Enhancing Good Governance – The Role of the Financial Sector in Korea

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Abstract

In Korea, economic growth has been primarily fuelled by capital accumulation in the past and this strategy was based upon a bank-dominated financial system under the tight control of the Government. A now widely-held consensus view is that the financial crisis of the late 90s can be largely attributed to weak governance mechanisms and in particular to inadequate financial structures.

It is the objective of the paper to examine how the Government-business-bank relationship worked in the past in Korea, how it contributed successively to the economic miracle and to its meltdown, how the system is being reformed and whether these changes can enhance better governance and help the country return to a stable growth path.

Beyond the reform of the financial system, what the country actually needs is a complete overhaul of its growth strategy which requires a redefinition of the intensity and form of Government interventions. The paper closes with an analysis of the remaining challenges Korea has to face in its endeavor to move toward a more market-oriented system of governance.

Keywords: Korea, Banking, Financial Sector, Financial Crisis, Chaebol, Governance

Introduction

In Korea, economic growth has been primarily fuelled by capital accumulation in the pre-crisis period, and this strategy was based upon a bank-dominated financial system under the tight control of the Government. A now widely-held consensus view is that the Asian crisis can be largely attributed to inadequate financial structures, with Korea as a case in point. This view concludes first, that the banking sector needs to be strengthened, in particular through tighter supervision, and second, that more emphasis should be placed in the future on domestic capital markets as alternative sources of financing rather than on bank loans, if Korea is to restore a strong basis for growth.

Strengthening the health of the financial sector can certainly be expected to ensure a better allocation of capital and to help avoid recurring financial crises. Yet beyond the reform of the financial system, it is the role of the Government and its relationship with finance and business that needs to be redefined. In other words, the issue is to improve governance mechanisms.

The objective of the paper is twofold. First, to describe the nature of the governance problem by examining how the relationship-based financial system worked in the past in Korea, what were its major flaws, and how it contributed to the financial crisis. Second, to show how the system is being reformed and how these changes may help the country return to a stable growth path.

The first two sections of the paper will examine the past strengths and shortcomings of the Korean financial system, in other words they will assess both its contribution to the protracted period of economic growth from the early 70s to the mid 90s and to the financial meltdown in 1997-98. The next section will start by analyzing the state of the reform process and close with an analysis of the remaining challenges Korea has to face in its endeavor to move to a more market-oriented system.

Pre-Crisis Finance and Growth Under Government Control

- Financial Institutions

Korean financial institutions belong to two groups: banking institutions (commercial and specialized banks) and non-bank financial institutions (NBFIs: development banks, savings institutions, investment and insurance companies, etc.). The foundation of the modern financial system in Korea was laid during the early 1950s, while specialized banks were established during the 1960s to facilitate capital mobilization and strengthen financial support for underdeveloped or strategically important sectors. Most NBFIs were introduced during the 1970s to diversify financing sources. The market share of NBFIs grew rapidly from the early 80s to the mid-90s as a result of a more favorable regulatory regime. .

All banks were nationalized in 1961 and became mere transmission belts of industrial policy decisions. In particular they helped channel the flow of financial resources to specific industries, and to the chaebols, which were the major beneficiaries of selective credit allocations. Exporters were for instance allocated preferential credit based upon their export performance. Of course, these preferential loans limited the access to capital by the less-favored sectors, thus resulting in a possible risk of inefficiency in credit allocation.

From the early 1980s, several commercial banks and NBFIs were added as part of a series of broad measures to spur financial liberalization and internationalization (Chung and Wang 2000). Despite an alleged shift from a government-oriented toward a more market oriented economic policy, the form of Government intervention simply changed but did not disappear, while the influence of the chaebols did not decline either. Control was exercised directly in the 60s through specialized government-owned banks, then the control went through direct targeting of loans to specific firms. After, 1981-83, despite privatization and greater managerial autonomy (at least officially) by commercial banks, the banking system was still subject to heavy Government intervention: policy loans still accounted for a fair share of banks' domestic credit while subsidized lending from the central bank distorted credit markets. The Government also intervened regularly in order to avert the bankruptcy of large enterprises by directing banks to provide relief loans or rescheduling loans (Smith 1998). The Korea Development Bank (KDB) also proved to be an effective instrument of Government intervention in the financial markets (Haggard and Mo 2000).

Government interventions could be felt in all stages of bank operations such as in project selection and credit operation. Most key managerial decisions such as the introduction of new products, pricing of products and opening of new branches needed government approval, which was only discretionary (Shirai 2001). Moreover, Government intervention was also felt in the management of banks: in particular presidents and high ranking officials of commercial banks were appointed by the Government even after these banks were privatized (Nam 1995). Finally, the Government provided implicit guarantee, sometimes, financial assistance to financial institutions that faced difficulties, particularly those arising from resource misallocation influenced by government decisions (Adhikari and Oh, 1999).

Insider relationships between banks and borrowers also resulted in lending without regard for rates of return (Smith 1998).

As a result of these policies, Korea's financial system has been heavily skewed toward indirect financing through banks and non-bank financial institutions over the past 25 years, with relatively little direct financing through the capital market.[1]

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[1] Also, the preference for debt financing over issues of new shares can be explained by the largest shareholders' desire to avoid dilution of their ownership so as to keep control of the management.

[[Table 1: Corporate Financing Structure]]

- *The Bond Market: a De Facto Banking System*

The size of bond issues was relatively large in Korea, at least larger than is often thought. The corporate bond market expanded rapidly in the 1990s after deregulation measures encouraged firms to increase financing from bonds rather than stocks. Yet, as explained by Yoshitomi and Shirai (2001), corporate bonds were essentially equivalent to de facto bank loans. Such is the case because most corporate bonds - largely short-term - were issued as guaranteed bonds where the payment of principal and interest is guaranteed by banks and other financial institutions. Moreover the Investment Trust Companies (ITCs) which were implicitly guaranteed by the government and were major buyers of corporate bonds, promised fixed payment to ultimate creditors (accepting de facto deposits). These financial institutions were prevalent in the corporate bond market, so that the expansion of the corporate bond market is tightly linked to the rise in ITCs.

The share of guaranteed bonds has been around 85 to 90 per cent over the two decades before the financial crisis. As a result, most bonds were issued according to similar conditions regardless of the financial standing of the issuing company and the bond rating system was not well developed in Korea (Chung and Wang 2000).

A further weakness of the Korean bond market is its chronic lack of liquidity. This is because of the basically inactive secondary market due to Government-controlled prices and a systematic buy and hold attitude.[2]

As a result, the bond market did not play the complementary role it was supposed to play next to the banking sector; it was as badly flawed as the banking sector. The underdevelopment of domestic capital markets raises a number of difficulties: it hinders the appropriate measurement of the opportunity cost of capital, it fuels inefficient use of high savings and excessive short-term debt (thus creating maturity mismatches). As a result, risk-pooling and risk-sharing opportunities are limited and the economy is deprived of a crucial source of information that helps coordinate decentralized decisions throughout the economy (Herring and Chatusripitak 2000).

- *The Stock Market*

During the 1980s and 1990s, several important policy measures were implemented to promote the development of the stock market : first the Government announced the gradual opening of the capital market to foreign investors in January 1981; second the Government announced measures to increase the demand for shares by providing tax and financial incentives to individual investors (also Korean firms were allowed to issue international financial markets equity-related securities such as convertible bonds), third, in 1986 the Government imposed limits to bond issues on firms that were recommended to go public but refused (Chung and Wang 2000).

The stock market grew rapidly during the 1980s, with a doubling in the number of listed companies and a sharp increase in the market value of all listed companies as a percentage of GDP (from 8 per cent in 1985 to 80 per cent in 1989, before declining to 30-40 per cent in the mid-90s). Yet the role of the stock market falls short of what is observed in other economies of a comparable level of development.

[2] Similarly in Malaysia, corporate bond issuance is large but the market is dominated by a single investor, the Employee Provident Fund, and is largely illiquid as a result.

Overall the Korean financial system can be described as a relationship-based system in which banks and firms are closely interconnected under tight Government control. The lack of transparency clearly hindered the development of an efficient capital market capable of mobilizing low-cost equity funds, while the inter-locking relationships between the government and the financial institutions weakened the monitoring capacity of the banks over the chaebols.

1. The Role of the Financial System in the Crisis

- Rising weaknesses

It is important to note at this stage that state-directed bank lending appeared to be quite successful in the early stages of Korea's development and can be held responsible for the country's fast industrialization. One possible explanation is that investment opportunities exceeded capital availability at the time, which is the condition for success of relationship-based finance (Tsuru 2000). Moreover, the Government probably managed to effectively act as a discriminating agent, favoring strategic and fast growing industries which became the engine driving economic progress. By privileging bank loans, the system no doubt permitted much more rapid expansion than would have been possible if companies had relied exclusively on their own resources (Krueger and Yoo 2001).

Easy lending under the tight control of the Government also contributed to shape the country's pattern of specialization (by picking winners and facilitating the emergence of given industries) as well as its market structure (by favoring the rise of large conglomerates, the chaebols[3]).

But on the downside, this system entailed a number of vulnerabilities, making the initial success highly questionable when circumstances came to change.[4] The Government's capacity to act effectively as a discriminating agent probably weakened over time. In other words, credit was channeled to sectors with modest prospects in some cases and often failed completely to identify industries that proved to be real winners.[5] A further difficulty was the gradual loss of control of the Government over the chaebols, and the tendency of the latter to use their protected position to engage into risky ventures. Of course the counterfactual situation cannot be observed so that a definite assessment of the policy is extremely tricky, but what remains are the perverse side-effects of this policy.

First, since the chaebols had strong incentives to rely on credit rather than on equity, their financial structures were in general highly leveraged. All this made the chaebols vulnerable to shocks, such as increases in the cost of capital or a deterioration in their revenues. As pointed out by Krueger and Yoo (2001), the vulnerability of the chaebols was particularly dangerous in Korea given their importance to the economy and given their high financial interdependence through cross share holdings and cross-loan guarantees. A further factor of vulnerability is that investments by the chaebols were not necessarily allocated to the most efficient purposes[6], as a result of easy lending but also of a traditional rivalry that led the chaebols to overstretch themselves and engage in excessive diversification into

[3] As pointed out by Jwa (2002), the chaebols emerged from Korea's past industrial policies and gradually gained importance so that they could no longer be controlled by the Government. Korea's economic history depends very much on the complex interactions between the Government and the chaebols.

[4] It must be stressed that, as is the case for exchange rate régimes for instance, no financial system is best for all countries at all times. Each financial system has merits and demerits but one type may work better in some circumstances and another in other conditions.

[5] According to many, the Heavy and Chemical Industries drive was probably one such case.

[6] See Borensztein and Lee (1999) for empirical evidence on the lack of efficiency of the system : credit flows were not necessarily or systematically directed to the relatively more profitable sectors (neither before nor after the financial reforms).

non-related business areas. Moreover, despite an increasing ambivalence towards the chaebols, the Government maintained its policy of supporting financially distressed chaebols, thus creating incentives for them to borrow and invest in risky projects since the bankruptcy of large firms was out of question (the "too big to fail" syndrome).

Second as a result of Government-led development lending from banks to focused industries, bankers had little incentive to review the economic rationality of proposed investment projects. They thus failed to develop adequate risk screening procedures and capacities and ended up financing unworthy investments. Moreover, as a consequence of the low profitability of these preferred sectors, banks accumulated non performing loans and inherited weak balance sheets (Claessens *et al.* 1998). A final problem is that lending to the chaebols by banks increased disproportionately, making them increasingly sensitive to changes in the economic fate of the chaebols. As the financial health of the borrowers was deteriorating, the quality of the banks' portfolio weakened.

Third, in bailing out banks in distress regardless of their viability, and in taking measures to avert bank insolvency by compensating banks for some of their losses through subsidized rediscounts, the Government created moral hazard and hindered further the development of risk analysis in banks. More generally, the reliance on directed credit to achieve industrial policy objectives clearly inhibited the autonomy and development of the banking sector. In this context, banks failed to monitor the management of the borrowing firms adequately (Khan 1999). As stressed by Haggard and Mo (2000), the so-called developmental state had advantages in spurring capital accumulation, but it rested on close business-government relationship that carried political dangers, including socialization of private risk taking and the lack of appropriate risk management capability.

For all these reasons, the Korean financial system was flawed and fragile. Yet it was made even more fragile by capital account liberalization and massive capital inflows.

- *Liberalization of the Capital Market*

Under the pressure of the US and other industrial countries, as well as from the need to fulfill the implicit preconditions for Korea's joining the OECD membership, Korea started to free its capital market somewhat hastily in the early 1990s (Park 2000). The financial liberalization which took place in the absence of a simultaneous strengthening of prudential standards made things worse as capital was more easily available and in larger amounts.[7] In the context of a relationship-based financial system (as was the case in Korea) the abundance of capital can be dangerous and lead to excesses, in particular to risky investments, and even more so if the number of profitable opportunities is limited. By contrast to what happens in an arm's length system, price signals are not there to guide "right" investments (Rajan and Zingales 2000, 2001).

Because of the cozy relationships between the banks and the Government, the former did not hesitate to borrow heavily abroad and lend to companies embarking in risky projects. Since firms were vulnerable because they were highly leveraged, banks ended up being also vulnerable because they were often exposed to a limited number of firms.

[[Table 2: Capital inflows to Korea]]

[7] Financial system's lending to the private sector increased by 17 per cent annually over the period 1990-96 (Kataoka 1999).

The system could survive as long as growth was sustained, and prospects were favorable, yet all the conditions were met for a crash to happen when circumstances started to change. In the immediate pre-crisis period, corporate bankruptcies exposed the weaknesses of the system. The relationship-based system as such cannot be said to be the root of the problem, but the specific context in which it was operating exacerbated the inherent weaknesses of such a system.

2. The Reform

Because of heavy Government intervention, as well as of the influence of the chaebols, banks, who were the dominant sources of external finance, were not in a position to monitor borrowers and indeed failed to do so effectively. In the immediate aftermath of the crisis, a number of measures were put in place in order to correct these inefficiencies. Now that they are apparently more independent of these pressures, can financial institutions develop the capacity to properly evaluate credit and other types of risks of borrowers and their projects ? It is the objective of the present section to examine these reforms in details in this perspective.

- *Post-Crisis Reforms*

It must be noted that the reform initially focused exclusively on banks, leaving NBFIs under loose regulatory supervision. As a result, these NBFIs, in particular ITCs, substituted for banks, hence their rising importance in the two years following the outbreak of the crisis and the boom in the corporate bond market which compensated for the contraction in other financing channels.[8]

Nationalization and mergers of ailing banks constituted the core of the short-term strategy to stabilize the system. In addition, the Government established the Korea Asset Management Corporation (KAMCO) to buy non performing loans from banks planning mergers or carrying out rehabilitation plans. Finally, the Government also injected public funds into the recapitalization of newly merged banks.

As a further step, a number of measures aimed at enhancing prudential supervision. Among the latter measures is the creation of the Financial Supervisory Commission (FSC) in April 1998, which succeeded the bank supervisory function from the Bank of Korea, to force bad loans restructuring, ensure capital adequacy guidelines are met and tighten up risk management and accounting standards. As a result, prudential norms now basically meet global standards.

Also, important steps regarding commercial presence in the banking sector were taken in the spring of 1998 to increase foreigners' access to the financial sector in Korea. The Korean Government wants banking groups rather than nonbank financial firms to run its big commercial banks, because they are more likely to see the investment as a long term relationship, while private equity funds and other financial services companies tend to view it as a short-term play to sell shares at a premium (FEER, 28.03.02).

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[8] In 1998, a number of depositors shifted their financial resources from bank deposits to investments in ITCs. As their funds rapidly increased, ITCs then bought bonds from manufacturers which were desperately looking for finance in the absence of bank loans. The boom came to an end in the middle of 1999 with the bankruptcy of Daewoo and the dwindling confidence of investors.

First in April 1998, foreign banks and securities firms were authorized to establish subsidiaries (without any restrictions), in addition 100 percent foreign ownership of Korean financial institutions was allowed (although subject to review by the FSC) and foreign nationals were allowed to become directors of Korean banks. Foreign ownership of a Korean bank up to 100 percent was permitted in April 1999.[9]

The objective of these various measures was obviously to allow foreign banks to play a major role in the consolidation of the banking sector. In a longer-term perspective, with the introduction of advanced management skills in the field of credit evaluation and risk management by foreign institutions, the efficiency of the domestic financial market should also be enhanced (Business Korea, October 1999, p. 44).

Also, Korea opened its domestic bond market and accelerated the opening of stock and money markets to attract foreign funds (Kim 2002). With regard to the capital markets, the Government introduced a policy plan to deepen Korea's bond market. It aims in particular to establish a benchmark by consolidating various governments bonds.

- *Changes in the financial landscape*

Significant changes have taken place in the ownership structure and concentration in the banking sector. First, in the wake of the crisis, there has been a rise in government ownership of Korean banks as a result of the recapitalization through nationalization strategy. The government's control thus increased from 33 percent of banking sector assets at the end of 1996 to 54 percent at the end of 2000.

Concentration in commercial banking also increased: the number of banks was reduced from 26 commercial banks at end-1997 to 16 at end-2001. The share of assets of the three largest banks rose in parallel from 26.7 percent to 54.3 percent. The voluntary merger of two privately-owned banks (Kookmin and Housing and Commercial Bank) gave rise to the largest bank in Korea in November 2001. Shinhan Bank followed suit by setting up its own financial holding company.

[[Table 3: Changes in the number of financial institutions]]

Further signs of consolidation and rationalization of the banking sector can be seen in banks' cost reduction efforts. From end-1997 to end-2000, the number of branches dropped by more than 22 per cent, the number of staff by 38 per cent and the costs by close to 21 per cent.

Progress in financial restructuring is reflected in the reduction in the non-performing loans (NPL) ratio: NPLs fell to 18.8 trillion won in 2001, down from 61 trillion won two years earlier. As a result they are now less than 4 per cent of outstanding loans at commercial banks, after reaching 14 per cent in 1998 (Beck 2002).

There have also been substantial changes in the types of activities conducted by banks, with a much wider range of products and services.

A final major change pertains to the presence of foreign investors in the Korean financial sector. Despite the relaxation of restrictions to the entry of foreign banks, Korea's financial opening has not led to any major change in the foreign banks' share in the Korean market. Their share of total banks' assets has steadily increased since 1998 but remains extremely modest, with 6.5 per cent as of the end of 2001. (Kim 2002). Yet this measure may not be the most appropriate to gauge the possible impact of foreign financial institutions on the local financial system. The mere participation of foreign actors

[9] Prior limit was 4 per cent for a nationwide bank, 8 per cent for a bank converted from other financial institutions, and 15 percent for a regional bank.

in domestic banks also matters. Foreign participation in the financial sector may take different forms: foreign bank entry and foreign participation in existing local banks. Progress have no doubt been much more substantial in the latter than in the former form, with foreigners as the largest shareholders of six nationwide commercial banks.

In the aftermath of the crisis, Korea First Bank (KFB) and Korea Exchange Bank (KEB) were capitalized jointly by the government and foreign strategic partners. Commerzbank invested W 350 billion to acquire 29.8 percent equity stake in the Korean Exchange Bank[10] and Newbridge Capital invested $ 417 million in the fall to acquire a majority stake in Korea First Bank (Lardy 2001).[11]

In early 1999 a group led by Goldman Sachs (including the ING group of the Netherlands) invested $500 million to acquire a 17 percent stake in Kookmin Bank, Korea's largest retail bank (Lardy 2001). In November 2000, a consortium led by JP Morgan and the Carlyle group paid $430 million for a 40.1 per cent stake in Koram Bank. Foreign investors also held a large share in Shinhan Bank and Hana Bank.

[[Table 4: Change in ownership in the Banking Sector]]

Another major change has to do with the financing choice of listed firms. While they tended in the past to rely primarily on bank loans and bond issues (which were, as recalled earlier de facto loans), their new preference ordering is as follows: internal funds, share issues, bank loans and bond issues. This change suggests that firms are more attentive to financial risk (Chung and Wang 2000).

The most significant change in the Korean bond market after the financial crisis is that most corporate bonds are now issued non guaranteed and on the basis of credit quality of the issuer (Chung and Wang 2000). This suggests that the bond market is now in a position to play a complementary role next to the other forms of financing. Despite this progress, the bond market still exhibits persistent weaknesses: a major issue is the lack of an appropriate benchmark due to the underdevelopment of the public bond market.

3. Whither The Korean Financial System ?

- Reforming both the Hardware and the Software

The first objective of the reforms described earlier was to clean up the system and restore its health. This has been achieved successfully to a large extent, as reflected in particular in the drop in the number and volume of NPLs.

Beyond this initial impact, the so-called hardware reform was also largely successful. In particular, a number of organizational measures have been put in place with a view to providing a sounder framework, while regulations are broadly consistent with international standards. Among the major changes one can cite the internal reorganization of the banks, with the establishment of independent

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[10] Commerzbank had been a partner to KEB since 1979 when they jointly established Korea International Merchant Bank (KIMB). Commerzbank invested W 20 billion again in March 1999 to acquire 45 percent stake in KEB Investment Trust Management Company, and W 260 billion in April of the same year in KEB, and again W 88 billion in August 1999, and finally W 210 billion in December 2000. Altogether, Commerzbank has injected $ 747 million since 1998. To date (early 2002) it is the only foreign bank with a controlling stake in a Korean counterpart, the KEB.

[11] The sale was done under particularly attractive conditions for Newbridge since the Government promised to compensate it for loans that were classified as performing and proved to be non performing within two years after the sale. Such put-back options on future bad loans resulted in huge and highly unpopular paybacks to Newbridge capital (FEER, 28.03.02, p. 47).

auditing committees; improved credit review process (in particular with a clear separation of credit origination and approval functions, as well as independent credit committees). Overall, transparency has been nominally greatly enhanced. In very much the same vein, incentives are now offered to the staff so as to enhance profit orientation. Profit generation is now key as opposed to emphasis on volume in the past.

More important is what can be called the software reform involving changes in practices and behaviors. The software that needs upgrading includes the way in which bank boards of directors are appointed, their unsophisticated credit analysis and complacent (if not incompetent) risk management capacity, as well as their dependence on collateral-based loan making procedures (Park 2000).

Software reform is by definition more difficult to implement because beyond changes in regulations, people have to change their ways (as the experience of the first wave of liberalization suggests this is not necessarily easily obtained). In this respect, the contribution of foreigners will certainly be key, because their presence in the banking sector may help diffuse new management practices in the sector and may give rise to demonstration effects. Moreover, they are more likely to act independently.

- The Key Role of Foreigners

The potential role of foreign financial firms is traditionally thought to be twofold: first to inject capital and second to provide sophisticated financial management skills (Lardy 2001). Graham (2001) also stresses competition enhancement. It is often argued that if their weight in the sector remains limited their catalytic role will also remain limited, yet this is debatable, in particular if their positive contribution is mainly expected in the software reform.

Drawing on the theory of comparative advantage, it can be argued that foreign banks can use management technology and banking expertise developed for their home use at a very marginal cost abroad. In this respect, the foreign presence in the form of increased participation in bank management through minority shareholding may serve the purpose as well as the establishment/expansion of foreign banks.

Anecdotal evidence from various foreign-invested banks suggests that the Korean banking sector may be indeed heading in the right direction. Generally, decisions appear to be more commercially sensible, reflecting a better monitoring of firms by banks. The refusal of the new foreign management of KFB to participate in the government-organized bailout of Hyundai and other large Korean corporations in January 2001 may be seen as a promising development. Similarly, since the arrival of Manfred Drost as the deputy president of KEB, the bank has reduced its exposure to high risk corporate giants like Daewoo, improved its lending practices and strengthened the credit analysis by its staff (Park 2000).

Also, as could be expected, foreign involvement in domestic banks resulted in better performances in terms of profitability in particular. In the case of Koram, for instance, the new shareholders were instrumental in shaking up the bank's management a few months after the takeover (FEER, 13.06.02). As a result, Koram's non-performing loans have fallen from 13.7 per cent of total loans at the end of 1999 to 9 per cent at the end of 2000 and 2.7 per cent at the end of 2001. It has written off or sold NPLs and made generous loan-loss provisions. Also it refocused its activities on consumer banking. Consumers now account for close to 30 per cent of the bank's loans (compared to 16 per cent in 2000). The bank's goal is for consumer lending to account for half its lending by the year 2004 (FEER, 13.06.02).

As far as the competition-enhancing effect is concerned, it is important to note that foreign banks, or banks with a strong foreign participation, are more likely to be competing head on with the domestic banks than was the case in the past, when the former tended to occupy very comfortable niches in a highly segmented market. As a result, their competition-enhancing and efficiency-enhancing impact is likely to be larger today than in the past.

A further advantage to be derived from the increased presence of foreign banks is related to their likely capacity to survive a local crisis better than domestic institutions. As a result, moral hazard is likely to be reduced because the Government will be confident that a complete meltdown is unlikely and it will thus have less incentive to bail out failed local banks.

All these factors suggest that the Korean banking sector now stands on firmer ground, with more commercially-oriented mechanisms. This is particularly important for the further development of the bond market. As stressed by Oh and Rhee (2001), even though developing the corporate bond markets is important, unless financial intermediaries such as ITCs are well disciplined, the negative effects may overwhelm the positive ones. For the capital market to function appropriately, investors who are compensated for credit risks should be responsible for the risks when they materialize; yet this simple principle has not been observed well in the Korean bond markets. Things may indeed be changing.

Yet, a number of problems still persist. In particular, as corporate restructuring is not yet complete, some banks are still being threatened by troubled firms, such as Hynix. Moreover, the Government has still to sell off the bank shares that it acquired in the course of recapitalizing troubled banks. So far it has failed to do so[12] and there thus remains a risk that the Government will be tempted to continue to exercise a great deal of discretionary power over banks. It remains to be seen whether resistance to change will give in or prevail.

Concluding Remarks

The financial crisis exposed the weaknesses of the Korean financial sector as well as of its economic governance system (both at the corporate and at the Government level).[13] As underscored earlier, tight connections between Government, banks and business, which were the basis of chaebol capitalism, were found badly wanting in the context of rising globalization. Beyond the reform of the financial sector, there is thus a need to redefine the relationship between the Government, banks and business, and probably also the country's overall development strategy.

As was explained earlier, substantial changes have taken place in the financial sector, in particular under the pressure of foreign investors, so that the system is today in a much better shape. Banks are healthier and a number of practices have changed in the direction of better monitoring, increased discipline, better risk management and contract enforceability, so as to ease the shift to more market-orientation. As a result, even if the financial system is still primarily bank-based, it is expected to be more resilient and less prone to excesses. Moreover, the progress towards more market-orientation should also help develop mechanisms favorable to the emergence of a knowledge-based economy.

All this suggests that adjustments in the software are under way in finance. The remaining challenge for Korea is to extend such adjustments to the historically-embedded and currently uncompetitive structures and strategies of the corporate sector as well as to the traditionally favorable stance of the Government toward the chaebols. At the end of the process, Korea may emerge as a very different

[12] Negotiations to sell Seoul Bank to Hong Kong and Shanghai Banking Corporation (HSBC) broke down in mid-1999. New negotiations started with Deutsche Bank ended again in failure in September 2001.

[13] In other words, one can probably assert that the crisis marked the end of the developmental state.

economy characterized by a new form of capitalism implying new relations between Government, banks and business, as well as new foundations for economic growth. Yet it is too early to know which will be the exact shape of the governance system replacing chaebol capitalism, and the risk that the Government may backtrack and return to its usual ways cannot be fully excluded.

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Table 1: Corporate Financing Structure, 1975-96
(in per cent)

	1975-79	1980-84	1985-89	1990-94	1995	1996
Internal Funds[a]	23.0	27.4	38.3	27.3	27.9	22.6
External Funds	77.0	72.6	61.7	72.7	72.1	77.4
Indirect Financing	25.8	28.1	23.1	28.1	23.1	21.5
Direct Financing	15.9	22.1	24.3	29.0	35.6	36.6
Equity	11.3	11.3	13.6	11.3	12.6	9.1
Debt securities[b]	4.6	10.8	10.7	17.7	23.0	27.5

a) Internal funds are savings, fixed capital depreciation, and capital transfer (net)
b) Includes bonds, industrial paper, and debentures
Source: Bank of Korea, adapted from Borensztein and Lee (1999).

Table 2: Private Capital Flows to Korea, 1989-96
(in per cent of GDP)

	1989-95	1991	1992	1993	1994	1995	1996
Net direct investment	-0.1	-0.1	-0.2	-0.2	-0.3	-0.4	-0.4
Net portfolio investment	1.4	1.1	1.9	3.2	1.8	1.9	2.3
Other net private investment	0.8	1.3	0.7	-1.5	1.7	2.5	3.0
Net official flows	-0.3	0.1	-0.2	-0.6	-0.1	-0.1	-0.1

Source: IMF, *World Economic Outlook - Interim Assessment,* December 1997.

Table 3: Changes in the Number of Financial Institutions[a] during 1998-2001

	Number of institutions at the end of 1997	1998-2000			2001			Number of institutions at the end of 2001
		Exit	Merger	Newly established	Exit	Merger	Newly established	
Banks[b]	33	5	6	--	--	2	--	20
Merchant Banking Corporations	30	18	3	1	4	3	--	3
Securities Companies	36	6	1	14	--	--	3	48
Investment Trust Companies	31	6	1	3	--	--	3	30
Life Insurance Companies	31	5	5	--	2	--	--	19
Non-life insurance companies	14	--	1	--	--	--	1	14
Mutual savings and finance companies	231	72	25	12	23	1	--	122
Credit Unions	1666	257	101	9	48	1	--	1268

a) Excluding bridge financial institutions and branches of foreign institutions.
b) Including nationwide commercial banks, local banks and specialized banks.
Source: Bank of Korea, *Quarterly Bulletin*, March 2002.

Table 4: Change in Ownership in the Banking Sector

	December 1996		December 2000		
	Government Ownership	Total Assets	Government Ownership	Foreign Ownership	Total Assets
Commercial Banks	15.70	315.30	36.81	31.45	516.60
National	**16.60**	**280.26**	**36.98**	**34.13**	**473.33**
Kookmin	*17.08*	*31.41*	*6.50*	*58.10*	*81.52*
Korea Housing and Commercial	*26.32*	*28.08*	*14.50*	*66.38*	*60.44*
Kookmin + KH&CB[a]			9.64	70.00	141.96
Shinhan	3.29	21.70	0.00	32.17	47.51
Hana	9.06	11.89	0.00	32.17	41.77
KorAm	4.74	6.69	0.00	61.49	28.17
KFB	7.00	29.93	49.01	50.99	25.45
KEB	47.88	35.27	32.16 // 43.17	33.50 // 32.54	44.55
Cho Hung	6.55	32.64	80.05	0.22	48.89
Hanvit[b]	14.20	57.46	100.00		69.85
Seoul	7.47	21.00	100.00		19.14
Peace[b]	19.17	4.20	100.00		6.04
Regional	**8.40**	**35.04**	**34.93**	**2.17**	**43.25**
S&D Banks	**88.12**	**96.38**	**99.50**		**200.22**
Total	32.64	411.67	54.32	22.67	716.80

a) merged on November 1, 2001.
b) merged into Woori Financial Holding Company in March 2001.
Source : IMF (2001).