basis.
- 5) For lenders, the loans were repaid at an annual interest rate of 20% and the interest rate was legally capped at 20%.
- 6) The government subsidized the interest difference paid to lenders and repaid by borrowers which was about 8%. The agricultural cooperatives acted as administrators between borrowers and lenders by issuing promissory notes to the lenders and collecting debt payments from the borrowers.

Figure 3-1 | Transaction Flow Diagram for Debt Relief Program



Source: Sang Ho Lee (1972)

In essence, the government's intervention should be seen at two levels. One, it sought to address the high debt among rural households. In the process of providing debt relief, it was an attempt to formalize a significant amount of informal loans. The debt relief program impacted an estimated 685,015 borrowers and lenders which accounted for 29% of total farming households (2.35 million households) at the time. Under the program, an estimated 1.17 million of loan transactions were modified, totaling about 4.8 Billion Won, from which 890 thousand loan transactions that totaled 2.9 Billion Won were identified by the arbitration committee as informal loans (<Table 3-2> and <Table 3-3>). The government also sought to encourage savings among low-income farmers, going as far as encouraging more frugality and discouraging extravagant spending way of life.

Table 3-2 | Number of Usury Loans Reported and Formalized

	Number of Loans Reported (A)	Number of Loans Formalized (B)	B/A
Kyunggi	121,644	102,407	84%
Chungbuk	109,392	83,645	76%
Chungnam	138,002	113,922	83%
Cheonbuk	171,446	133,772	78%
Cheonnam	270,163	185,425	69%
Kyungbuk	183,809	143,911	78%
Kyungnam	140,952	103,413	73%
Kangwon	24,450	17,598	72%
Jeju	10,813	6,226	58%
Total	1,170,671	890,329	76%

Source: National Agriculture Cooperative Federation (NACF), Agriculture Yearbook, 1962
Cited from Lee, Myunghwi (2010)

Table 3-3 | Amount of Usury Loans Reported and Formalized

(Unit: 100 Thousand Won)

	Amount of Loans Reported (A)	Amount of Loans Formalized (B)	B/A
Kyunggi	5,519	3,782	69%
Chungbuk	3,485	2,155	62%
Chungnam	5,862	3,959	67%
Cheonbuk	7,603	5,264	69%
Cheonnam	11,470	5,976	51%
Kyungbuk	6,246	3,782	61%
Kyungnam	6,179	3,384	54%
Kangwon	1,220	673	55%
Jeju	476	295	61%
Total	48,060	29,270	60%

Source: National Agriculture Cooperative Federation (NACF), Agriculture Yearbook, 1962
Cited from Lee, Myunghwi (2010)

The debt relief program was relatively small in scale when considering that nearly 90% of rural households had usury loans which was estimated to total about 15.1 Billion Won in 1960. In comparison, the program was estimated to have impacted only 29% of total farming households that reported about 4.8 Billion Won of loans. The small scale of the program was because the program only targeted households with loans of less than 15,000 Won, suggesting that the government sought to assist the poorest households.

Moreover, the program itself seemed to have produced mixed results at best. First, the total amount of usury loans reported under the program was relatively low, largely because lenders did not want to take haircuts while borrowers were afraid of not being able to borrow in the future (Lee, Myunghwi, 2010). Moreover, most of the loans that did get reported and modified were not paid back. In the first five years of the program, only 21.3% of the modified loans were collected. As seen <Table 3-4> below, only 51.9% of what was owed to the lenders, which totaled 4.3 Billion Won (principle of 2.6 Billion Won + interests of 1.7 Billion Won at 20% annual interest rate), was actually paid to the lenders by the agricultural cooperatives between 1961-66. Moreover, only 21.3% of what borrowers owed, which totaled 3.7 Billion (principle of 2.6 Billion Won + interests of 1.1 Billion Won at 12% annual interest rate) was paid to the agricultural cooperatives by the borrowers. The amount of modified loans repaid by borrowers did increase to 45.9% by 1968 and eventually to 53.3% by 1971. The rest of the uncollected modified loans were absorbed by the agricultural coops which either forgave or wrote off the loans. In contrary, most of the lenders, 97.4%, were able to eventually redeem their promissory notes issued by the agricultural cooperatives.

Table 3-4 | Results of the Debt Relief Program for 1961-1971

(Unit: Million Won, %)

Year	Repayment of Promissory Note Issued to the Lenders by the Agricultural Cooperatives					Repayment of Modified Loans by Borrowers to the Agricultural Cooperatives				
	Modified Loans			Payments		Modified Loans			Payments	
	Principle	Interest	Total (A)	Payment (B)	B/A	Principle	Interest	Total (C)	Payment (D)	D/C
1962-66	2,663	1,670	4,333	2,250	51.9%	2,663	1,086	3,749	800	21.3
Dec 31, 1968	2,663	1,670	4,333	4,158	96.0%	2,663	1,086	3,749	1,722	45.9
Dec 31, 1971	2,663	1,634	4,297	4,185	97.4%	2,663	1,086	3,749	1,997	53.3

Source: Lee, Sang-Ho (1972)

By 1971, a large portion of the modified loans remained uncollected due to the lack of debt service capacity among the rural households which continued to suffer difficult financial conditions. As a result, a special law was enacted in August 1969 which basically exempted borrowers who were determined as “incapable of repayment” from further obligation to repay the modified loans reported in 1961. As can be seen in <Table 3-5>, these borrowers exempted from repayment were classified into three groups: 1) Farmers on government support; 2) Tax exempted farmers; and 3) Deceased borrowers. A total of 2.0 Billion Won of modified loans were not collected as of the end of 1968. After the special law was passed, a total of 0.9 Billion Won of modified loans were forgiven by the agricultural cooperatives. The rest of the remaining uncollected modified loans (about 1.1 billions) were written off by 1981. Some households were essentially bailed out by the agricultural cooperatives, which wrote off the unpaid loans. The debt relief program failed in a sense that it invited moral hazard by forgiving some of the loans initially which created expectations for further loan forgiveness.

Table 3-5 | Classification of Borrowers Exempt from Repayment

	Number of Borrowing Cases	Amount of Borrowings (Million Won)		
		Principle	Interest	Total
Farmers on government support	10,308	52.4	18.1	70.5
Tax exempted farmers	57,143	357.9	121.4	479.3
Deceased borrowers	49,046	278.2	99.0	377.2
Total	107,497	688.5	238.6	927.0

Source: Lee, Sang Ho (1972)

Despite the debt relief program, the informal credit market continued to play a large role in the agricultural sector. The agricultural cooperatives did not play a major role in improving financial inclusion during the 1960s. Indeed, agricultural cooperatives suffered losses and could not properly play the role of financial intermediaries. In 1971, financial inclusion remained low, as 60% of the total debt held by farmers was informal loans at usurious rates (See <Table 3-6>).

Table 3-6 | Farmers' Dependence on Informal Credit Markets

(Unit: %)

	1971	1980	1985	1990
Farmers' Ratio of Informal Loans	60.0	49.0	28.9	13.9
Interest Rate for Informal Loan (A)	54.0	46.8	26.4	21.0
Interest Rate for Loan from agricultural coops (B)	28.0	22.0	14.5	14.0
Interest Rate Differential (A-B)	26.0	24.8	11.9	7.0

Source: NACF, *30 years of Agricultural Cooperative History*, 1991, p446. Cited from Park, Park and Shin (2012)

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Chapter 4

State-Controlled Financial Sector

1. Nationalization of Banks and Emergency Financial Measure in early 1960s
2. Interest Rate Adjustment in 1965: Walking a Tight Rope

State-Controlled Financial Sector

1. Nationalization of Banks and Emergency Financial Measure in early 1960s

Immediately following the military coup in 1961, the new government nationalized (re-nationalized, to be more precise) the commercial banks by forcing large stockholders to return their shares to the government on grounds that they had been acquired illicitly in the previous regime. Subsequently, the annual budgets of the commercial banks and appointments of top management positions became subject to the approval of the Minister of Finance. Special banks such as the Small and Medium Industry Bank were established, which fully owned and controlled by the government. The charter of the Korea Development Bank, formerly Industrial Development Bank, a state-owned bank, was revised to increase its capital and to give it authority to borrow funds from abroad. Thus the banks—both nationalized commercial and state-owned specialized banks—were tightly controlled by the Ministry of Finance, effectively becoming a government instrument of credit allocation.

The nationalization of commercial banks was accompanied by the reorganization of the BOK. In 1962, the BOK Act was revised, making it unequivocally subject to the control of the Ministry of Finance. This step was crucial to the government's strategy to finance development projects, which depended heavily on the BOK's monetary expansion. Under the amended Act, the BOK's governor was to be appointed by the President on the recommendation of the Minister of Finance. In addition, the Minister of Finance had the authority to override resolutions adopted by the BOK's Monetary Board. The 1962 amendment also empowered the MOF to direct the BOK to purchase securities issued by government agencies with redemption guarantees.

As pointed out by Cole and Park (1983, p.58), these reforms were a “manifestation of the orientation of the new government towards a centrally managed and powerful set of institutions and instruments for carrying out the government’s policies”. This marked a clear departure from the policy stance of the previous regime, which adopted, albeit in principle only, a policy of central bank autonomy and the private ownership of commercial banks.

For example, the government wanted to use the financial institutions as a policy tool to promote industrialization. On June 10, 1962, it adopted the Emergency Financial Measure to mobilize domestic savings. The main idea of the Measure was to secure the private deposits, and then, invest the savings into a development fund that would issue shares to the owners of the deposits. To this end, the government was going to establish a government agency called the Industrial Development Corporation (IDC) to mobilize domestic savings, which it would use to finance the First Five-Year Economic Development Plan. As a first step toward achieving this goal the government took measures to rationalize the currency system by changing the monetary unit and the name of its denomination. As such, 10 Hwan was to be converted into one Won. The inability to access foreign capital left the government with little choice but to turn to domestic savings. It attempted to take direct control of the savings of the wealthy class, which had no other alternative but to comply in exchange for equity shares in IDC. Against public outcry, the funds of wealthy depositors were frozen and could be drawn by the IDC to finance the capital investments of industrial companies. Any returns on the investments made by the IDC would then be used to finance other enterprises.⁹ The Korean media and the US government criticized this action as being driven by principles of state capitalism rather than democratic one. In its response, the US government went as far as threatening to cut off economic aid if the Korean government continued with these policies. Left with no choice, the Korean government acquiesced. On July 13, 1962, President Park Chung-Hee ceded to the U.S. demand to abandon the Emergency Financial Measure. As a result, the depositors’ savings accounts were unfrozen and released. In the end, the government was able to only re-denominate the Korean currency. Regardless, the damage had already been done. The affects of the government’s intervention, which was tantamount to state seizure of private properties, was immeasurable. Although the government gave up on implementing the banking measure, the private deposits were in

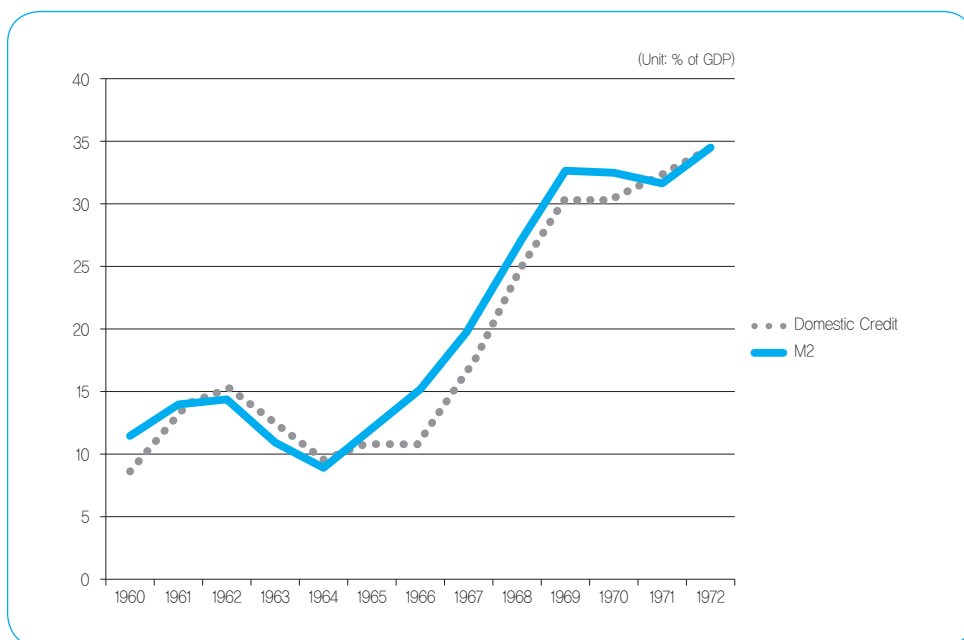
9. According to published accounts of General Yoo Won-Sik, who was leading the government’s economic policy measures, and Korean Ambassador to the United Kingdom, Kim Yong-Sik, the first phase of the Emergency Financial Measure, which sought to rationalize the currency system, was decided on July 22, 1961, when the First Five-Year Economic Development Plan was introduced, almost a year before the announcement of the Emergency Measure. At the time of the introduction of the First Five-Year Economic Development Plan, the military-led government considered the banking system outdated and inadequate as a financial intermediary as banks largely relied on collateral-based lending practices (Kim, Chung-Yum, 2011).

fact frozen for about three weeks. This had broken the public's trust of financial institutions, which no longer could be seen as safe havens but rather subject to the state's will. As seen in Figure 10, the supply of M2 decreased sharply based on the ratio of M2/GDP from 14.5% in 1962 to 8.9% in 1964, indicating that a large amount of capital went underground into the informal credit market.

Figure 4-1 | Masses of People in Lines at a Bank to Exchange their Currencies during the Emergency Financial Measure



Figure 4-2 | M2 and Domestic Credit in the Banking Sector: 1960-1972



Source: World Bank, World Development Indicators ([http:// data.worldbank.org/data-catalog/world-development-indicators](http://data.worldbank.org/data-catalog/world-development-indicators))

The Emergency Financial Measure was the culmination of a series of actions including the nationalization of banks that took Korea down a path of *state-capitalism*. This failed attempt at a financial *coup d'état* marked when the pendulum began to swing towards a more market-oriented economic development or *developmentalism*, after swing too far to the left towards a communist state model. Indeed, President Park replaced the economic policy makers which were largely from the military with professional technocrat.

2. Interest Rate Adjustment in 1965: Walking a Tight Rope

After the banks were nationalized in 1961, interest rates were kept low to support the corporate sector. Amid high inflation, the real interest rates were actually negative. This invariably drove much of the savings underground into the informal financial sector, where interest rates ranged from 40% to 50% per annum. Besides the negative real interest rates, depositors were weary of putting money in the banks following the failed *Emergency Banking/Currency Measure*.

In 1965, the government adjusted the interest rates short of full liberalization, as part of efforts to pursue more market-based policies. As market interest rates became more aligned with informal interest rates, the flow of funds reversed as more savings flowed into the formal financial sector during the latter half of the 1960s. In retrospect, the interest rate reforms may have turned out to be the single biggest event in Korea's financial development, having a ripple effect on the financial sector and real economy.

Prodded by the IMF, Korea pursued a set of market-based policies in the mid 1960s aimed at liberalizing the foreign exchange rates, interest rates, and imports. In 1964, the government led by President Park replaced the multiple exchange rate system and adopted a single floating exchange system. Subsequently, the Korean Won devalued from 130 Won/USD to 255 Won/USD. In addition, imports were liberalized with the introduction of a negative list for imported goods. Unlike the foreign exchange rate and imports, the liberalization of interest rates was much more difficult and complex.

On September 30, 1965, the government made a significant change in its interest rate policy, raising the nominal interest rate on one-year time deposits from 15% to 30% and the general loan rate from 16% to 26%.¹⁰ These changes created negative margins between deposit and loan rates, which were intended to promote savings while not overburdening businesses with higher interest rates on loans. To protect the profitability of banks, which obviously suffered from the negative margins, the central bank paid an annual interest rate of 3.5% on the required minimum reserves of deposit taking banks held at the central bank. The reform brought the official interest rates closer to market rates except for rates on loans used to finance export and agricultural businesses, and other kinds of investments. In adjusting interest rates, the policymakers walked a tight rope since interest rates had to be raised high enough to attract depositors from the informal markets, but had to be low enough not to overburden the corporate sector. Raising interest rates on bank deposits had the effect of diverting private savings from informal credit market to the deposit money banks (DMBs). In the meantime, subsidized loans such as export loans were all discounted

10. The Korean policymakers went back and forth on when and how to implement its interest rate liberalization policy. Chang Ki-Young, Deputy Prime Minister, was a key figure and supporter of the liberalization efforts, and a strong advocate of raising interest rates. He understood the problems caused by a combination of low interest rates and high inflation which contributed to the contraction of the formal financial sector and expansion of the informal credit markets. The lack of financial resources in the formal market constrained the supply of credit, which meant that a lot of firms would be chasing after the little loans there were at that time. This invited political influence peddling, since the banks were controlled by the government. As such, he argued that interest rates had to be raised sufficiently high enough to attract savings from the informal credit markets. There was a lot of debate regarding this issue right before the implementation. In the morning of September 29, 1965, there was a meeting where many of the policymakers were hesitant to proceed with liberalizing interest rates, and therefore, decided to postpone it. This decision to postpone was reported in the media. On the evening of the same day, the decision was reversed after a meeting of key policymakers, who after some debate decided to liberalize interest rates as planned (Kim, Yong-Hwan, 2002).

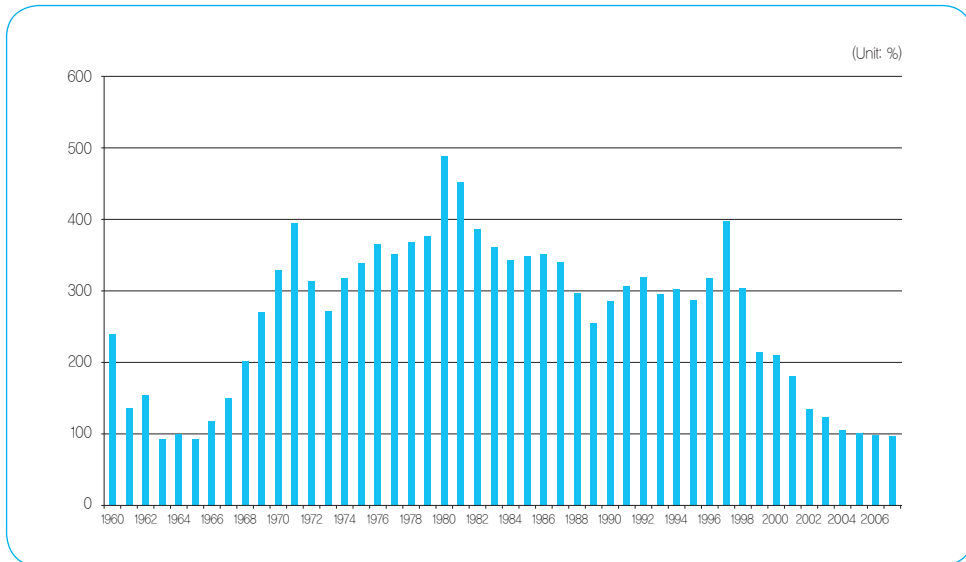
by the central bank at lower rates to bolster the profitability of the deposit banks. Interest rates on loans to exporters, for example, remained at 6.5% when the general loan rate was raised to 26%.

In the first three months of the reform, time savings deposits increased by 50%, and in the subsequent four years, grew at a compound annual rate of nearly 100%. As can be seen in Figure 9, the M2/GDP ratio shot up from 8.9% in 1964 to 31.7% in 1971. Moreover, the supply of domestic credit based on the domestic bank credit to GDP ratio shows a similar pattern, increasing from 9.6% in 1964 to 32.3% in 1971. Moreover, the amount of total bank loans increased as well, growing from 10.9% in 1963-64 to 61.5% in 1965-69.

The partial liberalization of interest rates brought much of the flow of funds back to the formal financial sector but it also helped fuel the rapid expansion of corporate debt. Even though rates in the formal and informal credit markets converged, the government which owned all the banks still held the levers to credit.¹¹ After the First Five-Year Economic Plan (1962-66), the Korean economy had already achieved take-off and was just entering a period of high growth, thanks to increased domestic credit following the partial reform of interest rates. The ability to access foreign loans after 1966 only helped to increase the amount of corporate debt in the system. From 1963 to 1971, the debt to equity ratio of manufacturing firms increased by more than four folds from 92% to 394% [Figure 4-3]. In the absence of well-functioning equity market, investment had to be financed by bank loans and foreign borrowings. Indeed, as <Table 4-1> shows, the number of listed firms in Korea totaled only about 40 in the late 1960s, and the total market value was only 4% of GDP.

11. The interest rate adjustment policy has often been cited as an exemplary case of financial liberalization, but in reality it only expanded the financial resources available for policy loans by diverting funds from the unregulated informal credit markets to the government owned commercial banks. During this period a host of U.S. advisors (E.S. Shaw, John Gurley, Hugh Patrick, and others) visited Korea frequently under the auspices of USAID and international organizations. Their recommendations were put into practice with much fanfare and had an apparently dramatic effect for a while. These experiments, imbued with American ideas and implemented by officials more susceptible to U.S. influence, made ripples on the surface of Korea's financial structure. *In most cases, these experiments were short-lived, distorted, ignored, and eventually overwhelmed by the main currents flowing steadily under the surface.* [Italics added] [quoted from Kim Pyung-Joo (1994, p280)].

Figure 4-3 | Debt/Equity Ratio for Manufacturing Firms: 1960-2007



Source: Bank of Korea

Table 4-1 | Growth of Korean Stock Market: 1963-1980

	Number of Listed Firms	Stock Market Value (10 Billion Won)	Stock Market Value/GDP
1963	15	17.0	3.4%
1964	17	22.2	3.1%
1965	17	14.6	1.8%
1966	24	19.5	1.9%
1967	24	38.5	3.1%
1968	34	64.3	3.9%
1969	42	86.6	4.1%
1970	48	97.9	3.7%
1971	50	108.7	3.2%
1972	66	246.0	5.8%
1973	104	426.2	7.8%
1974	128	532.8	6.9%
1975	189	916.1	8.8%
1976	274	1,436.1	10.0%
1977	323	2,350.8	12.8%
1978	356	2,892.5	11.7%
1979	355	2,609.4	8.2%
1980	352	2,526.6	6.5%

2012 Modularization of Korea's Development Experience
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and Financial Inclusion in Korea

Chapter 5

Korea's First Corporate Debt Crisis

1. August 3 Emergency Economic Measure in 1972
2. Post-1972 Crisis Corporate Restructuring and Regulation of Informal Lenders

Korea's First Corporate Debt Crisis

1. August 3 Emergency Economic Measure in 1972

The expansion of domestic loans and access to foreign loans combined with increased optimism in the business community about Korea's economic future fueled the investment boom of the second half of the 1960s. By the end of the 1960s, the Korean economy showed signs of over-heating with a swelling current account deficit in the late 1960s. To cool the economy and prevent a debt crisis, the government pursued a set of macro-economic stabilization measures on the recommendation of the IMF, which pushed for the devaluation of the Won, deregulation of import restrictions, abolition of export subsidies, tighter monetary policy, and imposition of a temporary ceiling on foreign borrowing (an orthodox IMF program).¹² Consequently, monetary expansion dropped from 52% in 1968 and 45% in 1969 to 11.3% and 24.9% in 1970 and 1971. Domestic credit expansion dropped from 66.3% and 59.8% in 1968 and 1969 to 32% and 28% in 1970 and 1971 <Table 5-1>. Economic growth also fell from 13.8% in 1969 to 7.6% in 1970. This drop was followed by a currency devaluation of 18% in 1971, and another 7% in the following year.

At the time, when these macro-stability measures were implemented, the Korean corporate sector was highly leveraged with many debt-laden firms on the verge of or already in financial trouble, which threatened to take down the whole economy. Though the corporate sector had access to more loans after interest rates were partially liberalized in 1965, it also meant that Korean firms had to pay higher interest rates on loans which

12. The Korean government did not accept these recommendations on the belief it could harm the second Five-Year Economic Plan and jeopardize rapid growth. But the pressure was intense, as the U.S. made its foreign assistance including Public Law 480 and development loans conditional on the acceptance of the IMF program. The Korean government then agreed to the IMF program in 1970, with the exception of ending export subsidies, which the government viewed as critical to its export-led growth strategy (Cho and Kim, 1995).

they were not accustomed to before. The higher interest rates on domestic commercial loans raised the debt payment burden of corporations. This situation was exacerbated by the fact that an increasing number of Korean firms held foreign loans which became more difficult to repay after the devaluation of the Won and tightening of the money supply. More troubling was that many firms had also accumulated a large amount of loans from the informal credit market during this period, largely to finance short-term working capital needs. As the 1970s began, the Korean economy seemed on the verge of its first debt crisis!

Table 5-1 | Key Economic Indicators between 1964 and 1978

(Unit: %)

	Investment (a)	Export (a)	Domestic credit (a)	Nominal Interest rate on General Loan	Rates of Return to Fixed Asset (b)	Informal Loans Interest Rate (c)	GNP Deflator (a)
1964	13.3	37.2	7.8	16.5	32	61.80	30.0
1965	19.3	47.0	34.8	18.5	34	58.92	5.8
1966	84.0	42.9	25.7	26.0	40	58.68	14.6
1967	25.2	27.9	64.3	26.0	37	56.52	15.9
1968	52.3	42.2	66.3	25.8	28	56.04	16.1
1969	45.1	36.7	59.8	24.5	28	51.36	15.5
1970	11.3	34.2	32.3	24.0	25	50.16	15.5
1971	24.9	27.8	28.2	23.0	23	46.44	12.5
1972	3.7	52.1	26.9	17.7	27	39.00	16.7
1973	40.7	98.6	31.7	15.5	34	33.24	13.6
1974	30.2	38.3	54.2	15.5	30	40.56	30.5
1975	24.9	13.9	32.2	15.5	29	47.88	25.2
1976	77.1	51.8	21.7	16.1	33	40.47	21.3
1977	43.1	30.2	23.6	15.0	-	38.07	16.6
1978	45.1	26.5	45.9	17.1	-	41.70	22.8

(a) Annual growth rate

(b) Manufacturing sector

(c) Prime enterprises

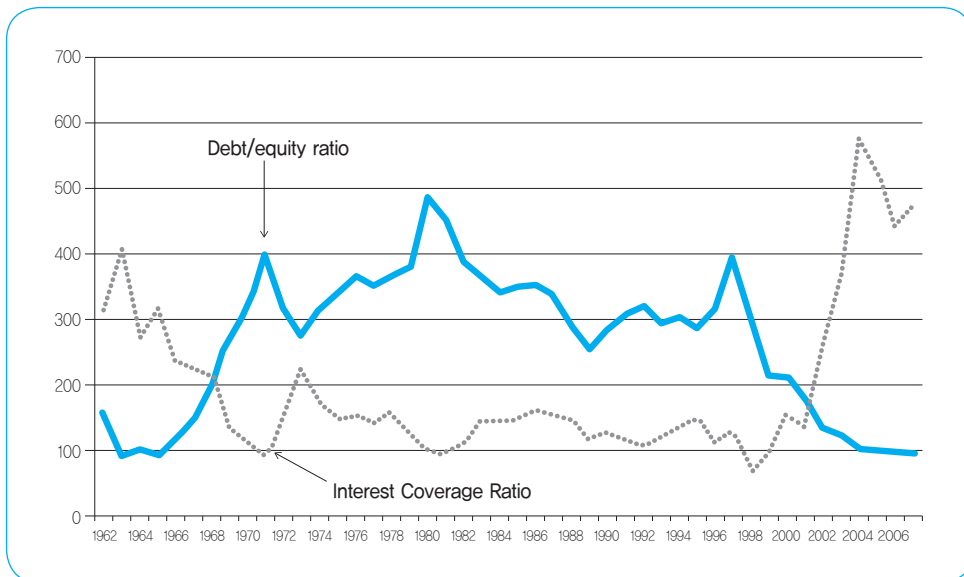
Source: Bank of Korea, “*Economic Statistics Yearbook*,” various issues; Hong (1979); and, Cole and Park (1983)
Cited from Cho and Kim (1995)

Continuing high domestic interest rates, a currency devaluation, and tight supply of credit hit domestic firms hard, especially those that borrowed from abroad. The world economic recession made things worse. Debt service capacity (measured by the interest coverage ratio) and the net profit ratio of the manufacturing sector as a whole fell sharply ([Figure 5-1] and [Figure 5-2]). Inevitably, banks’ non-performing loans (NPLs) started to pile up. Under tight credit conditions, domestic banks could not help firms finance their foreign loan

payments. Business turned to the last available resort: the informal credit market, which charged a hefty rate for short-term loans. Indeed, the informal credit market had long been part of the dualistic financial system in Korea, and had proved flexible, pervasive, and resilient under the repressed system. While outside the rule of law, it was tolerated, if not implicitly encouraged, by the government, because the informal credit market was the only source from which households and some business could obtain loans. During times of tight monetary policy such as during 1969-72, the informal credit market was a major source of funds to large firms. When businesses could not pay back their informal loans, they capsized.

By the end of 1968, banks took management control of 55 large-sized firms in financial trouble. The situation seemed to worsen when it became clear that some of the troubled firms included firms at risk of defaulting on foreign loans. In this case, the financial institutions such as the Korea Development Bank, which had guaranteed the foreign loans, stepped in by paying the loans that matured in place of the firms. By June 1969, banks had to pay the foreign loans of 12 Korean firms (Kim, Jae-hoon, 1991. See <Table 5-2>).

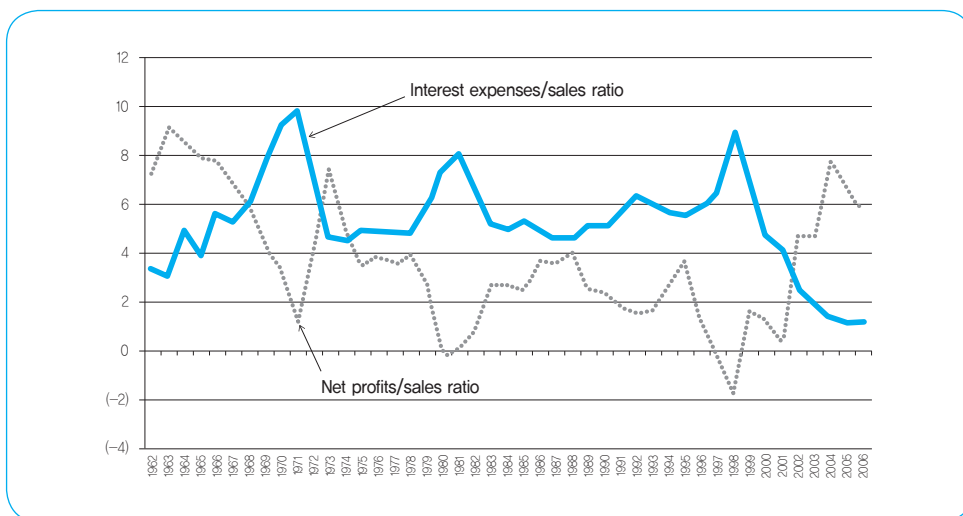
Figure 5-1 | Financial Indicators for the Manufacturing Industry: 1962-2007
Interest Coverage Ratio and Debt/Equity Ratio



Note: 1) Total liabilities/net worth, 2) Operating profits/Interest expenses

Source: Bank of Korea, “Financial Statements Analysis”

Figure 5-2 | Financial Indicators in the Manufacturing Industry: 1962-2006
Interest Expenses/Sales Ratio and Net Profit/Sales Ratio



Source: Bank of Korea, “Financial Statements Analysis”

Table 5-2 | Government’s Payment of Foreign Loans in 1969

(Unit: Million Won)

	End of January	End of February	End of April	End of June	End of July	End of August
Heunghan Chemical Fiber	550.1	550.1	550.1	637.1	637.1	686.1
Hankuk Mabang	75.0	75.0	50.0	-	-	-
Samyang Pulp	14.0	-	-	-	-	-
Korean Air	132.6	-	-	-	-	-
Hanyoung Industry	44.7	89.0	44.7	-	-	-
Choongbuk Cement	110.5	99.0	-	-	-	-
Union Cellophane	87.0	87.0	87.0	52.0	36.0	-
Kongheung Industry	33.0	-	33.0	-	-	-
Daehan Plastic	937.2	-	23.7	-	-	-
Kongyoung Chemical	-	-	-	130.0	30.0	-
Hankuk Electrometallurgy	-	-	-	-	48.0	48.0
Fishery Development Corporation	10.0	-	-	-	-	-
Total	1,024.8	1,026.8	788.5	824.1	751.1	734.1

Source: Kim, Jae-hoon (1991)

The risk of Korean firms defaulting on foreign loans grabbed the attention of policy makers since Korea's credibility with foreign lenders was also at risk. To try and contain a potential foreign debt crisis, the government led by the Blue House began to intervene by implementing a kind of managed bankruptcy program for troubled large firms, starting in May 1969. The goal of this program was to undertake corporate restructuring either through debt rescheduling and M&A of troubled firms or the liquidation of their assets. But this program became bogged down as the stakeholders including the banks and companies stalled and delayed during the restructuring efforts. Initially, this program targeted companies with foreign loans. However, companies that did not borrow foreign loans also sought assistance from the government. The lack of progress in restructuring the troubled firms in a timely manner seemed to only worsen the situation. As such, the Blue House-led committee was dissolved and the responsibility of restructuring was essentially transferred to the Economic Planning Board which chaired the Company Resolution Committee, whose powers were expanded in July 1971. The first major task of the Committee was determining which firms with foreign loans would qualify for the restructuring program. The firms had to meet one of the following criteria to qualify: 1) a firm's payment of foreign debt was guaranteed by a financial institution for more than 1 year; 2) the firm's capacity utilization rate was less than 50%; or 3) losses resulted in negative net-worth. Based on this criterion, a total of 26 firms out of 147 firms with foreign loans qualified for the program (Kim, Chung-Yum, 2011). <Table 5-3> and <Table 5-4> show the list of troubled firms and their main banks, and their foreign creditors (Kim, Jae-hoon, 1991).

Table 5-3 | 26 Troubled Firms with Foreign Loans and Main Banks

(Unit: Thousand Dollars)

Mainbank	Firms (Amount of Foreign Loans Outstanding)
Korea Development Bank	Hankuk Steel (\$3,500), Hankuk Aluminum (\$13,487), Incheon Steel (\$22,386), Hankuk Fertilizer (\$44,077), Heunghan Chemical Fiber (\$11,293), Hanyoung Industry (\$2,732), Daehan Shipbuilding Corporation (\$5,266), Shinjin Automobile (27,055), Daesun Shipbuilding (\$380), Hankuk Electrometallurgy (\$373), Hankuk Mabang (\$2,475), Dongrip Industry (\$12,000), Samyoung Hardboard (\$1,782)
Korea Commercial Bank	Daehan Kwanghak (\$507), Heunghwa Kongjakso (\$4,320), Hwail Industry (\$2,785), Samsung Steel (\$1,500)
Choheung Bank	Daewon Paper (\$1,300), Daesung Woods (\$23,525)
Korea First Bank	Samyang Hanghae (\$31,947), Donam Mobang (\$600), Saman Industry (\$706)
Hanil Bank	Daerim Fishery (\$4,939), Naewoe Bangjeok (\$1,070)
Korea Exchange Bank	Taeheung Industry (\$7,000), Punghan Industry (\$2,186)

Source: *Economic Review* (1975, 8), Cited from Kim, Jae-hoon (1991)

Table 5-4 | Sources of Foreign Loans by Country

(Unit: Thousand Dollars)

Country	Firms (Amount of Foreign Loans outstanding)
Japan	Hankuk Fertilizer (\$44,077), Daehan Shipbuilding Corporation (\$5,266), Shinjin Automobile (\$27,055), Donam Mobang (\$600), Daerim Fishery (\$4,939), Daewon Paper (\$1,300), Daesun Shipbuilding (\$380), Punghan Industry (\$2,186), Daehan Plastic, Kongyong Chemical, Hankuk Chemical
United States	Hankuk Steel (\$3,500), Heunghan Chemical Fiber (\$11,293), Dongrip Industry (\$12,000), Hwail Industry (\$2,785), Saman Industry (\$706), Dongyang Chemical, Samsung Steel (\$1,500), Daesung Woods (\$23,525)
Others including West Germany	Incheon Steel (\$22,386), Samyoung Hardboard (\$1,782), Taeheung Industry (\$7,000), Samyang Hanghae (\$31,947), Heunghwa Kongjakso (\$4,320), Bohae Liquor, Daehan Jonghap Food

Source: *Economic Review* (1975, 8), Cited from Kim, Jae-hoon (1991)

Despite these efforts, the situation in the corporate sector worsened due to the global economic slowdown which slowed exports, reflected by the large swing in Korea's current account <Table 5-5>. On top of this, the financial situation of Korean companies worsened. In fact, the weaker currency worsened the Korean companies' ability to service their foreign debts. The Korean companies' capacity to service foreign debts deteriorated considerably as seen in the sharp increase in foreign loan repayment/foreign exchange earnings ratio, which went from 5.9% in 1968 to 10% in 1969. This ratio continued to deteriorate beyond 9%, a threshold if crossed would be cause for concern based on international standards. This threshold was outlined in Article 20 of the Korean Foreign Capital Inducement Act. It was apparent that the situation was spiraling out of control, and only a matter of time until Korea would face its first debt crisis.

Table 5-5 | Current Account Balance and Foreign Loans Repayment

(Unit: Million Dollars)

	1967	1968	1969	1970	1971	1972
Current account	-191.9	-440.3	-548.6	-622.5	-847.6	-371.2
Foreign Loan Repayment	38.6	60.4	102.7	170.5	214.9	315.0
Foreign Loan Repayment/ Foreign Exchange Earnings (%)	5.6	5.9	10.0	12.3	13.3	14.1

Source: Korea Economic Indicators, Cited from Kim, Jae-hoon (1991)

Business was in an uproar. The Korean Federation of Industrialists (FKI) urged immediate remedies; it was something short of declaring a national bankruptcy to the international financial community and a call to bail out the troubled firms. The government originally considered mobilizing a special fund totaling 10 Billion Won (about 3.3% of the total money supply). Businesses responded by warning that the amount was far too small of what was required. After discussions with business leaders, the government concluded that some extraordinary measure was needed to ease the financial burden of the debt-ridden firms. As such it began to prepare a policy solution in complete secrecy (Kim, Chung-Yum, 2011).

The government issued its Emergency Economic Measure on August 3, 1972 (8.3 Measure) to bail out the debt-ridden corporate sector. The measure essentially issued an immediate moratorium on the payment of all informal loans borrowed by corporations.

Before implementing the Measure, one of the key issues for the government was determining how the informal loans would be reported. The government's intention was to target firms that had borrowed from the informal market while excluding individual households. A key policy issue was defining which informal loans should be reported. The issue was whether to use a negative list that would define all loans outside of the formal financial institutions as informal loans, or to apply a positive list that would specifically define which kinds of financial transactions were considered as informal. After much debate, it was determined that the goal should be to cast the widest net to capture as much of the informal loans as possible by taking a negative list approach. This was stipulated in Article 10 of the Presidential Emergency Decree.¹³ According to former Finance Minister, Kim, Yong-Hwan, using the positive list would have been ineffective as informal lenders and borrowers would not have reported their loans since it would have been easy to circumvent the list (Kim, Yong-Hwan, 2002, p91-92).

From August 3, 1972, a moratorium on all repayments for informal loans went into effect, and subsequent to that, all loan agreements between companies and informal lenders had to be disclosed to the district tax office or financial institution within seven days from August 3. The moratorium was to last three years, after which all informal loans had to be modified into a five-year loan with a maximum annual interest rate of 16.2%. At the time, the prevailing market rate was more than 40%.

The Measure mainly targeted large professional informal money lenders and not small individual lenders. Small informal loans of less than 300 Thousand Won were exempt from being reported. In fact, the payment grace period and length of the repayment schedule was shorter for smaller transactions. For informal loans that were between 300 Thousand

13. Under Article 10, informal loans were defined as all financial obligations that originated directly or indirectly from sources other than banking institutions.

Won and 3 Million Won, the terms of the repayment schedule were more favorable for the lenders since the grace period was much shorter at 1 to 3 years and the repayment period was 1 to 3 years, depending on the size of the loans. This Measure was intended to soften the financial blow to small-sized lenders, which were mainly individual households.

Even though the Measure targeted informal loans, a considerable amount of bank loans were modified at reduced interest rates. This resulted in about 30% of short-term commercial bank loans being restructured into long-term loans. Business were given a three-year grace period for payments, and loans could be repaid on an installment basis over a five-year period at an 8% annual interest rate. The interest rate on bank loans was reduced from 19% to 15.5% for up to one year. This conversion was ultimately backed by the central bank, which accepted 200 Billion Won of special debentures issued by commercial banks. Moreover, the Credit Guarantee Fund for up to 1 Billion Won was created for small and medium sized enterprises (SMEs) and the agricultural sector. Within the Korea Development Bank, an industrial rationalization fund was established to provide low interest long-term loans.

In the end, a total of 210,936 individual loan cases were reported by informal lenders amounting to 357.1 Billion Won. In terms of borrowers, a total of 40,677 loan cases amounting to 345.6 Billion Won were reported by borrowing firms. Surprisingly, the amount of loans reported by borrowers is very close to what the lenders reported, as seen in <Table 5-6>. The loan amount reported by the borrowers was equivalent to 80% of the then money supply (M1) and the 34% of the then outstanding DMB loans.

The biggest beneficiaries of the Measure were large-sized companies, though smaller firms also benefited. Indeed, the largest loans (greater than 50 Million Won) accounted for the largest share of loans reported at 64.2%. The borrowers of these loans were mainly large-sized firms, totaling about 1,108 firms. Some of these firms also held foreign loans.

Since the Measure was mainly targeted at helping large-sized companies in financial trouble, the terms and conditions of the loan modifications for borrowers of smaller loans (less than 3 Million Won) which were many small firms, were less favorable compared to the bigger firms. As mentioned, this was intended to ease the negative financial impact of the Measure on small-sized lenders, many of which were households. Out of 357.1 Billion Won of reported loans, 32% of the loans were less than 3 Million Won. Furthermore, a total of 10.4 Billion Won of loans that were less than 300 Thousand Won were exempt from the Measure, even though they were reported.

As seen in <Table 5-7>, the manufacturing sector borrowed 195 Billion Won in informal loans, or 56.4% of total loans. The distribution of informal loans based on industry was similar to the pattern for the bank loans, where the manufacturing industry accounted for the largest share.

Table 5-6 | Informal Loans Reported by Lenders and Borrowers

(Unit: Billion Won)

Amount	Loans Reported by Lenders		Loans Reported by Borrowers	
	Number of Loans	Amount of Loans	Number of Loans	Amount of Loans
<Less than 3 Million Won>	189,245 (89.8%)	114.3 (32.0%)	30,756 (75.6%)	24.7 (7.2%)
Less than 0.3 Million Won	73,957 (35.1%)	10.4 (2.9%)		
0.3 – 0.5 Million Won	31,650 (15.0%)	11.7 (3.3%)		
0.5 – 1 Million Won	41,263 (19.6%)	27.9 (7.6%)		
1 – 2 Million Won	29,935 (14.2%)	37.2 (10.4%)		
2 – 3 Million Won	12,467 (5.9%)	28.2 (7.8%)		
<Greater than 3 Million Won>	21,661 (10.2%)	242.8 (68.0%)	9,921 (24.4%)	320.9 (72.8%)
3 – 5 Million Won	9,958 (4.7%)	36.2 (10.1%)	2,924 (7.2%)	11.1 (3.2%)
5 – 10 Million Won	7,028 (3.3%)	44.9 (12.6%)	2,766 (6.8%)	19.4 (5.6%)
10 – 50 Million Won	4,146 (1.9%)	75.3 (21.1%)	3,123 (7.7%)	68.3 (19.8%)
50 – 100 Million Won	331 (0.2%)	21.9 (6.1%)	561 (1.4%)	39.0 (11.3%)
More than 100 Million Won	198 (0.1%)	64.5 (18.1%)	547 (1.3%)	183.0 (52.9%)
<Total>	210,936 (100%)	357.1 (100%)	40,677 (100%)	345.6 (100%)

Source: Bank of Korea, *Comprehensive Report on August 3 Presidential Emergency Decree*, 1973, p. 190

Table 5-7 | Informal Loans Reported by Borrowers based on Industry

(Unit: Billion Won)

Industry	Loans Reported by Borrowers
Manufacturing	195.0 (56.4%)
Construction	26.2 (7.6%)
Distribution	42.7 (12.4%)
Transportation and Storage	17.5 (5.1%)
Service	27.9 (8.1%)
Others	27.5 (8.0%)
Errors	8.8 (2.5%)
Total	345.6 (100%)

Source: Bank of Korea, *Comprehensive Report on August 3 Presidential Emergency Decree*, 1973

Figure 5-3 | Masses of People Reporting Informal Loans at a Bank on the Last Day of Reporting on August 9, 1972



The Measure resulted in a fair amount of corporate and financial restructuring of Korean companies. After the loans were reported by the lenders and borrowers, both parties entered private negotiations to settle the new terms and conditions of the loans. As of the end of July 1973, most of the loans were successfully restructured considering that 267.2 Billion Won of loans (19,788 companies) or 80% of reported loans were modified (See <Table 5-8>). For the parties that did not reach an agreement, which was about 68.1 Billion Won of loans, an arbitration process was outlined under the Measure where creditors could request mediation by the National Tax Commission within 30 days.

One of the unintended results of the Measure was exposing cases of where owners of a company were found to have lent money to their own companies as a way to earn income on interest and to evade taxes. In response, these types of loans were required to be converted as equity shares of the company. A total of 114 Billion Won or about a third of total loans reported were exposed and subject to this equity conversion requirement. As of July 1973, a total of 85.9 Billion Won of loans (1,760 companies), or money lent by a company's owner, were converted into equity (See <Table 5-8>).

Table 5-8 | Modified Informal Loans

(Unit: Billion Won, As of the end of July 1973)

	Restructured (Rescheduled) Loans		Loans Converted into Equity		
	Number of Companies	Amount of Loans	Number of Companies	Number of Shareholders	Amount of Loans
Seoul	5,699	108.2	789	2,679	30.6
Jungbu	4,375	82.3	518	2,031	29.5
Daejeon	1,893	8.7	70	255	2.2
Kwangjoo	1,887	10.2	61	250	1.3
Daegu	1,851	15.8	90	318	3.9
Busan	4,083	42.0	234	1,070	18.4
Total	19,788	267.2	1,760	6,603	85.9

Source: Bank of Korea, *Comprehensive Report on August 3 Presidential Emergency Decree*, 1973, p191

Box 5-1 | Reforms in Actions: A Policymaker's Experience

Interview with Lee Yong-Man, who was the Director General of Financial Policy Bureau at the Ministry of Finance during the implementation of the August 3 Measure, and later went on to become the Minister of Finance.

Director General (DG) Lee was the one of the key policymakers that was involved in implementing the post-reform measures following the August 3 Measure. The government was already under great political pressure for bailing out the corporate sector indiscriminately. However, the government risked a large public backlash when it rescued companies that caused huge losses to commercial banks. Indeed, public sentiment had soured as many believed that "Even if the company dies, its owners will thrive". Many people believed that some of the business owners had hidden their assets and evaded taxes. In response, the government made efforts to investigate and uncover cases of business owners having evaded taxes or hidden their wealth. If business owners were found to have committed illegal activities, then they were sanctioned by being placed on a black list and by having their assets recovered. The blacklist was disclosed to the public and the companies on the black list were considered as "socially immoral companies". Moreover, these business owners were prohibited from receiving loans for 5 years.

Mr. Lee also had the very difficult job of directly dealing with informal lenders in implementing the August 3 Measure. He described this experience as being the most demanding and challenging episode of his long career in government. At that time, Mr. Lee was warned by former senior officials that he would put himself in harms way if he pursued the informal money lenders. The most difficult part was the job of rounding up the informal lenders, which meant identifying and registering hundreds of small private money lenders (*mujin*). Then, it was a matter of consolidating the lenders by having them merge. Mr. Lee described that job was made impossible because many of these small money lenders were unregistered, basically underground, and did not have reliable financial records. In fact, many of the financial records and books that were prepared by accountants were falsified. The money lenders closely collaborated with the accountants. To register the money lenders, a public official or a banker was dispatched usually to inspect the financial statement of the money lenders. Once the money lenders were registered, they were merged with other moneylenders. All in all, Mr. Lee said that the consolidation of the money lenders resulted in the creation of 350 MSFCs.

These measures had considerable repercussions throughout the economy, shifting the crushing burden of the corporate sector's foreign debt service payment (caused by the Won's devaluation to support the competitiveness of exports) to domestic informal money lenders and bank depositors. The interest burden of firms was lightened significantly. The ratio of interest expense to sales volume for manufacturing firms dropped sharply from 9.9% in 1971 to 7.1% in 1972, and then to 4.6% in 1973 [Figure 10-2]. As the financial situation of the corporate sector improved, banks' NPLs began to subside. The share of commercial bank NPLs fell from 2.5% in 1971 to 0.92% in 1973, and to 0.6% in 1974 <Table 5-9>. The economy recovered quickly. Total investment grew by 40%, and export growth was almost 100% in 1973. The real growth of the economy in the first quarter of 1973 increased to 19.3% from 6.4% for the same period of 1972 (Kim, Chung-Yum 2011).

Table 5-9 | Share of NPLs and Profitability of Commercial Banks

(Unit: %)

	1971	1972	1973	1974
Share of NPLs (a)	2.46	2.24	0.92	0.63
Net Income to Total Asset	0.28	0.21	0.30	0.78

(a) Non-performing loans/total credit. Non-performing loans are defined as those against which actions of collection or other measures are necessary, regardless of whether they are secured with collateral (classified as fixed), or are unsecured (classified as questionable) or are judged to be uncollectible (estimated loss)

Source: Bank of Korea, cited from Kim Pyung-Joo (1990) and Cho and Kim (1995)

The Measure raises key questions on whether the rule of law, more specifically, the property rights of private citizens was infringed by the government's intervention in the informal credit markets in the process of bailing out the corporate sector. Indeed, some may view the government's action as too extreme or even communistic, going against the principles of a democratic and market economy. However, the policy makers at that time believed the government had a strong case for intervening. Besides, preventing an economic collapse driven by the corporate debt crisis, policy makers believed the informal credit market was outside of the rule of law and therefore, illegal in the first place. Indeed, policy makers were aware that money lending activity in the informal market was in part driven by incentives to evade taxes.

2. Post-1972 Crisis Corporate Restructuring and Regulation of Informal Lenders

In the aftermath of the crisis, the government pushed a set of policies to undertake corporate and financial restructuring. It also sought to institutionalize the informal markets by building a regulatory and legal framework for the operation of informal lenders.

2.1. Corporate Restructuring

The government made concerted efforts to restructure and deleverage the corporate sector and the financial system by introducing a set of policies designed to promote the domestic capital market by activating the issuance of stocks but also to diversify the capital and ownership structure of the large companies by promoting initial public offerings, divestitures, and spin-offs of firms that were bailed out.

Established on July 1, 1974 under the Office of Bank Supervision (OBS) at the Bank of Korea, the credit control system sought to monitor or check against excessive borrowing by large-sized firms and to push the public listing of firms that were bailed out. In the process, it was also intended to induce corporate restructuring and to diversify the ownership structure of major firms. Indeed, large-sized firms with more than 5 Billion Won in debt fell under direct control, and then were divided into two sub-groups: firms with a debt/equity ratio over 400% and firms with a debt/equity ratio under 400%. It should be noted that the debt/equity ratio incorporates not only the main parent company but also its affiliates. So, the debt/equity ratio is defined as total borrowings divided by total equity (net of investments in affiliates) for the entire group, including all affiliates. Lending banks were prohibited from provisioning loan guarantees for both foreign and domestic loans to firms with debt/equity ratios over 400%. In addition, the firms were required to submit a "3-year Restructuring Plan," that included plans to list their shares on the stock market, dispose land holdings,

spin-off affiliates, merge, increase capital, and sell shares of major shareholders. The government in the face of continued resistance and setbacks in implementing the credit control system carried out these policies until late 1970s.

According to In-Soo Kim (1997), tangible progress was made in improving the capital structure of large-sized firms, which remarkably included a total of 69 groups with 578 affiliates as of the end of 1977. Indeed, as can be seen in <Table 5-10>, many firms were able to meet the requirements set out in the 3-year plan by successfully consolidating via mergers (61 firms), spinning-off affiliates (40 firms), increasing equity capital (443 Billion Won), and sales of share of major shareholders (69 Billion Won). Furthermore, as can be seen in <Table 4-1>, the number of listed firms increased sharply to 355 by 1979, compared to only 66 listed firms in 1972.

Table 5-10 | Results of Post-Crisis Corporate Restructuring

(As of End of 1977)

	Planned (A)	Actual Results (B)	B/A
Number of Firms (or Affiliates) for Public Listing	146	90	62%
Number of Affiliates for Mergers	50	61	122%
Number of Affiliates for Spin-offs	38	40	105%
Sales of Major shareholders' Share (Billion Won)	67	69	103%
Equity Capital Increase (Billion Won)	169	443	263%
Issuance of Corporate Bonds (Billion Won)	187	1,797	963%
Sales of Non-operating real Estate Assets (1,000 pyung)	715	382	53%
Sales of Other Assets (Billion Won)	338	331	98%

Source: Hyundai Economic Daily, 1978. 5.28, Cited from In-soo Kim (1997), p13

The bailout of troubled firms probably set a precedence that the government would step in and rescue firms in financial trouble, instilling the idea of too-big-to-fail and inviting moral hazard. In the wake of 8.3 Emergency Measure, the government did make concerted efforts to apply some sort of penalty or cost for bailing out the troubled firms by pushing or even forcing firms to undertake corporate restructuring. The results of corporate restructuring indicate that some progress indeed was made in restructuring the troubled firms. But, this story becomes more complicated since the Korean economy entered a new stage of rapid growth, the push to develop the heavy and chemical industries (HCIs) during the 1970s, right in the midst of the restructuring.

2.2. Regulation of Informal Lenders

Another major development of the August 3 Emergency Measure was the institutionalization of informal money lender with the legislation of the Short-term Financing Company (STFC) Act, the Mutual Savings and Finance Company (MSFC) Act, and the Credit Cooperative Act. These acts together combined to establish a legal regulatory framework for informal money lenders.

First of all, the STFC Act targeted large money lenders by formalizing them as short-term investment finance companies (called *dan-ja-hoi-sa*) that specialized in commercial paper (CP) for large companies and call-market loans. STFCs were subject to a regulatory capital of requirement of at least 500 million and a lending limit of 15 times its capital base. Inevitably, many of these STFCs were established by large-sized companies and *chaebols*, which had deep pockets. As seen in <Table 5-11>, a total of seven finance companies were established in 1973 short after the STFC Act was introduced. Amongst them, five STFCs were affiliates of *chaebols*, including Daewoo, Lucky (LG) and Haitai.

On the other hand, the MSFC Act targeted smaller money lenders in the informal credit market. The small money lenders were formalized as MSFCs to provide small loans to small and self-employed businesses and low-income households with limited access to commercial banks. As a regulatory capital requirement, MFSCs had to have at least 15 Million Won to 50 Million Won of capital depending on the region it was located. They were also subject to a lending limit of 10 times their capital. STFCs and MSFCs were allowed to set their interest rates freely as long as the rates were below the limit set by the financial authority.

As will be discussed further later, a legal regulatory framework was also established for all types of cooperative financial institutions (CFIs) in Korea, such as credit unions, agricultural cooperatives, and village cooperatives, etc. Since the act was established in 1972, interest rates of credit cooperatives were regulated by the financial authority.

Table 5-11 | Largest Shareholders of STFCs

(As of the end of 1985)

	Name	Dates Established	Major Shareholder
Located in Seoul	Korea	71. 6	Long-term Credit Bank
	Seoul	73. 1	Seoul Trust Bank
	Hanyang	73. 6	Doosan, Kolon, Bumyang Ship
	Daehan	73. 7	Haitai
	Dongyang	73. 7	Daewoo
	Choongang	73. 7	Dongkuk Steel
	Jeil	77. 7	Korean Japanese
	Shinhan	82. 10	Kukje
	Hanil	82. 10	individual
	Koryo	82. 11	Dongah
	Samsam	82. 11	Sambu, Samhwan
	Dongah	82. 11	individual
	Samhee	82. 11	Hankuk Hwayak (HanHwa)
	Kukmin	82. 11	Dongbu
	Keumsung	82. 11	Goldstar
Taepyungyang	82. 11	individual	
Located in Local areas	Busan	73. 5	Lucky
	Youngnam	73. 6	Youngnam Education
	Kwangjoo	74. 6	Keumho
	Donghai	74. 10	Hyundai, Kukje
	Jeonbuk	79. 11	Group of small regional businesses
	Kyungnam	79. 11	Group of small regional businesses
	Daegu	79. 11	Kolon
	Daejeon	79. 12	Dongyang Nylon
	Incheon	79. 12	Sunkyung
	Hangdo	80. 9	Group of small regional businesses
	Choongbuk	80. 9	Choongbang
	Ulsan	81. 10	Hyundai Heavy
	Kyungsoo	81. 11	Group of small regional businesses
	Shinra	83. 1	Group of small regional businesses
	Kwangmyung	83. 5	Kwangmyung Construction

Source: National Association of Short-term Finance and Companies, Cited from Kim, Joon-Kyung (1999), p14

After the 1972 Presidential Decree, the newly established STFCs and MSFCs, or NBFIs, began to attract funds from the informal credit market, particularly because they were able to set interest rates freely. For example, the MSFC attracted more deposits due to their ability to offer higher interest rate than other financial institutions, as seen in the <Table 5-12>.

Table 5-12 | Deposit Growth and Interest Rates at MSFCs and Credit Unions

		1980-83	1984-86	1987-88	1989-90
Mutual Savings Finance Companies	Annual average interest rate above bank rate	6.6%	3.0%	2.5%	3.8%
	Annual average deposit growth rate	53.2%	37.8%	17.0%	33.4%
Credit Unions	Annual interest rate above bank rate	1.1%	1.0%	1.0%	1.0%
	Annual average deposit growth rate	57.3%	22.5%	38.6%	39.8%

Note 1) interest rates are based on time deposit for maturity of 1-2 years

Source: National Credit Union Federation of Korea (NACUFK), National Association of Mutual Savings and Financial Companies, Bank of Korea, Cited from Kim, Joon-Kyung et. al (1992)

The main, and most likely, the only advantage of MSFCs was their ability to offer higher interest rates compared to commercial banks whose interest rates were regulated. Indeed, the selling point of MSFCs was higher interest rate rather than their branch network or types of services and products they could offer. A survey of 500 MSFC customers conducted by the Association of MSFCs in 1988 shows that high interest rate were the key selling point for nearly 51% of the customers surveyed <Table 5-13>. MSFCs operated more like commercial banks in that they collected deposits and relied on profits from higher interest rates, as opposed to CFIs which have to rely on and serve their members by taking a relationship-based approach. Indeed, MSFCs were did make an effort to serve their customers considering that most depositors of MSFCs (84.4%) had to go to the MSFCs to make deposits instead of having bankers go directly to the location of customers to collect deposits. The MSFCs were generally focused on short-term transactions, and they did not take a relationship-based approach in servicing customers. Most of their relationships with customers lasted less than 2 years (42.1%).

Table 5-13 | Survey Results of MSFC Customers

(Unit: %)

Motivation for Banking with MSFCs ¹⁾		How Customers Made Deposits ²⁾		Transaction Period ²⁾	
1. High deposit interest rate	50.8	1. At the bank	84.4 [66.0]	1. Less than 1 year	18.0
2. Simplified loan process	20.4	2. Deposits by the transfer	11.3 [33.5]	2. 1-2 years	24.1
3. Solicitation by MSFC staffs	13.5	3. Sending bankers to the customers	4.3 [0.5]	3. 2-3years	23.9
4. Customer friendly	8.4			4. 3-5 years	16.8
5. Safe	6.9			5. 5-7 years	9.3
				6. more than 7 years	7.9

Note: 1) 1988 survey result

2) 1990 survey result

3) Figures in () are Seoul

Source: Cited from Kim, Joon-Kyung (1991), p17

MSFCs were required by law to provide loans to small business with less than 100 workers. As such, Korean small and medium enterprises (SMEs), which were unable to access credit from commercial banks, came to rely on MSFCs. <Table 5-14> shows that SMEs with less than 100 workers accounted for 8-10% of total borrowings from MSFCs as of 1990. <Table 5-14> also shows that the informal credit market accounted for small share of total borrowings for SMEs, although the smallest businesses with less than 10 workers were the biggest borrowers of informal loans. As seen in <Table 5-15>, SMEs borrowed informal loans largely from relatives/friends.

Table 5-14 | Source of Borrowing for SMEs by Firm Size

(Unit: %, As of 1990)

	Banks	NBFIs	Corporate Bond	Informal Credit Market	Other	Total
5-9 workers	78.5	8.4	0.0	13.0	0.1	100
10-19 workers	84.4	10.4	0.0	5.0	0.2	100
Small-size firms	82.8	9.8	0.0	7.2	0.2	100
20-49 workers	86.7	8.1	0.2	1.9	3.1	100
50-99 workers	86.7	8.4	2.8	0.7	1.4	100
100-199 workers	72.5	16.1	10.3	0.5	0.6	100
200-299 workers	66.9	12.9	19.3	0.9	0.0	100
Medium-size firms	77.9	11.9	7.9	0.9	1.3	100
SMEs	78.5	11.7	7.0	1.7	1.1	100

Source: Kukmin Bank, *Report of Financial Situation for SMEs*, 1991. Cited from Kim, Joon-Kyung et. al (1992), p10

Table 5-15 | Sources of Informal Loans for SMEs

(Unit: %, As of 1990)

	Moneylenders	Relatives/Friends	Transaction Firms	Total
5-9 workers	22.6	73.3	4.1	100
10-19 workers	15.4	83.6	1.0	100
20-299 workers	31.3	66.5	2.2	100
SMEs	24.9	72.7	2.4	100

Source: Kukmin Bank, *Report of Financial Situation for SMEs, 1991*. Cited from Kim, Joon-Kyung et. al (1992), p11

<Table 5-16> shows the uses of the informal loans, along with the terms and conditions as of 1990. The share of loans used to fund operating capital was 81.4%, and most of the loans were less than 6 months in maturity. <Table 5-17> shows that the most of loans were secured with real estate as collateral while the informal loans were largely unsecured.

Table 5-16 | Terms and Conditions of Informal Loans

(Unit: %, As of 1990)

	Uses of Loans		Borrowing Period (Maturity)				Monthly Interest Rate
	Operating Expenses	Non-Operating Expenses	Less than 1 Month	1-6 Months	6-12 Months	More than 1 year	
5-9 workers	76.4	25.4	4.9	44.6	30.6	19.9	2.05
10-19 workers	79.9	20.1	4.8	57.0	23.8	14.4	1.99
20-49 workers	82.0	18.0	14.7	73.2	5.7	6.4	1.92
50-99 workers	90.8	9.2	2.4	76.6	21.0	0.0	1.92
100-199 workers	100	0.0	0.0	4.1	95.9	0.0	1.78
200-299 workers	96.2	3.8	0.0	10.5	89.5	0.0	1.82
SMEs	81.4	18.6	7.7	56.7	24.6	11.0	1.96

Source: Kukmin Bank, *Report of Financial Situation for SMEs, 1991*. Cited from Kim, Joon-Kyung et. al(1992), p12

Table 5-17 | Type of Security Used for SME Loans

(Unit: %, As of 1990)

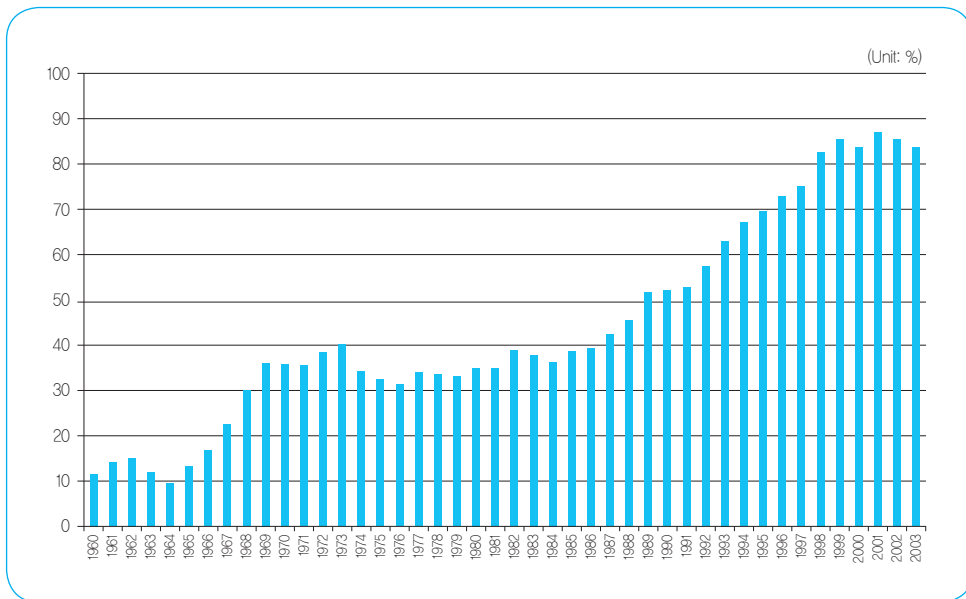
	Bank Loans		NBFi Loans		Informal Loans	
	5-9 workers	10-19 workers	5-9 workers	10-19 workers	5-9 workers	10-19 workers
Real estate	75.6	75.8	77.2	31.6	15.9	10.7
Non-collateralized	10.6	7.0	11.3	43.2	84.1	89.3
Credit guarantee	13.8	16.1	11.5	2.4	0.0	0.0
Personal Guarantee	0.0	0.6	0.0	22.0	0.0	0.0
other	0.0	0.5	0.0	0.8	0.0	0.0
Total	100	100	100	100	100	100

Source: Kukmin Bank, *Report of Financial Situation for SMEs*, 1991. Cited from Kim, Joon-Kyung et. al (1992), p13

Korea's total liquidity over GDP ratio stayed relatively flat during the 1970s until the early 1980s, which was due to high inflation and low regulated interest rates in the banking sector (See [Figure 5-4]). As such, the new regulatory environment set up for STFCs and MSFCs combined with low interest rates in the banking sector did not lead to a sharp expansion of funds into the formal financial sector. We can assume the increase in deposits among NBFIs was largely due to the fact that they could offer higher interest rates which would have drawn funds from the informal market and formal market. As such, we can conclude that there was not a great deal of financial deepening during this period.

In the meantime, as seen in <Table 5-12>, the deposits of credit unions steadily expanded during the 1980s despite the fact that they offered lower interest rates compared to the MSFCs. The number of credit unions and members increased steadily since their establishment in the 1960s.

Figure 5-4 | Liquid Liability (M3)/GDP



Source: World Development Indicators

2012 Modularization of Korea's Development Experience
Institutionalization of the Informal Credit Market
and Financial Inclusion in Korea

Chapter 6

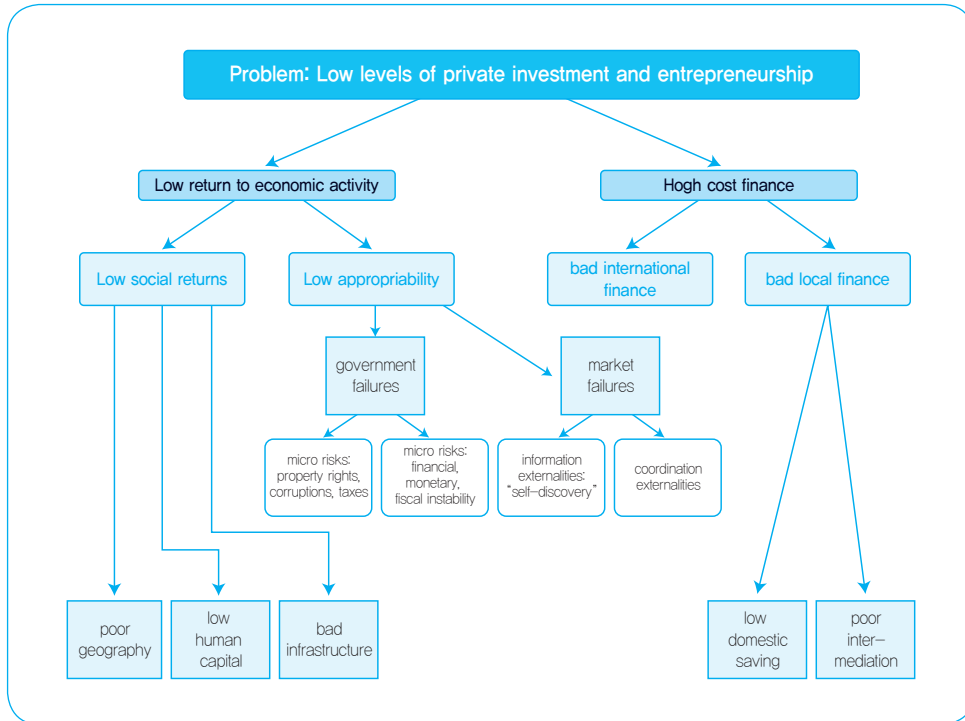
Financial Inclusion and Cooperative Financial Institutions in Rural Korea

1. Credit Unions
2. Agricultural Cooperatives
3. Village Cooperatives (Community Credit Cooperatives)

Financial Inclusion and Cooperative Financial Institutions in Rural Korea

The lack of access to basic financial services can often be a binding constraint or obstacle to economic growth and development. Ragnar Nurkse (1953) observed that most farmers in underdeveloped countries were trapped in a “vicious cycle of poverty” due to low income and savings which resulted in low investment. An analysis based on Dani Rodrik’s diagnostic model (2006) (See [Figure 6-1]) would also suggest that high financing costs are often found in underdeveloped settings due to the lack of financial deepening.

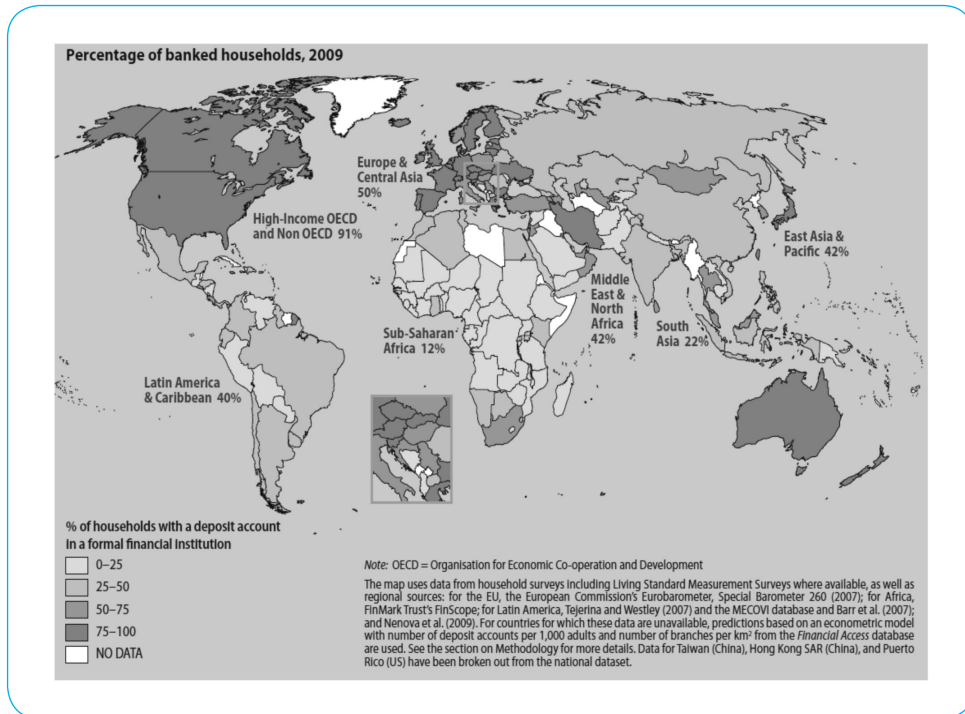
Figure 6-1 | Diagnostic Analysis: Factors behind Low Private Investment and Entrepreneurship



Source: Dani Rodrik (2006), “Goodbye Washington Consensus, Hello Washington Confusion? A Review of the World Bank’s Economic Growth in the 1990s: Learning from a Decade of Reform,” *Journal of Economic Literature*, Vol. XLIV

Indeed, financial development and greater financial inclusion remains a challenge today in development settings. As of 2009, about half of the households in the world had no access to a bank account, according to a study by CGAP (Consultative Group to Assist the poor) and World Bank Group. The percentage of households having deposit accounts in a formal financial institution (banks and non-bank financial institutions such as CFIs) varies greatly across countries. Financial inclusion in the Democratic Republic of Congo and Afghanistan was less than 1%. Indeed, the low levels of financial inclusion – providing access to financial services for all – represent an *obstacle* to economic development.

Figure 6-2 | Percentage of Banked Households (2009)



Source: *Financial Access* 2010, World Bank Group

1. Credit Unions

Credit unions were important to raising the level of financial inclusion in Korea, especially in the *rural* sector since 1960s. The introduction and evolution of these Cooperative Financial Institutions (CFIs) offer a unique perspective into Korea's financial development and inclusion. In particular, the introduction of credit unions in Korea was spontaneous effort on the part of the private not the public sector. In contrary, the conventional thinking is that some government intervention is inevitable to establish and nurture CFIs. [Box 6-1] describes the general definition and key features of credit cooperatives.

Box 6-1 | What is Cooperative Financial Institution (CFI)?

CFIs are composed of member-owners who both supply and use the funds (principle of identity). In contrast, owners (shareholders) of banks are clearly separated from clients. For CFIs, another key feature is the principle of one-person/one vote. According to the Statement on the Cooperative Identity, promulgated by the International Co-operative Alliance (ICA), a co-operative is defined as “an autonomous association” of persons united voluntarily working together to meet their common needs. “Cooperatives” are based on the values of self-help, self-responsibility, democracy, equality, equity and solidarity. In the tradition of cooperative founders, cooperative members believe in the ethical values of honesty, openness, social responsibility and caring for others (ICA 2008). (Table A) summarizes the key distinctive features of membership of cooperatives compared to the shareholders of banks.

Table A | Key Differences between Members and Shareholders

	Members of CFIs	Shareholders of a public limited company
Inclination of Valuation	Double capacity, member \equiv client \rightarrow stakeholder value ¹⁾	Clear-cut separation between the shareholder and the client \rightarrow shareholder value
Voting right	One person, one vote (the member is considered for what he is, not what he financially represents)	One share, one vote when applied (the shareholder is considered for what he financially represents)
Motives	‘co-operative dividend’ (social interactions and conviviality) beyond financial interest	Financial dividend (individual financial interests)
What to seek effective value	Seek high quality products at a convenient price, in a long-term relationship with the CFIs	Seek short-term return on shares (possible conflict with the clients)
Participation within the system	Involved at several levels of the organization: local, regional and national	Involved in case of significant shareholding, at the central level (board)
Claims on net assets	None ²⁾	Yes
Stability of return	Remuneration of co-operative share: stable over time	Return on listed shares (more or less) volatile
Benefits	Specific benefits for members (products, services, events)	No specific events ³⁾

Note: 1) Thus, there is no ground for a conflict of interests between shareholders and clients

2) Italian Banche Popolari provides their members a proportional claim to the net assets, as appropriation of operating profit to reserves is subject to company income tax

3) French Crédit Agricole S.A. provides specific benefits for shareholders

Source: European Association of Co-operative Banks, “60 Million Members in Co-operative Banks: What does it mean” (2007, p.6)

In 1960, the first credit union (named Holy Family Credit Union) was established in Korea in the city of Busan by members of a catholic hospital. The original members of the Holy Family Credit Union totaled 27 and staffed with workers from the hospital and the National Catholic Welfare Conference, a catholic relief service. Sister Mary Gabriella, who has been called the Mother of the Korean Credit Union Movement, introduced the Antigonish Movement¹⁴ in Canada and established a charter for a primary credit union borrowed from the United States.

The charter for the Holy Family Credit Union outlined the following: Article 2 (Mission) stated that the objective of credit unions was to provide members with a way to save in order to encourage diligence and prudence among members. The saving would then be pooled to provide loans at fair interest rates for productive purposes in a way that mutually benefits the members of the credit union. Article 3 (Membership eligibility) stated that credit unions must be established to serve their own members only. Credit unions can only be established among members that share a common bond like being member of an organization, and place of work and home. Article 24 (One person One vote) stated that one person will be allocated only one vote regardless of their ownership amount.

After the first credit union was introduced, other credit unions began to be established based on the same model. Sister Gabriella emphasized a policy of “Education First” in that anyone who wanted to be a member of the credit union had to participate in a five day

14. The Antigonish Movement was grassroots movement based on principles of cooperatives and education. This Movement was voluntary and private-initiative to help small fishermen in Nova Scotia, Canada improve their economic and social circumstances. A group of priests and educators, including Father Jimmy Tompkins and Moses Coady among others led this movement by promoting and instilling ideals of voluntarism among leaders of fishing village. Tompkins and Coady discussed and promoted to the villagers the Antigonish Movement which is based on the ideals of self-help through group forums or study club. This eventually led to the creation of the first maritime cooperatives in Canada. The following conversation between Coady and villagers recorded during Coady’s visit to Antigonish in early 1930s highlights ideals of self-help:

Coady: How are you doing these days?

Villagers: Life is very difficult. We can barely make a living. When weather conditions are bad, we cannot catch any fish. And when the weather is good and can catch fishes, we cannot get a decent price for fishes.

Coady: Who do you sell your fish to?

Villagers: We sell our fish to a wholesale merchant in Boston, US.

Coady: I see. What is the price of fish per kilogram?

Villagers: We can only sell our fish at a very low price

Coady: Then, do you know the price the merchant at Boston sells the fish to the customers?

Villagers: No. How would we know?

Coady: Why don't you check by calling Boston?

Villagers: What? We do not even know how to make a call. Could you call for us?

Coady: I am not sure as well. This is your problems so you should find a way to solve it by yourself.
(Coady then leaves the villagers)

training course. And on the sixth day, candidates for the board of directors were elected. They then took a three day special training program. The practices of the Holy Family Credit Union set an example for numerous credit unions to follow (Lee, Sangho, 2002).

To disseminate the benefits of the Holy Family CU, Sister Gabriella established a Cooperative Leader Training Center in February 1962 to train CU leaders. The newly trained leaders then returned to their home towns and led the established of their own credit unions. The funds to pay for the costs of running the training center came from various sources including the Mizereo Foundation in West Germany, the NCWC (National Catholic Welfare Conference) in the US, and the Asia Foundation.

Korea's Credit Union Association (KCUA) was established in 1964. In the early stage, the KCUA received a considerable amount of foreign aid from international organizations such as CUNA International, Asia Foundation, US Aid, and so on as seen in <Table 6-1>. The share of foreign assistance to total revenues for KCUA reached 79% as of October 1965. Despite the foreign aid, the association initiated efforts to become self-sustainable as soon as possible by increasing the membership fee from primary credit unions. From the beginning, KCUA encouraged primary credit unions to collect membership fees based on one the principle of one member/one Won. Later, the Association charged 30-45 Won per member of a primary credit union during 1967-73.

Table 6-1 | Foreign Assistance to Korea's Credit Union Association

(As of Jan 31, 1972)

Source	Type of Assistance	Amount	Year
Asia Foundation	Education/Establishment of New Credit Unions	500,000 Won	1965
CUNA	Education and Training	US \$2,500	1965
Pusan Diocese Catholic Church	Education and Training	US \$3,000	1965
LARA	Education and Financial Support for Operation of the KCUA	US \$2,000	1965
AID	Education and Training Support	35,000,000 Won	1968
Christian Reform Mission	Education and Training Support		1971 1972
UNDP	Education and Training Support		1972

Source: 30-year History of Korea's Credit Union Movement (p. 169)

Table 6-2 | Korea's Credit Union Association Membership Fees for 1968

Region	Number of CUs Charged a Fee	Number of CUs Paying Fees	Total Amount of Fees (A)	Total Amount of Fees Paid (B)	B/A
Seoul	17	10	299,680	215,285	75%
Busan	18	9	351,603	190,245	54%
Inchon	15	8	174,294	102,681	59%
North Choongchung	16	12	105,556	67,647	64%
South Choongchung	7	5	22,684	18,020	79%
North Kyungsang	10	6	39,806	25,803	64%
South Kyungsang	19	6	110,242	50,050	46%
Jeju	6	2	29,354	8,500	28%
Namhae	6	1	8,355	1,724	21%
Geoje	8	1	33,829	3,000	4%
Other	8	4	31,585	19,801	63%
Total	130	64	1,206,988	702,756	58%

Source: 30-year History of Korea's Credit Union Movement (p. 156)

In the process of enacting Korea's law on credit cooperatives, the principles of volunteer-based, autonomy, and self-help, were also promoted. The Holy Family Credit Union established a committee on its own to study and research credit cooperative laws in other countries. In particular, discussions on enacting a statutory basis for credit cooperatives were initiated in earnest in 1964 when the association was established. The association wanted the following principles of cooperatives be included in the by-laws (30-year History of Korea's Credit Union Movement). First, government supervision should be minimized as much as possible and limited to requirements that ensure the well-functioning of credit unions, thereby, guarding the founding principles of credit unions including independence, self-reliance, and self-help. Second, the process of registering and obtaining approval from the Minister of Finance for the establishment of new credit unions should be streamlined due to the small size of credit unions. Third, new members must undergo education and training on cooperatives. In 1972, the Credit Cooperative Law was enacted. This not only legitimized the establishment of credit unions but also established a legal framework for operating credit unions. For example, it established a legal means of collecting unpaid loans.

Korea's credit union movement had a significant impact on increasing financial inclusion, particularly in rural areas. For the first time, many poor Koreans in rural regions were able to get access to a real deposit account. Although their savings may have been meager, it provided a sense of being part of the greater society, instilling further hope and confidence

for a better future. As seen in <Table 6-3>, CFIs were prominent at the local level, as the members were from the same community. Unlike regional based financial institutions like MSFCs, credit unions were able to flourish in rural communities. Moreover, the practices and values of cooperatives such as elections based on the principle of one person having one vote contributed to moving Korea towards a more open democratic-based society. Indeed, Korea's experience shows how credit cooperatives can be promoted through a bottom-up approach without direct government intervention.

Table 6-3 | Distribution of Financial Institutions by Region

(As of the end of 1991)

	MSFCs ²⁾		Credit Unions		Local Banks ³⁾		Commercial Banks ³⁾	
	Number	Share	Number	Share	Number	Share	Number	Share
Seoul	75	22.5%	229	16.7%	25	3.9%	1,005	59.3%
Busan	38	11.4%	69	5.0%	114	17.9%	142	8.4%
Inchon/Kyunggi	59	17.5%	162	11.8%	81	12.7%	188	11.1%
Other ¹⁾	40	12.0%	218	15.9%	157	24.6%	135	8.0%
Other region (City, County, Eup)	122	36.5%	691	50.5%	261	40.9%	225	13.3%
Total	334	100%	1,369	100%	638	100%	1,695	100%

Note: 1) City, County, and Eup

2) As of the end of June 1991.

3) As of the end of 1990

Source: National Mutual Savings and Finance Companies Association, NACUFK, Bank of Korea, Bank Management Statistics, 1991.

A survey of 1,120 credit union members conducted by the NACUFK in 1985 shows that 32% of the members believed that credit unions were convenient <Table 6-4>. Moreover, 28% of the members believed that sharing a common bond was an important motivation to joining a credit union. Nearly 30% of the members had a relationship with the credit union for longer than five years. This suggests that members had other motives rather than just financial reasons for becoming a member of the credit union.

Table 6-4 | Survey Results of Credit Union Members

(Unit: %)

Motivation for Banking at MSFCs		Method of Depositing		Transaction Period	
1. More convenient	31.6	At the bank	70.3	Less than 1 year	12.4
2. Common bond with other members	27.9	Deposits by the transfer	28.3	1-2 years	14.0
3. Simplified loan process	15.9	Sending bankers to the	1.5	2-3 years	19.1
4. Custom friendly	9.1	customers		3-5 years	24.5
3. Safe	6.4			5-10 years	23.0
4. To be the board member	3.1			More than 10 years	7.0
5. Good return	1.9				
6. Others	4.2				

Note 1): 1985 survey result

Source: Cited from Joon-Kyung Kim and Cheol-yong Kim (1992)

2. Agricultural Cooperatives

After the foundation of the Republic of Korea in 1948, the government began to work on establishing a legal framework for agricultural cooperatives based on self-help and cooperation to assist rural farmers. This was promoted together with efforts to implement land reform. But the enactment of the agricultural cooperative law was delayed because the government was debating whether primary cooperatives should be authorized to extend credit or only allowed to facilitate the procurement and sales of agricultural resources. The government did not believe the cooperatives had the capacity to offer financial loans essentially. When the act was eventually passed in 1957, agricultural cooperatives were only given the economic functions of supplying and marketing agricultural goods. Under separate act legislation, the financial function was actually given to the Agricultural Bank which was also established at the same time and owned by the government. The Agricultural Bank was supposed to provide credit to individual primary cooperatives, however, most of the financing was given to agricultural businesses.

Immediately after the military coup in 1961, the Agricultural Bank was reorganized to form the National Agricultural Cooperative Federation (NACF). Moreover, primary agricultural cooperatives were authorized to offer credit. As of 1961, there were a total of 21,042 primary cooperatives with an average of 82 members. Even this did not improve the functioning of the cooperatives due to their small scale. A number of factors could have contributed to the inactivation of cooperatives including highly indebted farmers with usury loans, lack of income, and restrictions against farmers using their land as collateral. As such, the government facilitated the consolidation of the primary cooperatives. As a result,

the number of primary cooperatives decreased to 16,963 in 1967 and further to 1,549 in 1973 (See <Table 6-5>).

Table 6-5 | Consolidation of Primary Agricultural Cooperatives

	Number of Coops	Number of Members	Number of Members per Coop	Note
1961	21,042	1,727,000	82	Early Establishment of Coops
1962	21,518	2,176,000	101	
1964	18,963	2,242,000	118	1 st Round of Restructuring
1967	16,963	2,243,000	132	
1969	7,525	2,241,000	298	2 nd Round of Restructuring
1972	1,567	2,183,000	1,393	
1973	1,549	2,062,000	1,331	Post-Restructuring
1981	1,476	2,076,000	1,407	

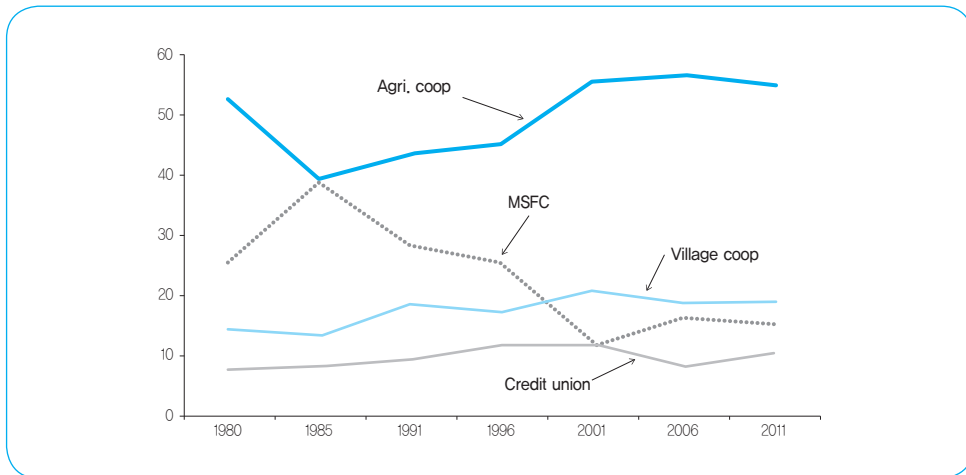
Source: National Agricultural Cooperative Federation, 「The 20 year history of NACF」, 1982, p.135, recited from Park, et. Al (2012)

From the beginning, agricultural cooperatives were used as policy instruments of the government in the rural sector. The government passed the temporary law in 1962 which basically outlined that the appointment and dismissal of a primary cooperative’s president was made by the president of NACF, with the approval of the Minister of the Agriculture and Forestry. This also meant that the president was not subject to term limit. As discussed in the previous chapter, agricultural cooperatives played a key role in rural debt-relief program implemented in the 1960s, acting as an intermediary between usury borrowers and lenders. During the 1960s and 1970s, agricultural cooperatives provided subsidized loans to agricultural related businesses to finance the procurement and distribution of goods such as fertilizer, pesticide, and equipment. Beginning in 1969, agricultural cooperatives began to receive deposits from members of primary cooperatives. The deposits began to grow rapidly as rural income began to also increase. As can be seen in [Figure 6-3] and [Figure 6-4], the share of agricultural cooperatives based on deposits and loans in the regional financial sector grew by 52% and 35% in 1980, respectively. In 1988, the temporary law for appointing the presidents of agricultural cooperatives was abolished, which allowed presidents to be elected by members.

So it is difficult to assess the impact of agricultural cooperatives on Korea’s financial development. On the one hand, the top-down approach would have hindered the development and well-functioning of agricultural cooperatives, which are supposed to act autonomously

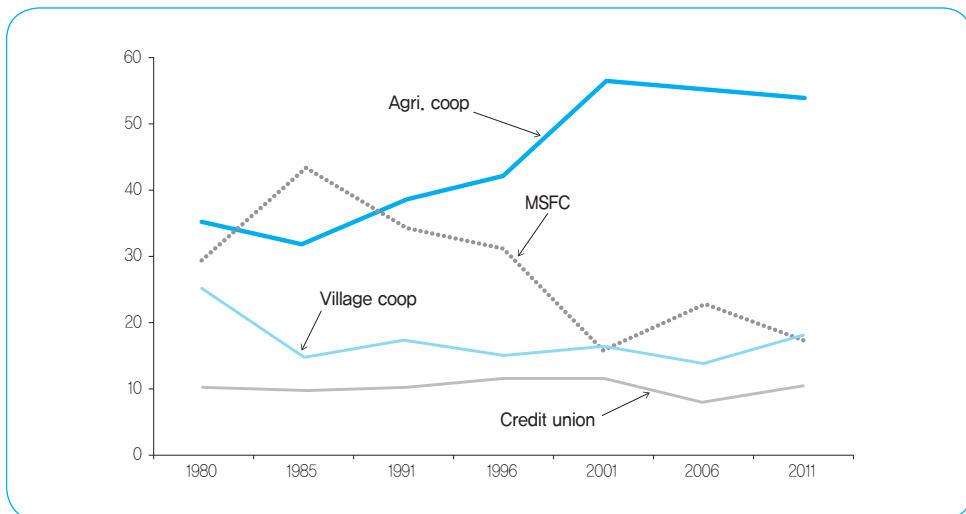
and independently. On the other hand, agricultural cooperatives may have had a positive impact on financial development if it helped to achieve the government's policy goals.

Figure 6-3 | Share of Deposits by MSFCs and CFIs



Source: Bank of Korea

Figure 6-4 | Share of Loans by MSFCs and CFIs

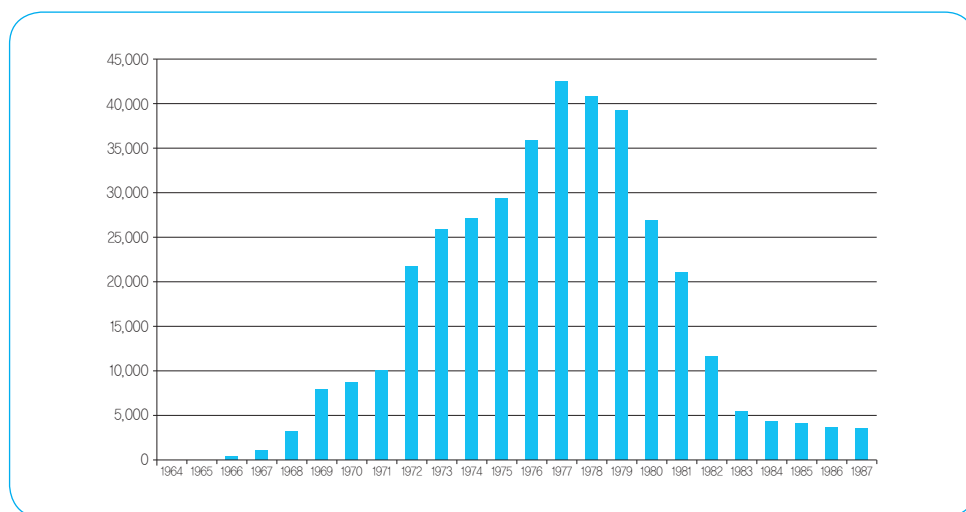


Source: Bank of Korea

3. Village Cooperatives (Community Credit Cooperatives)

During the 1970s, Korea saw a rapid expansion of “village cooperatives” when the *Saemaul* Movement, or New Village Movement, was promoted as part of the government’s rural development efforts. The *Saemaul* Movement was a Community Driven Development (CDD) Program that sought to increase the income of farmers and rural living standards by promoting the principles of self-help, diligence and cooperation. Because the village or community coops grew during the government’s promotion of the *Saemaul* Movement, there has also been a strong association with the Movement. The rapid ascent of village coops was as steep as its eventual fall, as seen in [Figure 6-5]. The eventual demise of village coop can be attributed to over-intervention on the part of the government.

Figure 6-5 | Number of Village Cooperatives



Source: Village Cooperatives Associations

The village coops were different from Korea’s credit unions, but their origins can be traced back to the introduction of credit unions, which began in city of Busan and spread through the region. Unlike the organic expansion of credit unions, the promotion of village cooperatives was deliberate, and targeted specifically for villages in rural areas in 1961 as part of Korea’s National Reconstruction Movement. The early pioneers of village coops attended the credit union training programs. In 1963, five village coops were established, which at that time were treated credit unions. The early village coops emulated many of the basic principles of credit unions, and even used the same name for the coops. By the end of the 1964, the number of village coops grew to 81.

The *Saemaul* Movement helped to increase the income of farmers by promoting community development projects which were implemented with government assistance. For instance, the government provided raw materials for development projects to rural villages that worked together while espousing the values of *Saemaul* including cooperation, self-reliance, and diligence. The government also promoted a Savings Reinvestment Program to develop the village economy. The program sought to promote income opportunities for farmers through community development projects. The idea was to generate income opportunities and reinforce the virtue of savings and investment which in turn would lead to more income and savings. A village fund was created in each village to save a portion the profits that came from the projects. The savings was then reinvested to finance future community development projects. The government promoted savings among farmers by providing financial and technical assistance for agricultural businesses and recommending that as much as 50% of the profits be saved in the village fund. As income grew, farmers purchased shares of the village coops. This allowed capital to be accumulated and mobilized through the village coops. <Table 6-6> shows how the government and villagers cooperated in funding community development projects through an equal cost sharing arrangement.

Table 6-6 | Source of Financing of *Saemaul* Projects

(Unit: Billion Won)

	Total	Government support			Financed by Villages	
		Sub-Total	Central Government	Local Government		Loans and Misc
1971	12.2 (100%)	4.1(34%)	2.7	1.4	-	8.1 (66%)
1975	295.9(100%)	165.3 (56%)	66.6	57.9	40.8	130.6 (44%)
1979	758.2 (100%)	425.2 (56%)	125.8	101.0	198.4	333.0 (44%)
1971-1980	3,425.1 (100%)	1,733.9 (51%)	488.7	463.6	781.6	1,691.2 (49%)

Source: Ministry of Internal Affairs

According to a survey by Hong (1976), village coops contributed to providing access to loans outside of the informal credit markets. The survey results show that 74% of the villagers relied on village coops compared to other sources of credit <Table 6-6>. Village coops were able to offer loans at a lower interest rate to coop members since these members had built a record of savings and loan repayments which could be used to make a credit assessment. Thus, farmers did not have to rely on the informal market or put up collateral to access loans. Instead, farmers could access loans based on their creditworthiness. Indeed, many farmers were able to refinance usury loans with lower interest loans offered by their coops (See <Table 6-7>).

Table 6-7 | Location of Farmers' Savings based on Annual Income in 1975

	Greater than 1.5 Million Won	0.5-1.5 Million Won	Less than 0.5 Million Won	Total
Agricultural Cooperative	5 (20%)	16 (18%)	7 (13%)	28 (17%)
Village Cooperative	17 (68%)	66 (76%)	41 (75%)	124 (74%)
Informal Credit Market	2 (8%)	2 (2%)	4 (7%)	8 (5%)
Others	1 (4%)	1 (1%)	-	2 (1%)
No response	-	2 (2%)	3 (6%)	5 (3%)
Total	25	87	55	167 (100%)

Source: Hong, Hyun-sun (1976)

Table 6-8 | Uses of Loans from Village Coops

(Unit: Billion Won, As of 1975)

	Amount	Share (%)
Farming	8.7	41%
Non-farming	5.0	24%
Healthcare and others	2.1	10%
Education	1.4	7%
environmental improvement/ housing improvement/environmental infrastructure construction(improvement)	1.4	7%
Refinancing Usury Loans	2.3	11%
Total	20.9	100%

Source: Village Cooperatives Association, Hong, Hyun-sun (1976, p42)

By the late 1970s, village coops began to lose their independence and autonomy due to over support and promotion of village coops by the government. The government made a push to create one cooperative in every village, after determining that in villages that had a village coop also produced better development outcomes. The government's heavy handed support led local government officials to only promote the establishment of village coops. After peaking in 1977, the number of village coops decreased significantly, which led to massive restructuring. In the end, there were no village coops left at the rural level, only at the county level. Even though village coops and credit union are governed by different laws and supervisors, village coops essentially operated similarly to credit unions. In fact, they shared the same location, practices, and even members.

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Chapter 7

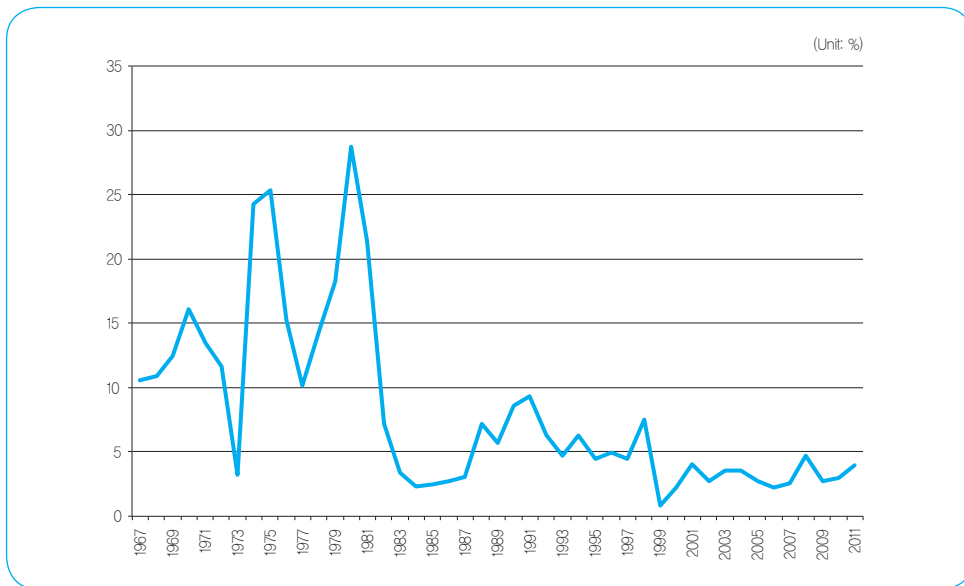
Macro Stability, Liberalization and Decline
of Informal Credit Market in the 1980s

Macro Stability, Liberalization and Decline of Informal Credit Market in the 1980s

The macro-economic stability measures of the 1980s led to a sharp drop in inflation which was persistently high since the late 1970s. The Chun Doo-Hwan government, which came into power in 1980, ushered in a new direction in economic policy which was squarely focused on achieving macroeconomic stability and structural reform. This meant fiscal and monetary tightening to subdue inflationary pressures, downsizing of export financing and HCI (heavy and chemical industry) investment, trade and financial liberalization, and policies on increasing competition. A tighter fiscal policy was at the center of the stabilization program. The budget was reformulated from a zero base to achieve across-the-board expenditure cuts. Monetary policy was also tightened to fight inflation. Moreover, the government was also implemented measures to limit wage growth. The stabilization policy was quite successful in reigning in inflation, which fell quickly to 3.4% by 1983, down from over 28.7% in 1980, as can be seen in [Figure 7-1].¹⁵

15. The current account deficit in proportion to GDP also fell to 1.8% by 1983 from its peak of 6.6% in 1979.

Figure 7-1 | Inflation Rate (Consumer Price Index)

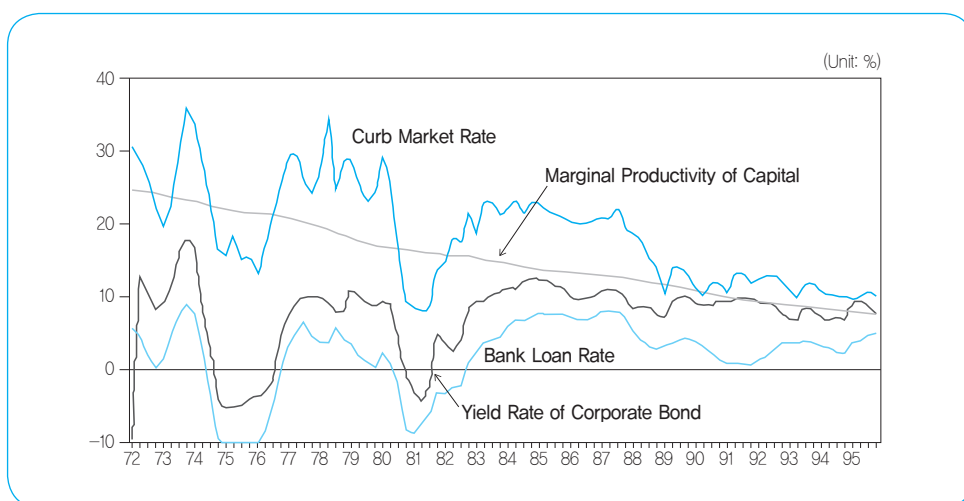


Source: World Bank, World Development Indicators ([http:// data.worldbank.org/data-catalog/world-development-indicators](http://data.worldbank.org/data-catalog/world-development-indicators))

The macro-economic stability measures helped led to positive real interest rates which set the stage for the decline of informal credit markets. (See [Figure 7-2]) Its decline was further steepened by a set of financial liberalization measures such as bank privatization, reduction of policy loans, interest rate liberalization, entry deregulation of banks and NBFIs and introduction of financial products for banks. In particular, the financial deregulation that allowed banks to offer higher yielding trust accounts had the largest impact on diverting funds to the formal banking sector. Starting in 1983, funds flooded back into banks and NBFIs. As a result, the Liquid Liability/GDP ratio, which is an indicator of financial deepening, which stagnated during 1970s began to increase sharply starting in the early 1980s (See [Figure 5-3]).

While pursuing macro stability, the Chun Doo-Hwan Government also attempted to implement a package of financial liberalization measures at the same time including.

Figure 7-2 | Real Interest Rate and Marginal Productivity of Capital¹⁶



In June 1981, the government first privatized Hanil Bank which was considered to be the best performer among all commercial banks. However, the bank privatization program was put on hold after two major *chaebols* including Samsung ended up acquiring controlling shares in Hanil bank. While this did not completely stop the privatization process, it subsequently triggered policy debates on the need to impose an ownership ceiling for single companies or individuals. As such, Korea's bank privatization proceeded slowly with little progress.

The outbreak of a financial scandal in May 1982, one of the biggest scandals in Korean financial history that involved the relatives of President Chun led to a greater sense of urgency on pushing ahead with bank privatization and the entry deregulation of commercial banks and NBFIs. Subsequently, two more banks, Korea First and Seoul Bank, were privatized by the end of 1982 and Choheung bank in 1983. Moreover, two commercial banks, Shinhan Bank (July 1982)¹⁷ and the KorAm Bank (March 1983) were created. In addition, the entry barriers for NBFIs were deregulated in 1982 in response to the 1982 financial scandal. Within one year, the number of NBFIs grew quickly, after 12 STFCs were created, many of which were owned by *chaebols* including Kukje, DongAh, HanHwa, DongBu, etc, as seen in <Table 5-2>. In addition, 57 new MSFCs were chartered.

16. We estimate the marginal product to capital using the Cobb-Douglas production function approach in Cho and Oh (1996). We assume a capital-output ratio of 1/3 and depreciation rate of 0.065. We also estimate the potential GDP and capital stock derived from the KDI quarterly model.

17. Shinhan Bank was formed by owners of Korean Japanese STFC (Jeil), which was created in 1977.

As part of the financial deregulation efforts, commercial banks were allowed to offer higher yielding deposits, or trust accounts. Local regional banks were first allowed to offer trust accounts starting in May 1983, then commercial banks starting in February 1984. This led to the rapid growth of trust accounts, which helped to raise the profitability of banks. It also allowed banks to better compete against NBFIs which could offer higher interest rates.

Even after the privatization of the banks, the government continued to influence the management of the banks. For instance, a bank's board of directors, which did not have a clearly defined role, was powerless against the government. Through privatized in form, the government heavily regulated the commercial banks and intervened in the credit market. The government's policy efforts were focused on steering more funds into small and medium enterprises (SMEs). The new emphasis on subsidizing SMEs was driven by Korea's political democratization and increased demand for social equity.¹⁸ Moreover, the government used the commercial banks to limit economic power being concentrated in the hands of the *chaebols*. In 1987, the government capped the amount of loans to the nation's 30 largest *chaebols* could borrow at each bank. The government also tried to reduce bank financing to *chaebols* more directly. The Bank Supervisory Board made the 30 largest *chaebols* raise new capital in the form of equity to repay their bank loans. As such, the supply of credit became scarcer for *chaebols* as the government rationed commercial bank loans to *chaebols* under the credit control system while turning policy focus to the SME sector. This made *chaebols* relatively more reliant on STFCs, which they had owned.

Table 7-1 | Share of Total Bank and NBFI Loans to Top 30 *Chaebols*

(Unit: %)

	1988	1989	1990	1991	1992	1993	1994	1995
Commercial Banks	23.7	20.7	19.8	19.5	19.0	16.6	14.8	13.9
NBFIs	32.4	36.6	37.8	36.6	35.9	37.1	37.2	38.4

Source: The Bank Supervisory Authority of Korea

18. The new government led by Chun Doo-hwan following the bloody coup in 1980 pursued to policies that were driven by achieving social equity, more balanced distribution of income and growth. Immediately following the coup, the new government amended Korea's Constitution which would allow direct government support of SMEs under the principle that "the government must protect and nurture SMEs and their business activities". (Article 124 Clause 2). This populist sentiment was strengthened by new government's pledge on June 29, 1987 for Korea's political democratization which further accelerated government support of SME policies. Most crucial element underlying political democratization is in Article 119, Clause 2 of the Korean Constitution, which states:

"[T]he state may regulate and coordinate economic affairs in order to maintain the balanced growth and stability of the national economy, to ensure proper distribution of income, to prevent the domination of the market and the abuse of economic power and to democratize the economy through harmony among the economic agents". (Quoted from Jwa and Yoon, 2004)

NBFIs could freely set interest rates long before. However, interest rates of commercial banks were generally regulated, except for trust accounts that provided higher yields. As such, the difference between the interest rates offered by NBFIs and commercial banks remained wide until the mid 1990s <Table 7-2>. There are a couple of reasons why interest rates for commercial banks remained regulated until the mid 1990s. First, the BOK was concerned with a possible surge in the M2 money supply if deposit rates were liberalized. The central bank believed that deregulating deposit interest rates for NBFIs, which are not part of M2, while maintaining control over commercial bank interest rates would prevent the rapid growth of money supply. More importantly, the government wanted to keep the cost of funds for SME policy loans low (Y.J. Cho, 2003). As a result, the uneven approach of the government's interest rate liberalization led to the steady expansion of deposits at NBFIs. As [Figure 7-3] shows, NBFIs' share in total deposits increased from less than 30% in the early 1980s to more than 60% in the 1990s. The total amount of deposits at NBFIs surpassed that of commercial banks in 1987. This data should be viewed with some care as trust accounts within the banking system are also included in the total deposits of NBFIs.

Table 7-2 | Average Interest Rates on Deposits for Banks and NBFIs

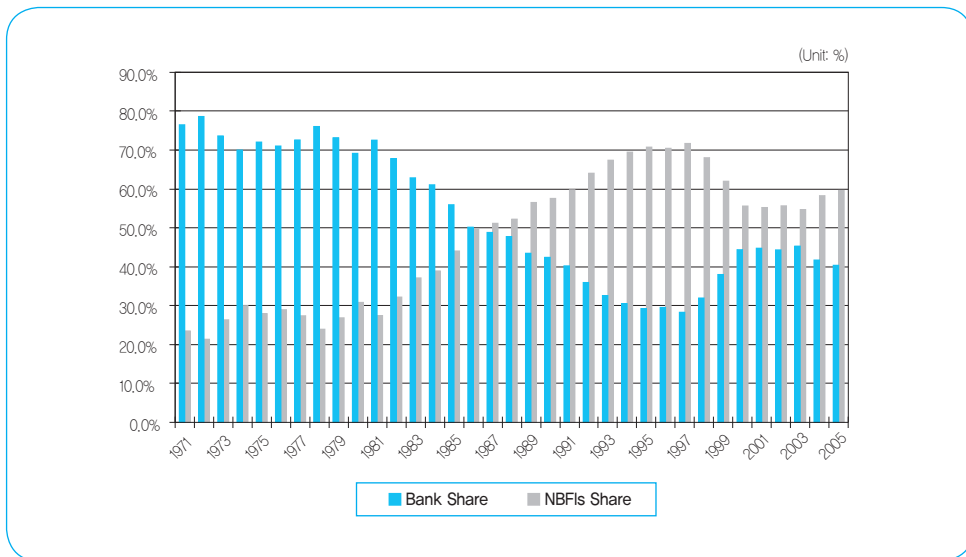
(Unit: %)

	1991	1992	1993	1994	1995	1996	1997
Commercial Bank Time Deposits (6-12 months) [A]	6.0	6.0	5.0	5.0	7.0-9.0	9.3	13.9
STFC Cash Management Account (180 days) [B]	15.0	15.5	11.9	12.9	13.3	11.8	12.6
[B] - [A]	9.0	9.5	6.9	7.9	4.3-6.3	2.5	-1.3

Note: Investment finance companies were transformed to merchant banking corporations in July 1996

Source: Bank of Korea, Monthly Bulletin. Recited from Joon-Ho Hahm (2003)

Figure 7-3 | Growth of Commercial Banks and NBFIs: Shares in Deposits



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Chapter 8

Institution of Real Name Financial System in 1993

1. Informal Credit Markets and the Impact of the Real Name Financial Transaction System

Institution of Real Name Financial System in 1993

As mentioned before, starting in the early 1980s, the new government led by President Chun was committed to securing price stability, thereby, significantly reducing the money supply. This was just before the macro stability measures took effect which meant that the informal credit market was still active and a source of short-term funding for large firms. Against this background, Korea was rocked by a financial scandal erupted that involved family members with distant ties to President Chun. It was the largest financial scandal in Korea's history at that time. The key figure involved in the scandal, Ms. Young-Ja Chang, whose sister was the wife of the First Lady's uncle. Furthermore, Ms. Chang's husband was the former Deputy Chief of the Korea's Central Intelligence Agency (KCIA). Ms. Chang and her husband were major players in the informal credit market due to their ties to President Chun. They were called the "big hand," because of their ability to mobilize huge sums of money, which were used to purchase commercial papers of large firms. These transactions were conducted through financial intermediaries, which kept them off the books. At one point, these commercial paper transactions amounted to almost \$1 billion (about 17% of South Korea's entire money supply). When the scandal broke out, Chang was charged with defrauding the issuers of the commercial papers of about \$250-300 million. It was also rumored that some of the money was diverted to the political funds of the ruling Democratic Justice Party (DJP).

The financial scandal reignited the liberalization efforts which had stalled for several years. It emboldened reform advocates such as Kim Jae-Ik and policymakers from the EPB officials to push ahead considering the large size of the financial scandal and the appearance of deep seeded political corruption. On July 3, 1982, the government announced its intention of instituting regulations that required all financial transactions to have real names starting in July 1983. To promote this measure, the government offered lower comprehensive

income tax rates to individuals that use their real names in financial transactions. At the same time, it sought to penalize individuals that used fictitious name by freezing their assets. However, the reform efforts to institute a real name financial regulation faced great political resistance, and consequently, lost traction. On December 31, 1982, the Real Name Financial Transaction Act was passed by the National Assembly. The act was to go into effect on January 1986. In 1989, the legislation once again ran into opposition from various stakeholders. The legislation finally came into effect on August 12, 1993, about five months after President Kim Young Sam took office. The main goal of the real name financial regulation was to expose hidden assets and transactions which were often used for political slush funds and bribes.

The following were outlined in instituting the real name financial transaction system:

- 1) Real names must be used for all types of financial transactions including bank accounts, CDs, stocks and bonds.
- 2) Real names of account holders at financial institutions must be confirmed. Funds cannot be withdrawn without such confirmation.
- 3) Holders of financial assets under fictitious names must register their names within the next two months (by October 12, 1993).
- 4) Failure to report the real names for an account held under fictitious names within the two month deadline will result in a penalty of up to 60% of the principal asset.
- 5) Account's source of funds held under a fictitious name that has been confirmed with a real name and financial assets less than 50 Million Won will be exempted from investigation.
- 6) Funds withdrawn in the excess of 30 Million Won during two month reporting period will be subject to a tax audit by the National Tax Service (NTS).
- 7) Overseas remittances of more than USD 3,000 will be monitored and overseas real estate holdings will be investigated.
- 8) Accounts suspected of being used for speculating in real estate will be subject to tax audits to minimize speculative real estate activities and adverse effects of implementing the real name financial transaction system.
- 9) Comprehensive taxation of unearned income will be gradually introduced starting in January 1996 after the NTS establishes an IT system for financial institutions.
- 10) The implementation of capital gains tax on equity transactions will be implemented in the final phases of instituting the real name financial transaction system. The capital gains tax will not be carried out during President Kim's term in office (1993-98).

<Table 7-1> and <Table 7-2> show the results of a public opinion survey taken a year after the real name financial transaction system was implemented. In trying to measure its impact, the survey included respondents from business, finance, and the general public. Based on the survey, private money lenders were considered to be the most impacted followed by SMEs, politicians and self-employed workers <Table 8-1>. <Table 8-2> shows that private money lenders opposed the real name system the most, followed by politicians and large firms.

Table 8-1 | Individuals Impacted by the Real Name Financial Transactions System

	Number of Respondents	Large Firm Managers	SME Managers	Politicians	High-Ranking Officials	Money Lenders	Wage Workers	Self-employed	Low Income Individual
Businessmen	665	16.7	41.4	23.2	14.6	43.5	1.8	37.8	20.9
Financial Services Workers	621	16.1	36.9	39.3	13.5	51.4	6.1	17.6	12.6
General Public	666	13.8	44.9	40.4	10.7	52.0	3.8	21.5	7.7
Total	100 (1952)	15.8 (308)	40.9 (798)	34.4 (671)	13.1 (255)	49.2 (960)	3.8 (75)	25.3 (493)	13.2 (258)

Source: Ahn, Jong-bum (1994), recited from Lim (2002)

Table 8-2 | Individuals Opposed to the Real Name Financial Transactions System

	Number of Respondents	Large Firm Managers	SME Managers	Politicians	High-Ranking Officials	Money Lenders	Wage Workers	Self-employed	Low Income Individual
Businessmen	661	31.5	20.9	33.7	27.0	60.9	1.9	18.0	6.5
Financial Services Workers	621	27.4	11.6	59.4	25.3	63.3	0.5	8.5	2.1
General Public	664	23.8	17.2	58.9	18.4	66.9	1.1	10.7	1.5
Total	100 (1946)	27.8 (541)	16.4 (319)	50.3 (979)	23.0 (448)	63.9 (1244)	1.1 (22)	12.4 (242)	3.1 (60)

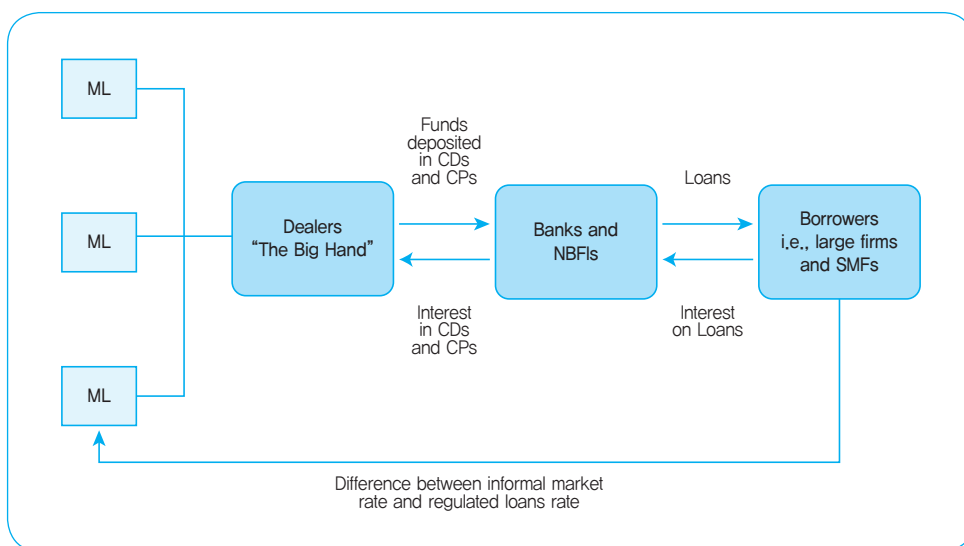
Source: Ahn, Jong-bum (1994), recited from Lim (2002)

1. Informal Credit Markets and the Impact of the Real Name Financial Transaction System

The use of fictitious or anonymous accounts contributed to the exponential growth of the informal credit market by allowing money lenders and dealers to facilitate large transactions underground. It also allowed large firms that had more financial resources to use fake accounts to fund political donations and other illegal activities. In the informal credit market, most of these underground money activities were facilitated using various types of CDs and were kept off the books of financial institutions. CDs were widely used by moneylenders in their lending operations because CDs could be withdrawn without revealing the CD holders' identity at the maturity. In other words, the sources of the funds could remain hidden.

As seen in [Figure 8-1], the key players in the informal credit market were the money lenders and the dealers, banks and NBFIs, and businesses.

Figure 8-1 | Transaction Flow in the Informal Credit Market



Source: Ministry of Finance (1994), Recited from Lim (2002)

After the real name act was introduced, all financial transactions had to have a real name which made it difficult to use fictitious or anonymous accounts. This meant that the sources of an account's fund held in financial institutions and corporations could be identified. It led to the decline of the informal credit market and helped to curb the use of financial accounts for funding illicit activities such as political slush funds. By the end of 1993, nearly all fake

accounts, or 98% of all fake accounts, amounting to 2.76 Trillion Won, were registered under a real name. In addition, accounts set up under someone else’s name totaling 3.48 trillion Won were also registered under real names (Korea Institute of Finance, “Recent Financial Reform in Korea: Real name Financial System Launched”, *Korean Financial Review*, Winter 1993).

Table 8-3 | Amount Registered under the Real Name Act

(Unit: Billion Won, %, as of End 1993)

	Bank	Brokerage	Insurance Co	Investment Trust Co	Investment & Finance Co	Mutual Saving & Finance Co	Other	Total
Real name account ratio (%)	83.2	91.1	90.9	80.0	97.8	85.5	92.7	87.3
Assumed name account	852	1,533	-	30	351	17	51	2,834
Real name account	830	1,497	-	27	351	17	48	2,768
Conversion Ratio (%)	97.3	97.6	-	90.3	99.8	99.3	93.4	97.6
Amount not converted	23	37	-	3	0.5	0.1	3	67
Conversion of borrowed name to real name account	1,360	331	332	269	287	678	226	3,482

Note: Others include NACF, Mutual credits, Credit unions, postal savings, and etc

Source: Ministry of Finance, Cited from Korea Institute of Finance (1993)

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Chapter 9

Rapid Changes in Korea's Financial Landscape Spawn a New Generation of NBFIs: Merchant Banks and Mutual Savings Banks

1. Merchant Banks at the Center of the 1997 Financial Storm
2. Current Challenges Faced by MSFCs

Rapid Changes in Korea's Financial Landscape Spawn a New Generation of NBFIs: Merchant Banks and Mutual Savings Banks

1. Merchant Banks at the Center of the 1997 Financial Storm

The rapid changes of the 1990s in Korea's financial landscape driven by liberalization and deregulation spawned a new generation of NBFIs, which were mainly STFCs and MSFCs. As discussed earlier, private money lenders were institutionalized as STFCs and MSFCs as part of the August 3 Measures. STFCs primarily lent to large corporations while MSFCs lent to SMEs and households. These NBFIs would come to play a large, if not out-sized, role in Korea's economy. In the case of STFCs, many of which were owned by Korea's largest *Chaebols*, later became merchant banks. The rapid and unchecked expansion of merchant banks, which essentially acted as short-term financing arms of the *chaebols*, contributed to Korea's 1997 financial crisis.

After Korea had secured macro-stability and real interest rates turned positive in the 1980s, money began flowing back into formal financial institutions. The institution of the real name financial system in 1993 was the final death knell that brought the end of the informal credit market's reign over Korea's financial sector. The institution of the real name system meant that banks and NBFIs could no longer engage in nefarious banking activities later exposed by the Chang Young-Ja Scandal in 1982, in which STFCs played a big hand in funneling funds from informal lenders to large businesses. In effect, the real name financial system had cut STFCs from their biggest source of money and profits. Unable to mobilize funds as STFCs did not have a network of branches like commercial banks, they had nowhere to go except abroad to access new sources of funding.

Starting in 1994, there was a rapid expansion in the number of merchant banks following a series of deregulatory measures, which was part of the government's broader push for

capital market liberalization. The entry barriers for merchant banks were lowered, which the government believed would result in greater competition, and therefore, a more efficient financial market. At the time, there were only a couple of merchant banks, which were established in the 1970s, that were operating and allowed to conduct foreign exchange operations similar to commercial banks. Once the entry barriers were lowered, STFCs were able to obtain merchant banking licenses. Between 1994 and 1996, a total of 25 STFCs were licensed as merchant banks. In effect, the STFCs had simply changed their names to merchant banks and began merchant banking activities.

Many of the newly created merchant banks were owned by Korean *chaebols* which essentially used them to borrow massively from abroad to finance their growing appetite for investments. To finance the loans, the merchant banks borrowed short-term foreign loans at higher interest rates since they lacked international name and creditworthiness.¹⁹ Consequently, the balance sheets of merchant banks suffered mismatches as they borrowed short and lent long, resulting in a high risk-high return business model. On top of this, the loan portfolios were prone to currency mismatches with high vulnerability to market and liquidity risks. Indeed, the merchant banks invested in risky overseas markets, while also making loans to *chaebols*. Moreover, merchant banks were not subject to the same lending restrictions as the commercial banks. For instance, a merchant bank could lend as much as 150% of its equity capital to any single borrower whether an individual or *chaebol*, whereas the limit for a commercial bank was 45%. This allowed merchant banks to make loans to *chaebol* affiliates as well.

Following the financial liberalization measures in 1993, Korean corporate and financial institutions now able to borrow abroad, went on a “borrowing spree,” as seen in Table 39. Merchant banks accounted for a smaller share of total foreign loans; however, the merchants saw the highest growth rate for foreign loans among financial institutions. In 1994, merchant banks only borrowed foreign loans of \$0.87 out of \$7 Billion Dollars, while commercial banks borrowed \$5.3 Billion Dollars. By 1996, the amount borrowed by merchant banks increased to \$3.19 Billion Dollars while it increased to \$7.19 Billion Dollars for commercial banks²⁰ (Kim and Lee, 2010).

As of March 1997, the top 30 *chaebols* accounted for as much as 51% of total outstanding loans of merchant banks. In early 1997, when Kia, an automobile manufacturer, was declared bankrupt, the non-performing loans (NPLs) of about 30 merchant banks amounted to 4 Trillion Won, which exceeded their total equity of 3.9 Trillion Won. The size of banks’

19. Starting in the mid-1980s Koreans were allowed to borrow abroad without government guarantee.

20. (Table 9-1) also shows that Foreign borrowing by non-financial institutions, notably by *chaebols*, also increased: from minus \$2.66 billion in 1993 to \$4.65 billion in 1994, \$8.05 billion in 1995, \$10.42 billion in 1996, and \$18.07 billion in 1997.

NPLs increased to 10 Trillion Won later in the year when several conglomerates (Jinro, Daenong, Sammi, and Woosung) went bankrupt (See Kim and Lee, 2010).

The 1997 financial crisis led to a series of massive failures of *chaebols* and financial institutions. The post-crisis reforms and restructuring in the corporate and financial sector led to all but one of the 30 merchant banks to be shut down by either having their licenses revoked or having them acquired, as can be seen in <Table 9-2>. The demise of the merchant banks closed a long and difficult chapter in Korea's economic and financial development.

Table 9-1 | Inflow of Foreign Capital in Korea

(Unit: 100 Million U.S. Dollars)

	1992	1993	1994	1995	1996	1997
Capital Balance (1+2+3)	69.9	32.2	107.3	172.2	239.2	60.3
1. Net FDI	-4.3	-7.5	-16.5	-17.8	-23.4	-19.5
2. Net portfolio investment	58.0	100.1	61.2	115.9	151.8	147.6
3. Other net investment (A+B)	16.2	-60.5	62.6	74.6	110.8	-67.9
A. Assets	-33.0	-45.9	-73.7	-139.9	-134.9	-107.4
B. Liabilities	49.2	-14.6	136.3	214.5	245.7	39.5
Net borrowing by Banks	24.3	12.0	89.8	134.0	141.5	-141.2
Long-term	12.0	0.8	19.5	16.1	15.3	7.2
Commercial banks	9.0	1.5	21.8	20.3	24.9	6.6
Development orgs.	0.8	-0.8	0.1	-3.5	-8.5	-0.1
Merchant banks	2.2	0.1	-2.4	-0.7	-1.1	0.7
Short-Term	12.3	11.2	70.3	117.9	126.2	-148.4
Commercial banks	7.0	3.9	53.8	85.2	71.9	-103.1
Development Orgs.	5.9	5.6	7.8	15.6	22.4	-24.3
Merchant Banks	-0.6	1.7	8.7	17.1	31.9	-21.0
Net Borrowing by Non-banks (i.e. Firms)	24.9	-26.6	46.5	80.5	104.2	180.7

Source: Bank of Korea, *The Balance of Payment*, various issues. Recited from Kim and Lee (2009)

Table 9-2 | Number of Financial Institutions Shut-down or Merged

(As of June 2009)

	Total No. of Institutions (end-1997) (A)	Type of Resolution					New Entry	Total No. of Institutions (June 2009)
		License Revoked	Merger	Others ¹⁾	Subtotal (B)	Ratio (%) (B/A)		
Banks	33	5	11	-	16	44.9	1	18
NBFIs	2,069	169	196	564	929	42.4	147	1,287
Merchant Bank Corporations	30	22	7	-	29	96.7	1	2
Securities Companies	36	5	8	3	16	44.4	27	47
Insurance Companies	50	10	6	6	22	44.0	25	53
Investment Trust Companies	31	6	8	-	14	45.2	50	67
Mutual Savings Banks	231	113	28	1	142	61.5	17	106
Credit Unions	1,666	2	137	553	692	41.5	14	988
Leasing Companies	25	11	2	1	14	56.0	13	24
Total	2,102	174	207	564	945	45.0	148	1,305

Note: 1) Includes dissolution and asset transfers to bridge institutions

Source: Financial Service Commission, Public Fund Management White Book, August 2009

2. Current Challenges Faced by MSFCs

The origins, and underlying causes, of the recent mutual savings bank crisis in 2011 share a similar pattern, as seen in the expansion and failure of merchant banks during the 1990s. As in the SFTCs, the mutual savings banks are a legacy of the 8.3 measures, which had institutionalized small informal money lenders as MSFCs. Similar to SFTCs, the MSFCs struggled to cope with the rapid changes in Korea's financial landscape. Faced with extinction, the mutual savings banks engaged in high risk, high reward financial activities on the back of haphazard deregulation and weak financial supervision. Despite their troubles, the mutual savings banks continue to operate today. But if the past is any indication of the future, then the mutual savings banks face an untenable future.

In the wake of the 1997 financial crisis, the once fragmented financial sector underwent structural changes as commercial banks expanded into the consumer and small business markets, which were the strongholds of the mutual savings banks, shifting from their traditional businesses of lending to large corporation. Moreover, regulatory change allowed the commercial banks to lend to previously prohibited service oriented businesses such as golf courses, condos, bars, etc, which were largely the customers of the mutual savings banks. As commercial banks began to lend to small businesses and consumer households, the commercial banks' share of the total loan market increased from 40.3% in 1995 to 70.1% in 2010, while the mutual savings banks' share decreased from 6.8% in 1995 to 4.6% in 2010. The same pattern can be seen for consumer loans, as commercial banks increased their share of consumer loan market (See [Figure 9-1]). This implies that savings banks were losing their share of the consumer loan market mostly to commercial banks.

As such, savings banks were forced to seek out new and riskier businesses by lending out a larger share of their loan portfolios to finance real estate investments and project financing activities. The share of loans for project financing out of total loans for savings banks increased from 16% in 2005 to 29% in 2007, while the share of consumer loans fell from 34% in 1999 to 13% in 2010 [Figure 9-2].

Figure 9-1 | Share of Consumer Loan Market by FIs

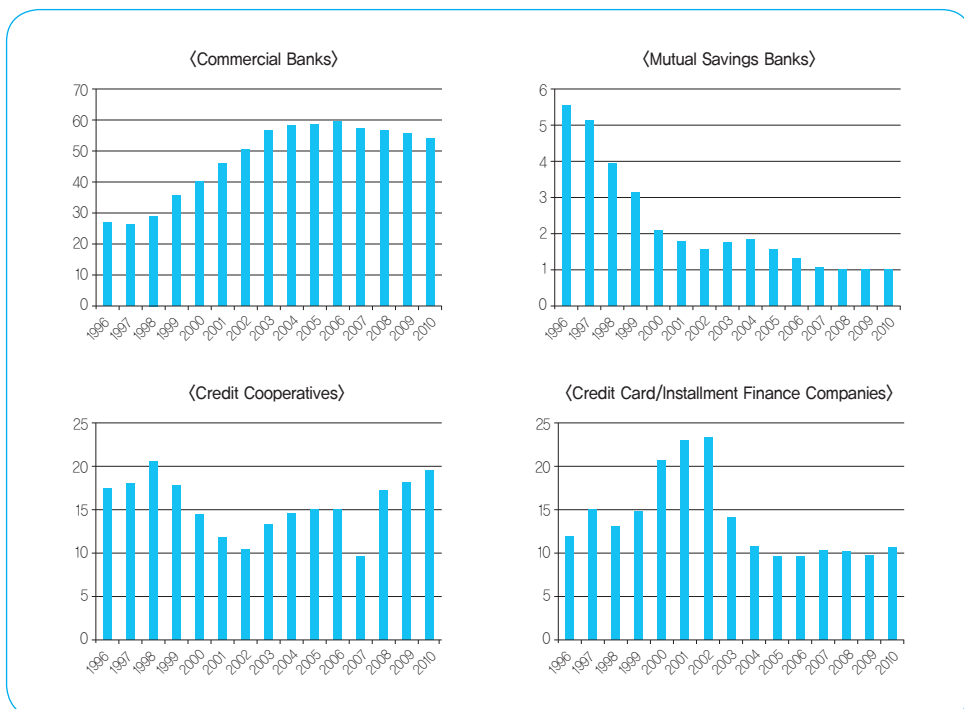
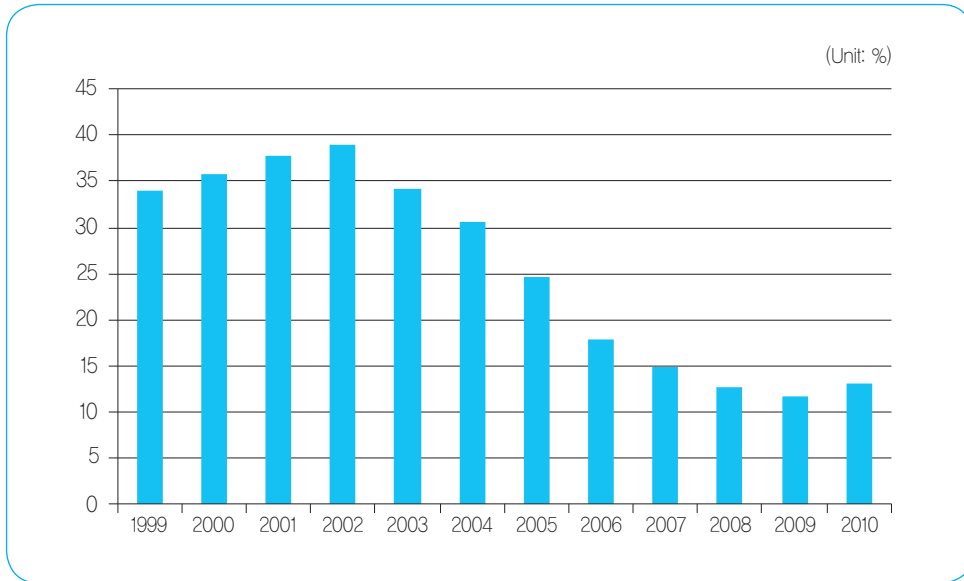


Figure 9-2 | Percentage of Consumer Loans Relative to Total Loans for Mutual Savings Banks



Source: Financial Supervisory Service

2.1. Haphazard Deregulation and Regulatory Changes

As mutual savings banks continued to lose market share due to increased competition from the commercial banks, many became troubled, resulting in the closure or restructuring of the savings banks in the years after the 1997 financial crisis. In 1997, there were 237 savings banks. By the end 2002, many of them were closed, acquired by or merged with other banks, which reduced the number to 116. For the next 8 years, 18 more banks were merged or shut down. Indeed, the mutual savings bank industry had undergone massive restructuring. However, the remaining savings banks that were left over from the restructuring continued to have difficulties in coping with the increased competition.

A series of regulatory changes in the overall financial sector in the wake of the 1997 financial crisis and active lobbying by the mutual savings bank industry created a favorable environment for mutual savings banks to attract the deposits. In response to the financial crisis, the deposit insurance for all deposit-taking financial institutions, which was set at 20 Million Won before the crisis, was given carte blanche between 1997 and 2000, and then subsequently reduced to 50 Million Won once Korea had recovered from the crisis. Then, the mutual savings banks were allowed to change their names from finance companies to banks in 2002 after lobbying for change.

Renamed as savings banks and now able to insure more deposits, the mutual savings banks experienced a continuous and rapid expansion of deposits. But the savings banks found themselves with growing deposits with no one to lend to due to increased competition from commercial banks. Unable to deploy their deposits, the savings banks lobbied to have lending limits, which were set at 8 Billion Won (approximately \$8 Million Dollars) per single borrower, to be raised. Subsequently, the lending limit was increased in 2006 by allowing banks that had a BIS ratio above 8% and the share of sub-standard loans below 8% to lend up to 20% of their capital for a single borrower. This opened the door for the savings banks to diversify their loan portfolio into real estate lending from household lending.²¹ Able to lend above the 8 Billion Won lending limit, savings banks began making large loans via special purpose companies (SPCs) they had set up. Since their main funding source was savings deposits, they were borrowing short and lending long, creating maturity mismatches in their balance sheets. The savings banks had adopted a high risk and high return model. Indeed, loans to fund project financing increased by 87% in one year alone in 2006.

By 2010, the share of corporate loans accounted for almost 90% of saving banks' total lending, and more than 50% of their total loans financed loans to construction firms, real estate activities, project financing, and real estate renting firms. However, the loans to finance some of the projects began to sour, leaving the savings banks with mounting NPLs amid a declining real estate market <Table 9-3>. Despite this, savings banks continued to attract more deposits by offering higher interest rates and making risky loans to offset the growing share of NPLs, essentially disguising the severity of the troubled assets by growing total assets.

Table 9-3 | Outstanding Project Finance Loans by Savings Banks and Ratio of Unpaid Loans

(Unit: Trillion Won, %)

	2005	2006	2007	2008	2009	2010
PF Loans	6.3	11.8	12.1	11.5	11.8	12.2
Share of PF Loans	16.2	26.7	28.9	20.9	18.5	18.9
Ratio of Unpaid PF Loans	9.1	9.6	11.6	13.0	10.6	25.1

Source: Financial Supervisory Service

21. These conditions proved to be difficult to enforce because of unreliability of balance sheets and income statements, many of them being falsified.

Since the crisis erupted in 2011, a total of 24 mutual savings banks have been shut down, decreasing the total deposits of mutual savings banks from 76.8 Trillion Won in 2010 to 44.8 Trillion Won by the September of 2012. A total of 93 mutual savings banks are operating despite large decreases in deposits. This raises questions about the future of mutual savings banks which seem to be on unsustainable path.

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Chapter 10

Financial Inclusion Remains a Social Issue in Korea Even Today

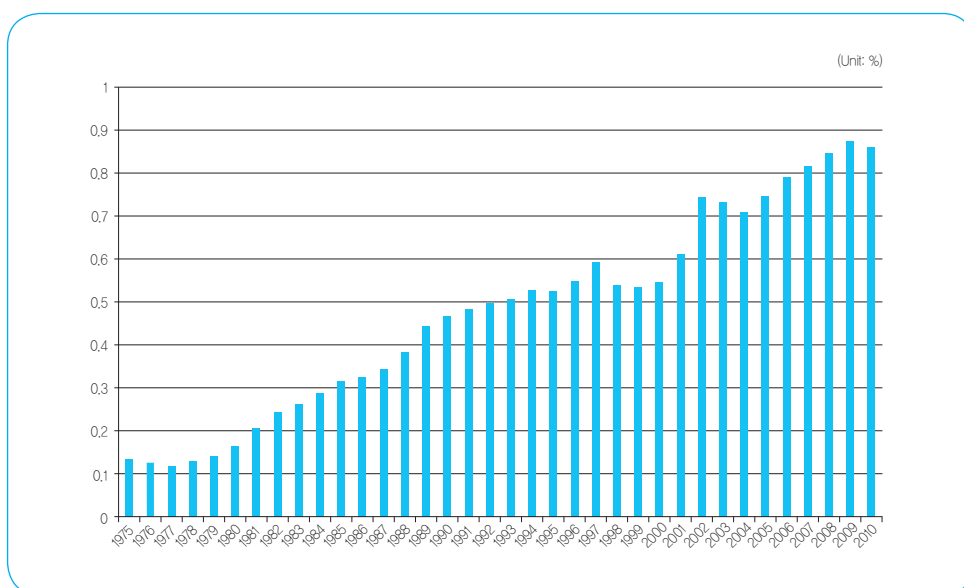
1. Expansion of Consumer Credit and the Distribution of Household Wealth
2. Consumer Loan Finance Companies and Micro Financing

Financial Inclusion Remains a Social Issue in Korea Even Today

Entering the new century, Korea has been able to achieve a high-level of financial development and inclusion, which has also led to the end of the informal credit market's reign over the financial sector. Indeed, the high degree of financial inclusion can also be seen in the growth of consumer credit which has steadily grown in the last 10 years. The consumer Loan/GDP ratio shows a steady growth trend since the early 1980s, before steepening after 2000 as seen in [Figure 10-1]. This has led studies to suggest that the expansion of consumer credit has enhanced the welfare of consumers as a whole by relaxing household financing constraints, and thereby, smoothing consumption. However, the rapid growth of consumer loans has also raised another set of economic and social issues more recently. More specifically, studies on the growth of consumer loans suggest that it may have worsened wealth distribution, as a larger portion of household credit has gone to higher income households. Indeed, a large share of consumer loans, nearly 55%, has been used to finance real estate activities.²²

22. It also asks the question of whether the rapid growth of household debts has increased the risk of a real estate driven crisis. The fact that large portion of household debts for all income groups was used to finance real estate activities would suggest the risk of inflated real estate markets. Although this raises the specter of real estate crisis, we can draw some comfort that Korea may be less vulnerable to a real estate driven crisis. First, as shown above, large portion of the growth in household debts was seen among the highest income group, or top 20%. In addition, the real estate loans are subject to a strict lending standard. In 2002, the Korean government imposed a stricter loan-to-value value (LTV) ratio for mortgage loans. In particular, the mortgage loans for apartments considered to be in the "speculative areas" were subject to LTV ratio of 40%. Korea's LTV ratio standard is relatively strict compared to advanced countries, where the normal LTV ratio ranges between 55-90% and 80-115% in some countries (OECD 2007).

Figure 10-1 | Consumer Loan/GDP Ratio (1975-2010)



Source: World Bank, World Development Indicators ([http:// data.worldbank.org/data-catalog/world-development-indicators](http://data.worldbank.org/data-catalog/world-development-indicators))

1. Expansion of Consumer Credit and the Distribution of Household Wealth

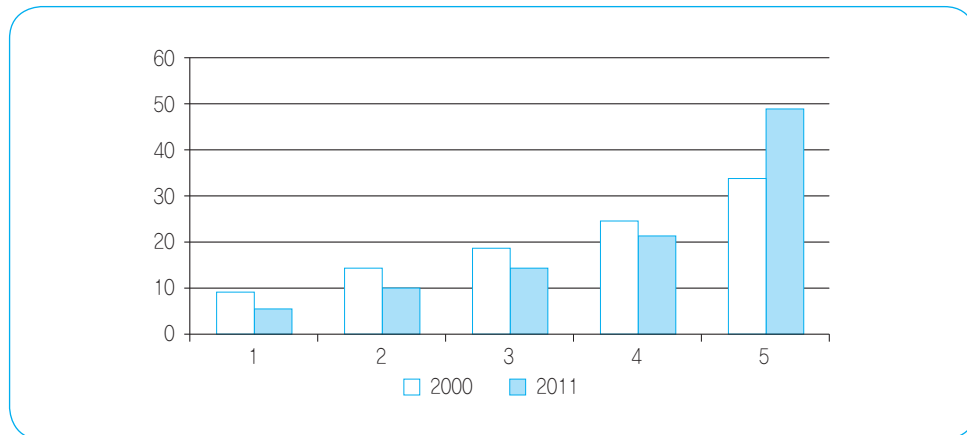
In order to measure the wealth distribution of households, two sets of data – the National Survey of Household Income and Expenditure (NSHIE: 2001) and the Survey on the Financials of Household (SFH) for 2011 are used. The NSHIE data was collected by the Korea National Statistical Office (KNSO), while the SFH data was compiled by three separate agencies including KNSO, the Financial Supervisory Service (FSS), and the Bank of Korea.²³

23. NSHIE which began in 1991 was conducted with intervals of five years and the last Survey was taken in 2001 (the 2001 Survey was conducted in May 2001 hence using the yearly income of 2000). SFH has been carried out every year since 2010. Although the two data sets are different in timing, both samples cover a wide range of households including one-person households. The data may be different but we can compare and identify how the trends of household financial structure have changed over the period of 2000 to 2011. Wealth of households consists of financial assets and real assets. Both 2001 NSHIE and 2011 SFH measured financial assets as the sum of deposits, stocks, bonds, insurance, pension, and loans to informal credit markets. Real assets were measured as the sum of residential housing (own house, Chonseil and monthly rental deposits) and non-residential real estate (house, land, building and others).

Households were divided into five groups based on income to examine the distribution of household debt. As can be seen in [Figure 10-2], the share of household debt of the highest income group, or top 20% income group, increased significantly from 34% in 2000 to 49% in 2011; in fact, it was the only income group to show any increase. On the other hand, the share of household debt of the lower income groups 1 and 2 decreased over the same period. [Figure 10-3] shows that the debt service capacity has deteriorated for all income groups, but it has worsened at a greater degree for the lowest income group. In examining how the household used their debts, it shows that as expected that low income households used a proportionally larger share of their debt to finance living expenses relative to higher income groups which used most of debt to finance real estate and business activities (See <Table 10-1>).

Korea's wealth distribution has been on a worsening trend, which has deteriorated rapidly in the last 10 years. The Gini coefficient based on total household asset was estimated to be 0.58 in 1988,²⁴ and stayed relatively the same until 2000, when it was 0.60. However, the Gini coefficient worsened significantly when it was estimated to be 0.70 in 2011. One can argue that the growth of household debt has contributed significantly to smoothing consumption among households. But, it also seems to have had a negative effect on wealth distribution based on the worsening trend in Gini coefficient.

Figure 10-2 | Share of Household Debt by Income



Note: The number 5 group represents the highest income group, which is the top 20% income group

24. The distribution of household wealth for 1988 was estimated by Kwon (1990), who used the KDI (Korea Development Institute) household survey data for 1988 on income and wealth. The KDI survey for 1988 included 4,291 households (3,343 urban households and 948 rural households).

Figure 10-3 | Percentage of Household Debt/Gross Income by Income

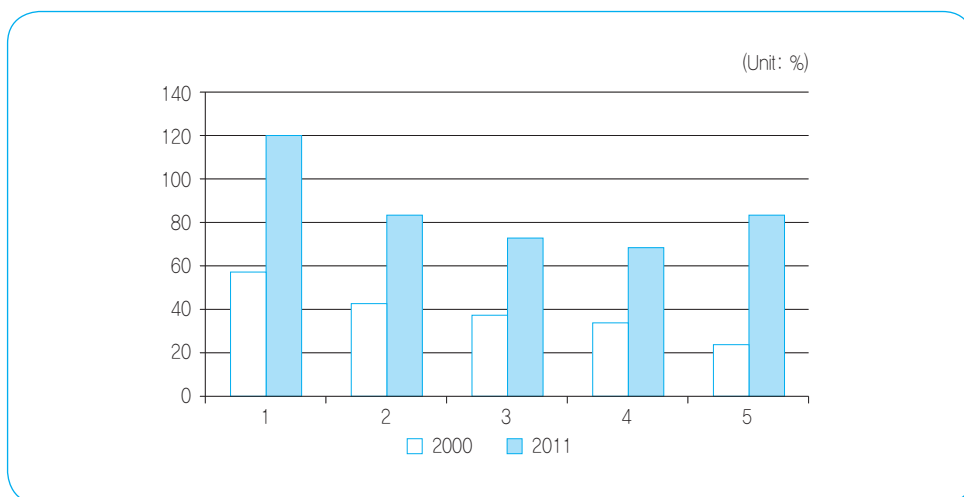


Table 10-1 | Uses of Household Debt in 2011

(Unit: 10 Thousand Won)

	1	2	3	4	5	Total
Buying house	117 (19.3%)	401 (27.5%)	840 (38.8%)	1,176 (36.9%)	2,076 (28.4%)	4,610 (31.3%)
Buying building and land	31 (5.1%)	205 (14.0%)	188 (8.7%)	539 (16.9%)	1,765 (24.1%)	2,728 (18.5%)
Payment for monthly rent or <i>Chonse</i>	29 (4.8%)	95 (6.5%)	178 (8.2%)	202 (6.3%)	223 (3.1%)	728 (4.9%)
Financial investment	0 (0.1%)	5 (0.3%)	5 (0.2%)	35 (1.1%)	44 (0.6%)	88 (0.6%)
Repayment of debts	49 (8.0%)	93 (6.4%)	69 (3.2%)	149 (4.7%)	182 (2.5%)	541 (3.7%)
Business expenses	129 (21.3%)	316 (21.7%)	606 (28.0%)	731 (23.0%)	2,538 (34.7%)	4,320 (29.3%)
Cost of wedding	12 (2.0%)	23 (1.6%)	38 (1.8%)	10 (0.3%)	35 (0.5%)	119 (0.8%)
Healthcare cost	17 (2.7%)	30 (2.1%)	11 (0.5%)	10 (0.3%)	2 (0.0%)	71 (0.5%)
Education cost	19 (3.2%)	61 (4.2%)	31 (1.4%)	60 (1.9%)	82 (1.1%)	254 (1.7%)
Living expenses	103 (17.0%)	120 (8.2%)	143 (6.6%)	184 (5.8%)	166 (2.3%)	716 (4.9%)

	1	2	3	4	5	Total
Others	100 (16.5%)	108 (7.4%)	56 (2.6%)	88 (2.8%)	199 (2.7%)	551 (3.7%)
Total	606 (100%)	1,458 (100%)	2,166 (100%)	3,183 (100%)	7,312 (100%)	14,726 (100%)

Note: 1) Figures in () are shares

2. Consumer Loan Finance Companies and Micro Financing

As discussed above, Korean households have benefited from the growth of consumer financing. However, it is still evident that low income households have difficulty accessing credit. Of course, this can be seen in any economy. So, this raises the question of what have been the economic and social consequences of low income households having limited access to consumer loans. A response to this has been the emergence of consumer loan finance companies (CLFCs) and micro financing, called ‘Miso (smile) Finance.’

Certainly, some degree of informality still exists as it would in any economy. In Korea, this can be seen in the emergence of CLFCs in recent years, which were formerly informal money lenders. In 2002, informal money lenders that provided loans largely to consumer households were required to register their businesses and made subject to an interest rate cap of 66% per annum. These informal money lenders that registered were formalized as CLFCs. This was a politically driven response to reports of aggressive lending and debt collection practices within the informal credit market where money lenders would charge extremely high interest rates. It was the first time interest rates were capped for CLFCs since being lifted in 1998 in the wake of 1997 financial crisis. The interest rate limit for CLFCs was lowered to 39% in 2011. The CLFCs did not fall under the supervision of the financial authority since they were not considered to be financial institutions and did not pose systemic risk to the financial system. Instead, CLFCs came under the supervision of local governments.

The number of CLFCs peaked in September 2007, totaling 18,197. In 2010, the number of CLFCs totaled 14,014. According to a KDI report (2010, Activating Financing for Low Income Group), the size of the CLFC market was estimated to have 1.67 million borrowers with a total of 5.9 Trillion Won of loans <Table 10-2>. A large portion of the loans, or 78.6% of total loans, were uncollateralized. <Table 10-3> The survey was based on 6,850 CLFCs out of a total of 14,783 registered CLFCs at the end of 2009.

Table 10-2 | Number of Borrowers and Loan Amount by Size of CLFCs

(As of the end of 2009)

	Number of Borrowers (person)	Loan Amount (Billion Won)	Loan Amount per Borrower (Million Won)
CLFCs with assets more than 7 billion Won	1,397,805	5,072	3.6
CLFCs with assets less than 7 billion Won	106,590	463	4.3
Individual	170,042	377	2.2
Total	1,674,437	5,911	3.5

Source: KDI (2010)

Table 10-3 | Uncollateralized and Collateralized Loans by Size of CLFCs

(Unit: Billion Won, As of the end of 2009)

CLFCs with assets more than 7 billion Won	Uncollateralized loans	4,215
	Interest rate	41.6%
	Collateralized loans	857
	Interest rate	12.4%
CLFCs with assets less than 7 billion Won	Uncollateralized loans	279
	Interest rate	37.9%
	Collateralized loans	184
	Interest rate	36.6%
Individual	Uncollateralized loans	150
	Interest rate	35.7%
	Collateralized loans	226
	Interest rate	32.6%
Total	Uncollateralized loans	4,645
	Interest rate	41.2%
	Collateralized loans	1,267
	Interest rate	19.5%

Source: KDI (2010)

In response to calls of growing social inequality, a micro finance program was introduced by the Korean government in 2010. The program targeted micro businesses, self-employed workers, and merchants. The initial capital to facilitate micro financing was provided from the private sector including some of Korea's largest *chaebols* (Samsung, Hyundai Automobile, SK, POSCO and Lotte) and commercial banks (KB, Shinhan, Woori, Hana and IBK). The private companies were expected to provide 2 Trillion Won of capital over 10 years. At the end of 2012, a total of 620 Billion Won of capital was provided. Between 2010 and 2012, a total of 550 Billion Won of micro loans was extended at an annual interest rate of 4.5%, for about 42,062 micro loans, or 13.1 Million Won per loan. (See <Table 10-4>) In addition, a total of 162 branches were established nationwide to serve micro borrowers including regional areas.

Micro credit, which targets the lowest income group ('poorest of the poor') that do not necessarily have resources and may not be suitable for cooperatives, should assist the poorest to help themselves. As such, micro credits should be provided based on the payment track record. Once borrowers have amassed a record of repaying the loans, then the size of next loans should be increased until they have built the ability to access traditional forms of financial institutions. So, micro credit can be a stepping stone for poor borrowers to get access to more financial services and products.

Table 10-4 | Total Amount and Number of Micro Loans

(Unit: Billion Won)

	2010	2011	2012	2010-2012
Total amount of loans (Billion Won)	79.6	254.8	215.9	550.2
Total number of loans	7,770	16,489	17,803	42,062
Amount per loan (Million Won)	10.2	15.5	12.1	13.1

Source: Miso Finance Central Association

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Chapter 11

Role of Cooperative Financial Institutions in Today's Era of Financial Development

1. Changes in the Legal Regulatory Framework for CFIs
2. Negative Impact of Policy Apathy on the Internal Governance of CFIs

Role of Cooperative Financial Institutions in Today's Era of Financial Development

The lack of access to credit by the lowest income groups and the emergence of CLFCs and micro credit in recent years begs the question of why CFIs, which have had a long and unique history in Korea's financial development, have not played a larger role in ensuring greater financial inclusion. The short answer to this obvious question is that CFIs in Korea are no longer operating as CFIs. Indeed, Korean CFIs do not seem to be operating under the same basic principles that they were once founded on and are reflective of CFIs such as member owned and controlled, voluntary-based, and members sharing a common bond. The underlying factors that have led to the diminished role of CFIs in Korea can be attributed to a highly fragment legal regulatory framework and to some extent policy apathy that has led to an over stured CFI industry and weakened internal governance.

1. Changes in the Legal Regulatory Framework for CFIs

The governing legal regulatory framework for Korean CFIs is highly fragmented. The three main CFIs in Korea, agricultural coops, credit unions and community credit cooperatives, operate as separate silos under different governing legal statues. Much of why this is the case can be explained in examining the legal regulatory history of Korean CFIs.

After a long drawn out delay in trying to pass legislation on cooperatives following Korea's liberation, the first cooperative law was enacted in 1957. However, the act did not authorize primary cooperatives to engage in credit lending, but only to facilitate economic activities such as the procurement and distribution of agricultural goods. In 1961, primary cooperatives were allowed to provide credit, though the credit function was not activated since many of the farmers did not have much income to save. Independent of government's

effort in cooperatives, two different cooperative movements - credit unions and village cooperatives (later changed to community credit cooperatives) - began to take off during the 1960s. Both credit unions and village coops did not have a legal regulatory basis. It was not until 1972 when the Credit Cooperative Act was passed that a statutory basis was established for credit unions and village coops. This placed credit unions and village cooperatives under the supervision of the Ministry of Finance. After the Credit Cooperative Act was passed, most of the village coops did not or were not able to comply with the new regulations for various reasons; and instead, they pushed for their own legal regulatory basis. As a result, the New Village Cooperative Act was enacted in 1983, which essentially gave village coops autonomy and a new statutory basis, and thus, the ability to operate separately from the credit unions. So this complex, loose patch work of laws governing cooperatives in Korea has resulted in highly fragmented legal regulatory body and an over saturated cooperative industry.

The highly fragmented legal regulatory framework has made it nearly impossible to promote or naturally facilitate consolidation with the CFI industry. There has been some consolidation among CFIs within their own group but not among different groups of CFIs. The result has been a bad case of overbanking. Indeed, several different cooperatives can often be seen operating on the same street corner only a few steps apart from each other. This over saturated market has resulted in CFIs chasing after the same customers (See <Table 11-1>) where one person may be a member of all three CFIs. As of 2009, there were a total of 982 credit unions with 5.2 million members and 8,505 employees. Also, there were a total of 1,501 community credit cooperatives with 8.0 million members and 13,742 employees.

Table 11-1 | Number of Small Regional Financial Institutions

(As of 2003)

	MSFCs	Agricultural/ Fisheries coops	Credit Unions	Community Credit Coops	{Postal Office}	Total
Youngdeungpo- Ku, Seoul	6	24	22	6	12	70
Cheonju City	3	37	17	33	29	119

Source: Financial Supervisory Commission, Cited from Kim (2006)

The lack of consolidation has significantly weakened the effectiveness of CFIs as financial intermediaries. Even though CFIs are able to effectively mobilize members' deposits, being given a favorable tax treatment on interest income, they are unable to effectively deploy the deposits to borrowers who need it. The relatively low loan to deposit ratio among CFIs

(See <Table 11-2>) indicates that funds are not being lent, but are sitting idle. Instead, CFIs have resorted to investing their funds in the financial markets. In contrary, CFIs in advanced countries such as US and Germany maintain a high loan/deposit ratio of more than 80%.

Table 11-2 | Loan/Deposit Ratio of Credit Cooperatives

	1992-1997	1998-2009
Agricultural Coops	75%	69%
Credit Unions	90%	67%
Community Credit Coops	77%	56%

Source: Kim et. al (2010)

2. Negative Impact of Policy Apathy on the Internal Governance of CFIs

Theory and evidence suggests that CFIs are better apt than banks in providing unsecured credit to borrowers. CFIs can reduce information costs by internalizing transactions since their customers are also members who own a share of the cooperative. The coop members would have more information about each of the members and strong incentive to monitor each other. This makes CFIs more effective in monitoring themselves and reducing opportunistic behaviors by imposing social sanctions (Banerjee, Besley and Guinnane (1994). Contrary to this, CFIs in Korea today are not providing unsecured loans to members based on their creditworthiness, reflected by the low amount of unsecured credit to their members. In the case of credit unions, the share of unsecured loans was more than 50% before the 1997 financial crisis, but has decreased to 36% in 2000, and further to 12% by 2009.

Two factors can be contributed to undermining the role of CFIs in Korea, thus, limiting their capacity to achieve greater financial inclusion. A primary factor for the failure of CFIs can be attributed to poor internal governance. In some cases, the pay of the CFI's chairman has been linked to asset growth. This has encouraged CFIs to merely focus on growing their assets rather than focusing on their member's needs. In the past, the position of chairmen in Korea was appointed on an honorary basis. An indirect consequence of linking pay with performance of CFI has been extending the membership base of CFIs beyond what has been the traditional base of membership such as place of home or work. This has led to the growth of members that do not share a direct common bond with other members. For example, CFIs from different locations have entered into coalitions, or syndications, to make large loans to finance real estate purchases such as apartment buildings.

This would imply that CFIs are taking a high degree of risk in making such loans when lending outside of their membership base, which would increase information costs. Not to mention, these CFIs lack risk management capacity. According to a study on the performance of credit unions by Joh (2010), the financial soundness of CFIs measured by NPLs and profitability was clearly worse for the credit unions which had a chairman that directly influenced the management of cooperatives. This implies that the chairman focused on maximizing the profitability and asset growth of the credit unions.²⁵

25. This study was based on the financial statements of 745 credit cooperatives in 2009.

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Chapter 12

Conclusion

Conclusion

There is no single event, policy or economic theory that can be cited in explaining Korea's rapid financial development. Thus, we focus on some of the salient features of Korea's experience. More than anything, interest rates were the biggest determinants of the informal credit market's role and dominance in Korea's financial system. Korea struggled to contain inflation early in its development, and later on, during its rapid growth phase in the 1970s. During much of this time, the government kept interest rates artificially low in the formal financial sector to promote economic development.

Amid high inflation and low bank interest rates, the flow of funds went underground into the informal market. The *failed financial coup d'état* in 1962 only worsened the situation by damaging the trust between financial institutions and customers. As real interest rates remained negative, the informal credit market played a dominant role throughout much of the 1960s until the early 1980s. In this respect, the interest rate reform of 1965 was a watershed moment in Korea's economic development. It marked a change of course in Korea's financial development. The August 3 Emergency Economic Measure helped to prevent a major corporate debt crisis but it was also the first policy attempt to formalize the informal credit market. Once Korea secured macro stability starting in the early 1980s by reigning in inflation and real interest rates turned positive, the size and dominance of the informal credit market began to rapidly decrease. On top of this, deregulation which allowed banks to offer new financial products and the entry of new banks accelerated the demise of the informal financial market. The end of the informal markets' role in Korea's financial sector came with the institution of the real name financial system in the 1990s.

Less known but just as important was the CFI movement in Korea, which began during Japanese colonial rule and took off with the introduction of credit unions in the 1960s. Both offer a unique experience not found in many developing countries. The credit union

movement is more extraordinary as it was a private, grass-roots movement. It spread quickly throughout Korea's rural sector as well as urban sector, helping to increase financial inclusion. But as the episodic experience of the village credit cooperative movement shows that too much government intervention can be harmful and lead to worse outcomes.

The evolution of Korea's informal credit market, which at times dominated the financial system, can be seen in the institutionalization, and then, rapid rise and decline of the NBFIs. STFCs played a key role in financing the corporate sector during much of Korea's rapid development. The demise of the STFCs in the wake of the 1997 Financial Crisis, and continuing problems of the mutual savings banks, draws a spotlight on the importance of financial supervision. Indeed, inadequate financial supervision to cope with the fast changing financial landscape can be seen as one of the key policy failures that led to crisis.

Today, Korea faces a whole new set of economic and social policy challenges. One of the biggest challenges will be addressing the growing income inequality, and its polarizing effect on society. Though the rapid growth of household debt in recent years suggests that financial inclusion is relatively high in Korea, it also poses a policy challenge seen by the worsening trend in household wealth distribution. One factor that has led to deterioration in wealth distribution has been the inability of low income groups to access financing. This has led to the emergence of CLFCs and the introduction of micro credit. Micro credit was introduced by the government to facilitate credit for the lowest income group, the poorest of the poor, who do not necessarily have resources. However, micro credit needs to be provided in a way that not only provides much needed financing but also can be a stepping stone for borrowers to get access to more financial services and products. This can be done by providing borrowers a small loan initially, and then providing a larger loan once borrowers have repaid the first loan and built a track record of repayment. Amassing a track record would raise the borrower's capacity to access traditional forms of financial institutions.

Finally, the biggest policy challenge facing Korea will be reforming and reactivating CFIs, which offer the best chance of improving financial inclusion among the lowest income groups and opening new potential areas of growth, and thereby, reducing income inequality. Today, Korean CFIs no longer operate under the basic principles of cooperatives as a member owned and controlled, voluntarily basis, and shared common bond. Moreover, the highly fragmented legal regulatory framework governing CFIs has resulting in an over-saturated CFI market where one person can often be a member of all three major cooperatives.

The most critical challenge in reactivating CFIs will be reforming the legal regulatory framework for governing CFIs. Currently, different CFIs in Korea are governed by different

laws and governing bodies. As such, integrating the different legal regulatory bodies would be needed to facilitate consolidation of CFIs, and to bring them under one unified governing body. A similar situation can be found to have existed in Germany before 1972 when the agricultural cooperatives in rural area, Raiffaisen Cooperatives, were consolidated with small business cooperatives in urban area, Schultze-Delitzsch Cooperatives, under one unified group (DGRV). As in the case of German experience, the consolidation of CFIs should seek to merge weak cooperatives with stronger cooperatives, and also consider various factors such as social, economic and demographic conditions.

Despite the poor state of CFIs in Korea, there is good reason to believe that CFIs can be reactivated again with the right reforms and framework in place. Indeed, according to a survey in 2010 of credit union members, the survey indicated that there was still some degree of loyalty among members for their cooperatives. As can be seen in <Table 12-1>, the cooperative members still seem to believe in and share the basic principles of cooperatives, as 33.6% of the members considered themselves to be a member that participated directly in the decision making process. This indicates that a strong bond still exists among the core, older cooperative members. In the short run, members with strong ties to their cooperatives can serve as the basis for promoting and reforming CFIs in Korea. These members with stronger ties and loyalty can take leadership role in the future of CFIs. However, many of the loyal members tend to also be much older at around age 60s, which threatens the sustainability of CFIs in Korea. As such, it is important to focus on increasing membership and loyalty among younger members below age 30s such as introducing new cooperatives in universities and other parts of society.

Table 12-1 | Coop Members' Self-assessment

	Number of Members that Agreed	Share of Members that Agreed
Do you consider yourself a member that participates directly in decision making?	198	33.6%
I consider myself a member, but I cannot participate in activities related to cooperatives.	145	24.6%
I maintain my membership in order to access the financial services of my cooperatives	140	23.8%
I consider myself a customer and not members of my cooperative	106	18.0%
	589	100%

Source: Kim, Joon-Kyung (2010)

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Ministry of Strategy and Finance, Republic of Korea

339-012, Sejong Government Complex, 477, Galmae-ro, Sejong Special Self-Governing City, Korea Tel. 82-44-215-2114 www.mosf.go.kr

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