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South Korea: Financial Sector Liberalization [redacted] 25X1

Summary

Since the early 1980s South Korea has moved to liberalize its financial sector, taking steps to attract additional capital, technology, and management skills; allow the market to determine interest rates; and expand the use of equity markets. Foreign bankers in particular have found increased opportunities to provide financial services in trade and foreign exchange transactions. [redacted] 25X1

Seoul has moved cautiously, in part to avoid shocking the private sector as banks and businesses are weaned from government-directed, subsidized credit. In addition, although the increased involvement of foreign banks has helped the domestic banking system mature through competition, the contrast between growing profits of foreign banks and the poor performance of their domestic counterparts has exacerbated underlying xenophobic

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sentiments, especially anti-Americanism. Nevertheless, we believe the South Korean Government is committed to a financial liberalization program that will strengthen the domestic economy by encouraging more efficient mobilization of capital and more equitable allocation of credit between large conglomerates and small firms, as well as by shrinking the illegal curb market in loan funds. [redacted] 25X1
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Financial Liberalization

Seoul began loosening controls on the financial sector in 1982, in our view, because of a variety of international as well as domestic considerations. On the foreign side, the South Koreans appeared to be responding to pressure from foreign bankers and protectionist measures against South Korean exports produced with subsidized credit. In the domestic setting, the government wanted to put a high priority on mobilizing domestic savings and feared that without a new policy, the scandals linked to the illegal curb market could recur. Liberalization efforts have varied from one financial market to another, but Seoul has crafted its program to benefit all sectors by:

-- Promoting competition in the financial system.

-- Reducing government intervention in the routine management of financial institutions, particularly commercial banks.

-- Encouraging foreign investment in South Korean financial institutions by easing restrictions on joint ventures and according foreign and domestic banks equal treatment.

-- Developing new savings and debt instruments to improve bank liquidity and phase out corporate dependence on subsidized bank loans. [redacted] 25X1

Easing Controls on Commercial Banks

A major target of the liberalization effort has been the banking sector. Seoul is gradually reducing the Bank of Korea's direct control over the day-to-day management of that sector, relying instead on general guidelines and standards of performance:

-- In early 1983, the Bank of Korea, the central banking authority and formerly the majority stockholder in South Korea's commercial banks, completed a nine-year divestiture program.

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-- The government has replaced direct credit controls for each bank with indirect measures modeled after those of developed countries, including reserve requirements, rediscount operations, and open market operations.

-- The Bank of Korea's Office of Bank Supervision and Examination is now concentrating on monitoring the financial performance of individual banks and has lessened its micromanagement of bank personnel, organization, and budgeting.

-- The government is phasing out its special financial treatment of specific industries by eliminating preferential interest rates and forced lending (that is, loans dictated by government policy). 25X1

Despite the relaxation of central controls, government influence over domestic banking remains extensive. Privately held South Korean banks are in fact under lightly veiled management control by the government. The Ministry of Finance, for example, selects the chief executive officer for each of these banks. The Ministry also controls interest rates in order to affect inflation and to avert the slower economic growth that might result from higher, market-determined interest rates in chronically credit-short domestic financial markets. Because the market plays a limited role in setting interest rates, the Finance Ministry must control the allocation of credit among sectors: domestic banks must reserve a specified percentage of their loanable funds for small- and medium-sized firms and other high-risk borrowers--groups banks would otherwise shun in favor of the largest firms, which now receive over half of all bank loans. 25X1

Seoul also continues to monitor credit flows to the largest firms and to restrict them if they absorb too large a percentage of total credit. The Finance Ministry took such action against South Korea's five largest firms in late 1984. Although Seoul relaxed these controls in 1985, when economic growth slumped, the government has put the conglomerates on notice that it will reinstitute credit limitations once growth picks up. Furthermore, Seoul has decreed that no person or firm can hold more than 10 percent of the voting shares in a single bank, in order to prevent concentration of domestic banks in a few hands. The government fears that if it stops intervening, the large business owners will quickly take over the banks and use them as ready sources of cash with no questions asked, a situation it views as politically dangerous. 25X1

The government has also been forced to keep its hand in the domestic banking sector because many of the loans banks made at its direction have gone sour. These bad loans amounted to about $4.5 billion at the end of 1985, while equity in commercial banks

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was only $1.2 billion--technically a state of insolvency. Much of this bad debt is traceable to losses on construction projects, primarily in the Middle East. The Bank of Korea has assisted commercial banks, absorbing the bad debts by extending loans to these institutions at preferential rates. Commercial banks pay 3 percent for these loans, while collecting 11 percent from borrowers. The profits are to be used to create a reserve to cover bad loans. If the government continues to make the special loans at this year's $560 million rate, however, it will take 45 years to make up the shortfall. Even if foreign lenders view the government's rescue plans skeptically, collapse of the Kukje group in February 1985--formerly South Korea' sixth largest conglomerate--provided an opportunity for the government to demonstrate direct support of the banking system, essentially confirming foreign lenders' views that corporate debt is also sovereign debt. [redacted] 25X1

Foreign Bank Rules Eased

Liberalization of the banking sector has extended to foreign banks, as Seoul's economic liberalizers have instituted new regulations placing foreign banks on near-equal footing with domestic banks in the public bond market and in the competition for won-denominated deposits and lending to domestic firms. Other changes allow foreign banks to enjoy domestic bank status through joint ventures with South Korean partners. [redacted] 25X1

Seoul took another step toward responding to foreign bankers' demands for equal treatment in early 1985, when it granted foreign banks access to the Bank of Korea's rediscount facility for export support loans--with the qualification that they provide at least 25 percent of such loans to small- and medium-size firms. Seoul has pledged to continue to improve foreign bankers' access to the rediscount window. Foreign bankers had cited their lack of access to the rediscount window--which left them with a chronic shortage of won--as a key constraint on their effort to expand business to domestic firms. [redacted] 25X1

As the government eases the restrictions on foreign banks operating in South Korea, it is also curtailing certain privileges enjoyed exclusively by foreigners. In gaining access to rediscount windows, foreign banks were required to surrender guaranteed profits and freedom from foreign exchange risk on swap[1] transactions--advantages not available to domestic banks. [redacted]

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[1] Swap transactions occur when a foreign bank acquires currency from its home office (usually in the form of a short-term loan) that is converted into won at the Bank of Korea. [redacted] 25X1

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Seoul has not addressed the contentious issues of foreign bank capitalization and property ownership. Foreign bankers cannot make large, single-borrower loans, open new branches, or provide high-profit, nonlending services on an equal basis with domestic banks because of regulations that narrowly define their capital--the basis for their lending limits. Moreover, the prohibition against foreign banks holding title to real estate and other property, including ships and aircraft, denies their use of such collateral to secure loans. [redacted] 25X1

Despite these restrictions, foreign banks have earned a good return on their assets in South Korea for the past five years. Profits in 1985 were 34.8 percent more than the previous year, according to the press. Last year US banks surpassed their South Korean rivals in business performance, largely as a result of their understanding of international business practices, advanced communication facilities, and up-to-date management procedures. The fortunes of South Korean commercial banks, in contrast, have declined, with profits last year down 46.1 percent from 1984. [redacted] 25X1 [redacted] 25X1

Although the foreign bank profits are reasonable by international standards, many South Koreans consider the profits excessive. Traditionally, banks have been perceived as instruments of the government with social responsibilities, not merely as profit-making institutions. Radical students and labor have attacked branches of the Bank of America and most recently Koram, a joint venture between the Bank of America and a Korean bank. According to the US Embassy, the latest round of anti-Americanism directed against the banks is probably in reaction to South Korean newspaper reports on the "high profits" of foreign banks. The tone of the press articles suggested that the foreign banks were somehow taking unfair advantage of the South Koreans. [redacted] 25X1

Seoul has taken a variety of steps to deal with the backlash set off by strong foreign bank performance. Earlier this year, for example, South Korean tax examiners launched the widest ranging audit of foreign banks since President Chun took power in 1980. Nine of the 15 banks audited were American. The government is undoubtedly trying to convey the message that it will not allow foreign bankers to profit unduly at South Korean expense. Moreover, continued depressed profits among domestic banks may prompt Seoul to close the door to new foreign banks. [redacted] 25X1

Strengthening the Non-Bank Sector

Seoul's financial liberalizers are also looking beyond the commercial banking sector and have taken some small steps to bolster the equity markets and install a more flexible interest rate regime:

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-- The government is implementing a comprehensive development plan for the Korean Stock Exchange, designed to encourage South Korean firms to replace debt with equity financing.

-- As of this year foreigners can for the first time invest directly in South Korean firms through convertible bonds floated in European exchanges. Small mutual fund-type investment in the Korean Stock Exchange, but traded in foreign exchanges, has been allowed since 1981.

-- The government has taken a few cautious steps to loosen its control over interest rates--the key to a market-led financial system. Before 1984, the Finance Ministry maintained a rigid schedule of loan and deposit interest rates, which is now making way for a more flexible system that allows rates to vary within limits imposed by the Ministry. Bankers are now allowed to charge loan rates that reflect the demand for credit and the riskiness of the borrower, although even the most creditworthy firms usually pay the highest limit on loan rates because of scarce credit. [redacted] 25X1

<u>Outlook</u>

We expect financial sector liberalization will continue in fits and starts as Seoul attempts to nurture its nascent domestic financial institutions and seeks to attract foreign capital and technology to this sector. The long-term prospects for movement toward an international, market-based financial system are good. The key argument of the liberalizers--namely that greater reliance on market forces will benefit the South Korean economy--is gaining wider acceptance within the bureaucracy. The current Chun cabinet, for example, is heavily weighted with proponents of liberalization, who have eased restrictions on direct foreign investment and imports, in addition to opening the financial sector. [redacted] 25X1

The US factor will also encourage Seoul to stay the course. Renewal of Generalized System of Preferences (GSP) benefits--which the 1984 US Trade and Tariff Act links to progress in economic liberalization--and the threat of stern US trade measures, such as 301 actions, will prod opponents to liberalization to give way. [redacted] 25X1

Nonetheless, the government is clearly handicapped by the weakness of the banking system compared with the impressive growth of other sectors in an increasingly complex--and profitable--economy. Whereas the South Koreans have often balked at taking steps to liberalize imports and investment for political reasons, the beleaguered banking system offers genuine

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constraints. Progress on reforms also will depend on attitudes among businessmen, politicians, and the general public. Greater reliance on market forces carries a variety of risks and uncertainties, and if economic conditions deteriorate, criticism of government policy would put heavy pressure on Seoul to retake control of the economy. [redacted] 25X1

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