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## Foreign Banks in Economic Development: Experiences from the Regulated Financial System of South Korea

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**Foreign Banks in Economic Development:  
Experiences from the Regulated Financial System  
of South Korea**

*Ralf Müller*

February 2000

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*Discussion Papers*

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# Foreign Banks in Economic Development: Experiences from the Regulated Financial System of South Korea

*Ralf Müller*

February 2000

## **Abstract**

Various less developed countries and newly industrialized countries use financial regulation as an instrument for industrial policy. Based on a theoretical analysis, this paper provides empirical evidence for South Korea on how foreign banks compete in a regulated environment and how competition changes with deregulation. Overall, the results show that foreign banks had a limited but positive impact on financial development. In terms of market performance foreign banks were found highly efficient although foreign banks' market shares decreased under deregulation. While foreign capital inflows finally led to a financial crisis, the lion's share of these funds was lent by domestic banks to loss-making Korean corporations. Thus, from a policy point of view it is more reasonable to give foreign creditors the freedom to allocate credits directly to domestic debtors.

JEL classification: G2, L5, O1

Keywords: Economic Development, Foreign Banks, Financial Markets, Korea, Regulation.

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## I. INTRODUCTION

Various developing countries have seen their financial system as an instrument for industrial policy. Consequently, regulations in these countries were mainly directed to influence banks and other financial institutions in order to allocate funds into specific economic sectors rather than to maintain solvency of financial intermediaries and stability of the financial system. The major results of this policy were institutionally weak intermediaries, flourishing crony-economics, high non-performing loans, and finally a tendency towards a banking crisis. Thus, economic development was more damaged than promoted. A vast amount of literature has already been written about government's impact on financial intermediation and recommends a reduction of government influence.<sup>1</sup> However, not all liberalizing countries really succeeded: Several countries suffered financial instability and withdrew reforms. Obviously, the main cause for liberalization failures was an inadequate sequencing of the reform process (Fischer/Reisen 1992). Frequently, freedom in business and market entry was given to financial institutions before or – even worse – without establishing a system of qualified banking supervision and strengthening the financial system institutionally (e.g. changes in banks' management and a reduction of non-performing loans).

One aspect of liberalization hardly investigated so far is how foreign banks may contribute to an upgrade of the financial systems' performance.<sup>2</sup> Foreign direct investment in the industrial sector has been proved to be an adequate mechanism for supporting economic development. For many newly industrialized countries economic success started when foreign direct investment was liberalized. This may also be true for the entry of foreign banks. The following analysis will investigate this question. Of course, it cannot serve as a final answer on how foreign banks contribute to financial and economic development. Instead, a case study will be presented that gives insight into the activities of foreign banks in a financial system which experienced decades of repressive regulations with a cautious reduction of government influence over time: Target of the investigation is the case of foreign banks in South Korea.<sup>3</sup>

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1 For an excellent overview see Fry (1995).

2 An early analysis that dealt, among other things, with foreign banks, is the well-known work of Goldsmith (1969, pp. 360ff.) about financial systems' development. He emphasized the importance of foreign banks for developing a financial system by pointing out that outside of Europe and North America the development of financial systems was widely based on foreign banks. The focus of later studies were the determinants of foreign banks' presence: Empirically, a relationship was identified between foreign companies' direct investment and both presence and market shares of foreign banks for various industrialized countries (Goldberg/Saunders 1981, pp. 17ff.). A similar influence is seen for trade (Budzeika 1991, pp. 14ff.; Hondroyiannis/Papapetrou 1996, pp. 207ff.). For developing countries, Sabi (1988, pp. 440ff.) identified a relationship between US-Banks' activities and US-companies' presence but no impact of trade. Contrary, Marashdeh (1994, pp. 113ff.) found a relationship between foreign banks' presence and trade in Malaysia while foreign direct investment had no influence according to that analysis.

3 This paper summarizes the main results of a comprehensive investigation of foreign banks in South Korea (see Müller 1999).

The analysis consists of two sections. In the first section, the regulation environment in the Korean financial system will be described and analyzed theoretically with regard to its impact on foreign banks' activities. In the second section, several aspects of foreign banks will be investigated: Entry motives, activities in the credit markets over time, influence of regulation and deregulation, preferred market segments, competition, and indicators of market performance like solvency, profitability and productivity. The analysis is primarily based on the evaluation of a questionnaire-investigation conducted in 1995. In this survey, 24 of 25 questioned foreign banks and 11 domestic – nationwide commercial – banks<sup>4</sup> gave answers concerning various aspects of their activities.<sup>5</sup> The 24 foreign banks held approximately 70 per cent of all foreign banks' assets in South Korea at time of questioning; the 11 nationwide commercial banks represented nearly 90 per cent of all nationwide commercial banks' assets. Thus, the analysis will provide a good review of foreign banking in South Korea compared to domestic banks. The period investigated ends shortly before the outbreak of the financial crisis in 1997, but the difference in efficiency of foreign and domestic banks in South Korea will illuminate the major causes for the crisis. In the final conclusion, implications regarding how to overcome the weaknesses of banking in South Korea will be presented.

## **II. FINANCIAL BACKGROUND IN SOUTH KOREA: ANALYSIS OF THE REGULATION ENVIRONMENT**

There are only a few countries that experienced a similar dynamic growth in the recent economic history. Even compared to other Asian countries South Korea's economic development is impressive. However, the recent events have revealed weak spots in the economic system and especially in financial intermediation.<sup>6</sup> One of the major critical aspects in South Korea's economic development, an important cause for the final crisis and a bottleneck for future development, is that financial development lags far behind economic development, this can be seen in an international comparison of "financial deepening" – measured by financial assets relative to GDP (see Table 1). In fact, South Korea's financial institutions are less developed in mobilization of savings and inefficient in credit allocation – the latter can be observed especially in practices of bribery and cronyism by bank managers. This weakness in financial intermediation was caused by decades of repressive regulation, which used intermediaries for industrial policy in a non-competitive environment.

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4 Two of these nationwide commercial banks were mainly in domestic hands but had also foreign owners. Thus, in the later analysis of the questionnaire they are indicated as joint-ventures (JV).

5 The questioning was realized under the assistance of South Korea's central bank: The Bank of Korea sent the questionnaire to both foreign and domestic banks but without influencing the questions and without getting any insight into the results of the questioning. Only a single foreign bank and no domestic bank refused to answer the questionnaire.

6 For a comprehensive and critical description of South Korea's economic development before the outbreak of the financial crisis see Cho (1994).

Table 1  
Financial deepening in several Asian countries in 1997

	Money <sup>a</sup> /GDP (in per cent)	Financial sector's claims on private sector/GDP (in per cent)
Japan	73,8	114,2
Singapore	67,4	100,7
South Korea	40,0	73,4
Malaysia	69,8	103,9
Indonesia	44,5	60,9

<sup>a</sup> Broad money as defined by IFS (International Financial Statistics) ("quasimoney").

Source: International Monetary Fund (1999).

Financial intermediation is very diverse in South Korea. The Korean financial system includes nationwide commercial banks, regional banks, specialized banks, branches of foreign banks (located in the cities of Seoul and Pusan) and various nonbank-financial institutions. This structure has grown since the early 1960s. After the military coup in 1961, a new government under General Park Chung-Hee ordered the nationalization of the few already existing (nationwide) commercial banks and the building of further financial institutions: Specialized banks for the whole country and regional banks for each Korean province were founded, and in 1967 the entry of foreign banks was allowed for the first time since the end of the Japanese occupation. Moreover, some nonbank-financial institutions were built – a process that accelerated in the beginning of the 1970s and received further boost in the 1980s.

The magnitude of using the different kinds of financial institutions varied in the past; however, none of these institutions was really free of government influence. Nationwide commercial banks, which were allowed to do business throughout the country but are still based mainly in the large cities, became the main credit source in the financial system. They were completely state-owned and controlled by government officials. Thus, nationwide commercial banks allocated funds into specific sectors and companies according to state priorities. During the 1960s and 1970s this resulted in a huge and excessive credit flow to large conglomerates (the "jaebol"). As far as there was an opportunity for independent allocation, bank managers strove for personal advantages (bribery and crony-activities). Compared to nationwide commercial banks, regional banks enjoyed more independence in selecting customers and setting conditions, but regional banks remained restricted to their province and concentrated business on small and medium-sized companies. Specialized banks served as development banks and, consequently, were directly bound by government orders. Specialized banks were founded for different target groups (e.g. export, small and medium-sized companies, housing, fishing, agriculture and forestry). Nonbank-financial institutions entailed a large spectrum of intermediaries and their instrumentalization was similarly diverse. For example, state-owned investment institutions were nothing more than government's longer arm in the financial business while leasing companies, finance companies or



merchant banks certainly were restricted to their specific business but in this area relatively free.

Foreign banks had a special function and, therefore, a special regulation status, too: On the one hand, they could not do business in such areas as trust or retail banking; on the other hand, they were relatively independent of government orders when channeling funds into specific companies at special rates. The main instrument for controlling foreign banks' market share and capital import was a swap-policy. Each foreign bank had a quota (swap-contingent) which allowed a limited import of foreign capital and exchange into the Korean currency "Won". By this swap-policy, the Bank of Korea offered foreign banks a special margin (swap-margin) for their swap-contingent that implied a generous profit. Thus, even in times of relatively low – regulated – domestic interest rates (compared to international markets), foreign banks' capital transfer to South Korea was lucrative. Other sources of refinance, however, were highly restricted. During the 1960s and 1970s there was no real access to the Bank of Korea's rediscount facility and it was not allowed for foreign banks to have more than one branch in Seoul (since 1978 one further branch could be founded in Pusan). Thus, refinancing like domestic banks through retail business was not possible.

Apart from these regulations on foreign banks' business, competition in the financial system was suppressed in several ways. Firstly, restrictive entry barriers protected existing banks and other financial institutions from new competitors. Between 1973 (when the foundation of regional banks was completed) and 1981 (when the first private-owned nationwide commercial bank was built) only foreign banks' entry could cause an increase in the number of market participants in the banking sector. Secondly, market-segmenting restrictions regarding business areas and customer groups for the different financial institutions limited competition among banks and especially between banks and nonbank-financial institutions. Finally, regulations on interest rates existed for both savings and credits and thus prevented real competition.

It began in 1981 and was at least partly the consequence of a short but deep recession in connection with the political crisis of 1979/80 (after President Park's assassination) when the government carefully started a reform process in the financial system. The major reform steps are summarized in table 2.

Table 2  
Major deregulation measures in the financial system since 1981  
until the outbreak of the financial crisis

Year	Deregulation measure
1981	The privatization of nationwide commercial banks begins. Licenses for new private-owned nationwide commercial banks were granted.
1981-1984	Abolition of credit controls (limits on credit volumes for individual banks) and reduction of minimum reserve requirements (during the 1960s and 1970s one of the major monetary policy instruments).
1984	Certificates of Deposit (CD's) were introduced for domestic banks (two years later also for foreign banks) – a first step towards the liberalization of interest rates. Partial liberalization of interest rates by allowing margins within interest rates to be set freely by banks.
1985	Reduction of swap-margins and swap-quotas for foreign banks (several further reductions followed during the next years). Foreign banks received limited access to the Bank of Korea's rediscount window. Restrictions that excluded foreign banks from trust business were relaxed.
Since 1985	Several deregulations regarding the capital account liberalized international capital transfer (but dependent on the current account situation there were repeatedly re-regulations for capital account transactions).
1986	Foreign banks' access to the Bank of Korea's rediscount facilities was extended.
1987	Derivatives were introduced.
1988	Different interest rates were liberalized (this reform was annulled just a few months later). Foreign banks received the permission to build more than one branch in both Seoul and Pusan, to open branches in other cities and the allowance to do business with individuals (retail banking).
1991-1997	Announcement and implementation of a four-step-plan to liberalize interest rates (apart from demand deposits all interest rates were deregulated until 1997).
1993	A so-called "real-name-system" was introduced that prohibits the holding of bank accounts under pseudonyms.

Despite these reforms, various restrictions remained: Regulations that repressed capital account transactions, minimum credit-quotas for banks' business with specific customers (especially minimum credit-quotas for small and medium-sized companies), the regulation of interest rates on demand deposits, and different market segmenting restrictions on business areas for intermediaries. Moreover, informal government influence on intermediaries' market behavior replaced formal regulations. Especially banks still served as "agents of development" for the government when in November 1997 the financial crisis became obvious.

For the supply of financial funds in South Korea the inflow of foreign capital was essential in the past, because apart from a short period between 1986 and 1989 the current account had continuously been in deficit – since 1990 with an increasing trend

and record-deficits in 1995 and 1996. Foreign financial institutions – both institutions that operated from abroad and foreign banks that operated branches in South Korea – were an important mechanism to channel funds into the financial system. The figures 1, 2 and 3 illustrate the potential impacts of such capital imports.<sup>7</sup> In figure 1, this is analyzed for the case of regulated interest rates (with  $i_{\text{regulated}} = AB$ ). It is assumed that foreign banks do not mobilize domestic savings and operate completely with funds from abroad (which was the case in South Korea as long as foreign banks were highly restricted in branching and retail banking). On the other hand, domestic banks attract funds only in the domestic market (domestic banks in South Korea were for a long time highly restricted in international business and, moreover, did not have the creditworthiness like foreign banks in international markets to attract funds). Consequently, domestic savings supply is domestic banks' credit supply (determined by Korean residents' savings) and foreign savings are imported and offered exclusively by foreign banks. Foreign banks do so under the prerequisite that the interest rate in the domestic (Korean) market (which was  $i_{\text{regulated}}$  in times of interest rate regulation) plus the swap margin (granted to foreign banks by the Bank of Korea) is higher or at least equal to the international interest rate – formally:

$$(1) \quad i_{\text{regulated}} + \text{swap margin} \geq i_{\text{international}} = AC.$$

Without foreign banks' entry the credit supply is AD – as illustrated by figure 1. Thus, because of the regulation-induced credit demand AE a not covered excess demand of DE remains. The effects of foreign banks' entry are the following: Credit supply increases up to an amount corresponding to the AE-line with foreign banks' market share being DE/AE. As long as foreign banks do not attract funds in the domestic financial market, the market position of domestic banks (with the credit amount of AD) is not threatened by the foreign entrants, because the additional supply of funds will only meet the regulation-induced excess demand for credits. In fact, an excess demand for credits still remained in South Korea because the swap transactions for foreign banks were very limited and not sufficient to cover the complete excess demand for credits at the regulated interest rate. This reflects the situation of South Korea's financial system as long as interest rates were regulated and foreign banks excluded from attracting domestic savings and thus concentrated on international savings (which were transformed by the Bank of Korea-swap into Korean Won).

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7 For the following graphic analysis it is assumed that there are no costs of intermediation. Thus, for perfect competition banks will offer credits at the interest rate for savings. Consequently, the supply curve for savings and the supply curve for bank credits are identical. A similar analysis as in figures 1 and 3 can be found in Blejer/Sagari (1987) who investigated the general impact of capital inflows.

Figure 1  
Foreign banks' entry under regulated interest rates and swap-policy

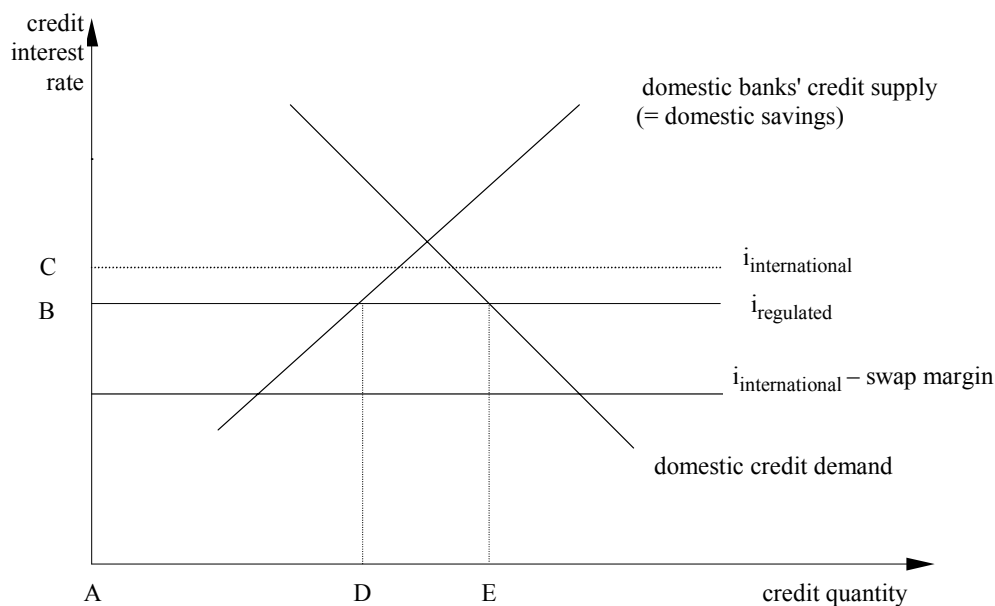


Figure 2 illustrates the efficiency (or inefficiency) of swap-policy applied to foreign banks in South Korea under the assumption of government-fixed interest rates (by regulations or informal pressure on banks to keep interest rates low) with

$$(2) \quad i_{\text{regulated}} = AB < i_{\text{international}} = AC.$$

Moreover, it is assumed that the competitive domestic interest rate for the closed financial system (no capital imports) is above the international interest rate:

$$(3) \quad i_{\text{domestic competitive market}} = AD > i_{\text{international}} = AC.$$

As long as the domestic regulated interest rate is below the international interest rate, the efficiency of international financial intermediation could be raised by capital imports through foreign banks. Highest efficiency occurs in a market equilibrium with

$$(4) \quad i_{\text{domestic}} = i_{\text{international}} = AC,$$

when savings according to AI are mobilized in the domestic financial system and savings of IL are taken from the international market (efficiency equilibrium). However, when capital import is not possible and interest rates are regulated (with AB) only an amount of savings AE could be mobilized in the domestic markets (while no international funds will be attracted) and an excess demand EN for credits remains. Compared to the efficiency equilibrium, inefficiency equal to the area FHMJ results. On the other hand, if the government would decide to deregulate interest rates domestically but keep the financial system closed for foreign funds, a – former – welfare loss FHK could be avoided but because of the absence of foreign funds a welfare loss JKM remains (domestic competitive equilibrium).

Now suppose that the central bank introduces a swap-policy by offering foreign banks a swap-margin that implies a price gain for them. A swap-margin that at least equals the margin between the (regulated) domestic interest rate and the interest rate in international markets ( $i_{\text{international}} - i_{\text{regulated}} = \text{CB}$ ) is necessary to attract foreign savings. In this way, the former excess demand for credit can be completely met by foreign banks' capital import EN. Compared to the efficiency equilibrium, only inefficiency equal to FGJ plus MPO remains. FGJ represents the welfare loss arising from the import of foreign savings (at the international rate AC) which could be mobilized for less in the domestic market (if the domestic interest rate would not be regulated). Welfare loss MPO arises because the regulation-induced low interest rate causes a further demand for credits (LN) which does not represent a profitable investment under the market interest rate AC in the efficiency equilibrium.

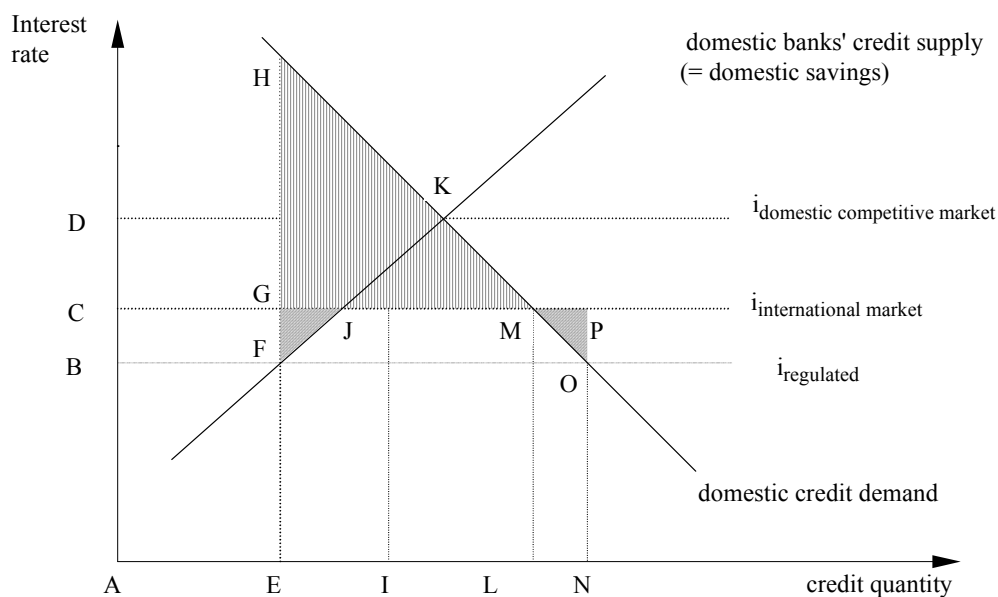
We can see in figure 2 that the swap margin CB is not only the minimum margin to attract foreign funds but also the most efficient solution to reduce inefficiencies caused by interest rate regulation through swap policy. Every swap-margin higher than CB would cause a capital import larger than EN and thereby inefficiencies larger than FGJ plus MPO. On the other hand, a swap-margin of less than CB would let everything be the same as before (which means an inefficiency FHMJ) because  $i_{\text{regulated}}$  plus swap-margin does not catch up with  $i_{\text{international}}$  and, consequently, capital imports are not profitable.

Thus, the lesson is: Obviously, swap-margins that serve as a subsidy to compensate foreign banks for the disadvantage of low regulated interest rates ( $i_{\text{regulated}} < i_{\text{international}}$ ) are potentially able to increase efficiency by attracting capital imports; nevertheless as figure 2 also shows, some inefficiency remains. This kind of inefficiency can be higher than the inefficiency that remains when the government accepts deregulated interest rates but prohibits foreign capital inflows. In the graphic example of figure 2 this is obviously not the case because the inefficiency caused by swap policy under interest rate regulation (FGJ+MPO) is not as high as the inefficiency (JKM) caused by prohibiting foreign capital inflows under a deregulated interest rate. However, also another constellation is possible.<sup>8</sup> Definitely, highest efficiency can only be realized by deregulating interest rates and allowing foreign capital inflows.

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<sup>8</sup> In figure 2, this could be shown by shifting the line for the international interest rate ( $i_{\text{international market}}$ ) closer to the line for the domestic competitive interest rate ( $i_{\text{domestic competitive market}}$ ). In this way, both FGJ and MPO will increase and overcompensate a decreased JKM.

Figure 2  
Efficiency effects of swap-policy



In figure 3, the deregulation process has been implemented so far that interest rates are deregulated. Moreover, it is assumed that swap policy does not exist or at least does not matter because without regulation-induced low interest rates special swap-incentives are not necessary to attract foreign banks. However, because competition in the financial system is relatively weak – which characterized South Korea still during the mid-1990s as a result of regulation-induced market segmentation and regulated market entry – existing domestic banks can earn excess profits (or oligopoly profits). The (monopolistic or oligopolistic) interest rate is AD and the corresponding credit amount supplied by domestic banks is only AE.<sup>9</sup> With increasing competition – that could be caused not just by foreign banks' integration but also by the entry of further domestic banks – the interest rate will be reduced to AC (with a corresponding credit amount AI) which causes an efficiency gain FGJ. Nevertheless, as long as domestic banks have no access to international financial markets at interest rate level AB, foreign banks have a stronger impact: They can import funds at AB and thus increase the domestic credit supply to an amount AI. The result is an additional efficiency gain corresponding to HJL compared to the situation of pure domestic competition without access to international markets (with an interest rate AC), and an efficiency gain FGLH compared to the initial situation of domestic credit market oligopoly (with the monopolistic or oligopolistic interest rate AD).

<sup>9</sup> It is assumed here that by acting in collusion, banks in the oligopolistic market are able to realize the monopolistic interest rate (by assuming: marginal cost = marginal return).



government to allow foreign banks' entry was to enlarge the access to international financial funds and thus financing the chronic current account deficit. Moreover, foreign banks were thought to increase the competitiveness of the domestic financial system, to attract foreign direct investment and to give Korean banks access to financial systems in countries which practiced the reciprocity principle for foreign bank entry (see Euh/Baker 1990, p. 8). However, in 1967 – the opening year for foreign banks – only a few branches started operation. Obviously, foreign banks were skeptical regarding South Korea's economic and financial development, but moreover, the government favored a strategy of slow market opening. The bulk of the 52 foreign banks that operated in South Korea during the mid-1990s took up business between 1974 and 1985. Since the end of the 1980s, foreign bank entry has stagnated and began to decline in the 1990s – during this time, especially since 1995, several foreign banks closed their branches in Seoul or Pusan.

In searching for the entry motives of foreign banks a clear change could be found over time. Table 3 indicates the results from the questioning of 24 foreign banks about their major motives for joining the Korean financial system. The majority of foreign banks built up branches in Seoul (since 1977 it has also been allowed in Pusan) in order to do business with Korean customers. However, at the beginning of the financial opening, several banks, especially Japanese, came primarily for doing business with companies from their home country that operated already inside South Korea. This changed during the 1970s, when Korean customers increasingly became the preferred business area for foreign banks, even for Japanese ones. Obviously, the South Korean economy became increasingly attractive for foreign banks over time, and thus their presence grew further. Moreover, an increasing current account deficit after the first oil crisis in 1973 promoted foreign banks' activities (see figure 4a-c).

Table 3  
Entry motives of foreign banks<sup>a</sup>

	Doing business with companies from a bank's home-country that operate in Korea	Doing business with other foreign companies that operate in Korea	Doing business with Korean customers	Other motives
All foreign banks	4	1	20	1
From:				
USA and Canada	-	-	7	1
Japan	3	-	3	-
Europe	1	-	6	-
Asia without Japan	-	1	4	-
With year of entry:				
1967 – 1972	4	-	5	-
1973 – 1985	-	1	11	-
Since 1986	-	-	4	1

<sup>a</sup> Two banks named two major motives for entry. Consequently, the first row of table 3 sums up to 26 (instead of 24).

Source: Survey.



The current account had a strong influence on foreign banks' market shares. In figure 4a, the development of foreign banks' market shares for all bank assets can be seen.<sup>10</sup> Figure 4b presents data concerning the growth of these market shares (in percentage points) in view of the current account deficit. Figure 4c sketches data about foreign bank growth of all assets compared to the current account deficit.

Figure 4a  
Foreign banks' market shares

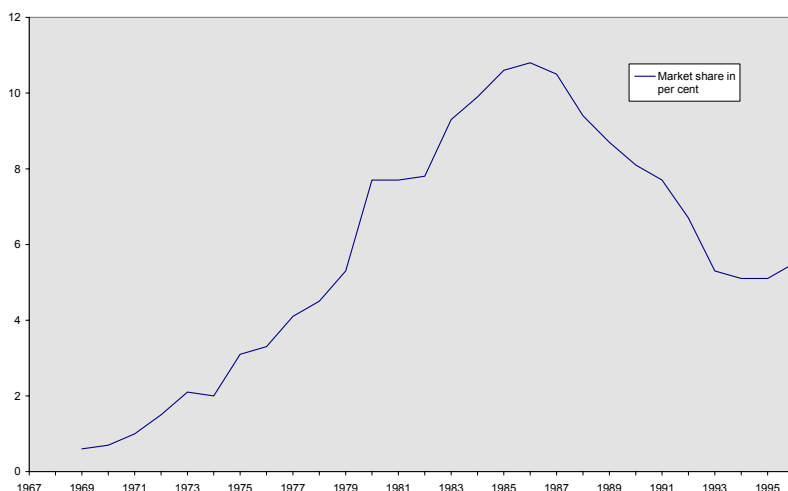
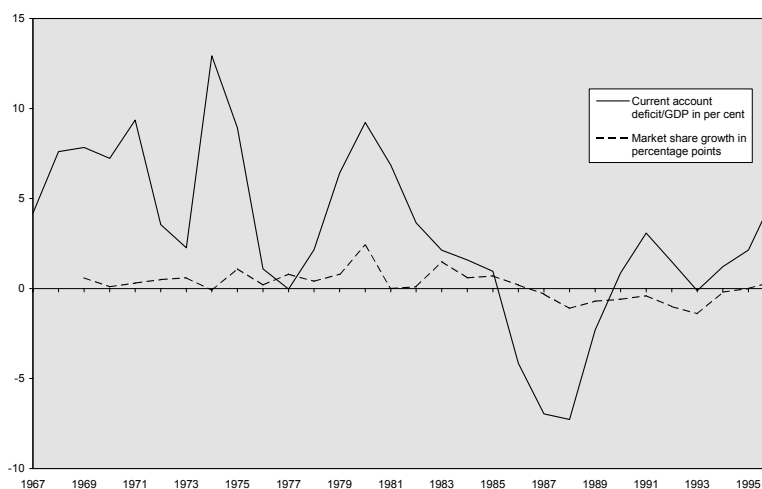
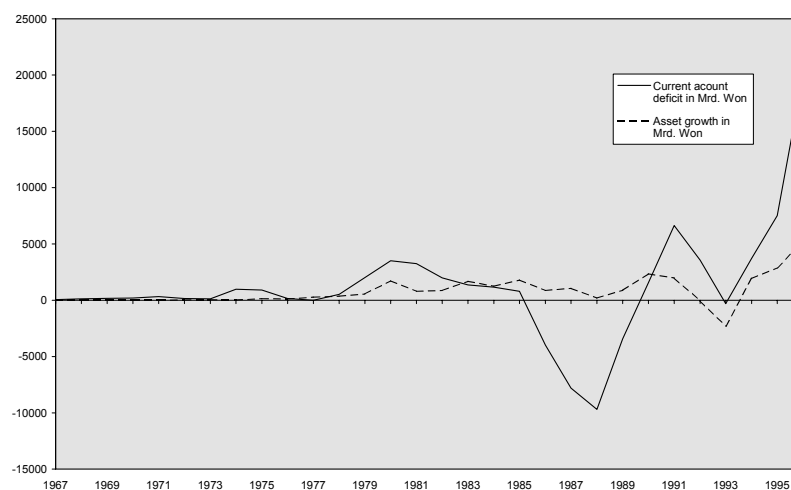


Figure 4b  
Foreign banks' market share growth  
and current account deficit/GDP



<sup>10</sup>Foreign banks' market shares in the domestic mobilization of savings is not presented here because – as a result of both rigid regulations regarding branching and, moreover, most foreign banks' strategy to concentrate on credit business – their activities in the mobilization of domestic funds remained marginal. Thus, refinancing in international markets and by the head-office of foreign banks in the home country is predominant still today.

Figure 4c  
Foreign bank asset growth and current account deficit



Source: Bank of Korea, International Monetary Fund.

After a slow beginning, foreign banks' market share in all bank assets increased in the late 1970s and early 1980s and reached a top of nearly 11 per cent in 1985. Afterwards, their market share decreased significantly and almost continuously – a process that was stopped in 1994 and reversed in 1996 (see figure 4a). Until 1989 the downward trend of foreign banks' asset share (which began during the mid-1980s) can be led back to South Korea's current account. As a result of an export-oriented economic development and an increasing success mainly of *jaebol* in world markets during the 1980s, the current account deficit shrunk and in 1986 a large surplus occurred, the first ever since independence (except for a very small one in 1977). Thus, the situation for foreign banks had changed completely in 1986 and in the following years the market shares decreased – but foreign banks did not lose market volume because South Korea's financial system grew at extraordinary rates year by year.

However, there was not just a changing current account in the 1980s. Moreover, motivated by deregulation, domestic banks began to expand their so far very limited overseas activities and gained access to international financial markets. Consequently, when South Korea returned to a current account deficit in 1990, foreign banks could initially not profit by increasing their market shares. Domestic banks were now able to attract the bulk of necessary foreign funds and, likewise, some Korean companies – especially *jaebol* – could borrow abroad, too. Thus, despite a current account that was almost continuously in deficit, foreign banks had lost market shares (see figure 4b) and began to close branches in both Seoul and Pusan. This continued till 1996 when the current account grew to a new deficit record (with a deficit record already in the year before – a sign for the approaching crisis). Foreign banks' asset share now started to increase again, but more moderately compared to the current account deficit. As figure 4c indicates, a parallel can also be drawn for foreign banks' asset growth in absolute terms and the current account deficit.

The conclusion of this first subsection is that especially in the relatively early phase of economic and financial development in South Korea foreign banks' market shares depended for a great part on the current account deficit. With an increasing access of domestic banks and jaebol to international financial markets this changed partly, and thus despite growing current account deficits foreign banks lost market shares even in the 1990s. An influence of the current account on foreign banks' market share still exists. However, deregulation, which enlarged domestic banks' freedom for international activities, took away a part of the foreign banks' market. The impact of deregulation will be analyzed in detail in the following section.

*b) Impact of deregulation*

Regulations are a crucial determinant for the structure and performance of each financial system. Consequently, deregulation in South Korea – as described in section 2 – caused a serious change in the financial system, even when considering that various regulations remained. The impacts of deregulation were one aspect of the bank questioning.

Table 4 shows deregulation effects on both foreign and domestic banks' activities and supports the thesis that foreign banks lost market shares in South Korea as a result of reduced regulations. While nearly all surveyed nationwide commercial banks (eight completely domestic banks and two joint-venture-banks) stressed an extension of their activities as a result of deregulation, foreign banks' consequences varied. 10 of 24 surveyed foreign banks saw no difference for the size of their business, six banks reduced activities and only four banks extended activities because of deregulation.

The decisive cause for this different behavior of foreign and domestic banks lies in the fact that in the era of repressive regulation foreign banks were mainly restricted to areas that they did not prefer anyway (e.g. retail banking, business in other cities than Seoul or Pusan). On the other hand, domestic banks – and especially nationwide commercial banks – were eager to do more business in international markets and in foreign exchange and could profit therefore from deregulation more than foreign banks. And a further fact matters. The deregulation process was not well balanced. Apart from government's still existing influence on domestic banks' customer selection (specific companies and sectors), domestic banks were freer than foreign banks to handle some specific financial products in the mid-1990s. For example, foreign banks were still restricted in doing trust business or getting access to the Bank of Korea's rediscount facility.

Table 4  
Impact of deregulation on foreign banks

Did deregulation cause an extension or a reduction of bank's activities?	Extension	Reduction	No significant difference
Foreign banks	4	6	10
Domestic banks	8 and 2 JV	-	1

Source: Survey.

Among the activities started or increased by domestic banks as a result of deregulation, international business plays an important role. Especially foreign currency lending became increasingly important. Other new or growing business areas were an extension of retail business, derivatives, certificate of deposits (CD's) and various further specific financial products. Of the foreign banks some banks started business with private customers, CD's, custody business and other specific bonds. On the refinancing side, apart from CD's there was no compensation for the reduction of swap-transactions for foreign banks. This refinancing privilege (that was necessary to compensate foreign banks for regulated-low interest rates – see section II) was reduced step by step beginning in the mid-1980s, when the current account changed into a significant surplus and domestic banks received access to international credit markets. Foreign banks were no longer seen as an indispensable source for foreign funds. Thus, a reduction of foreign banks' market shares in credit business resulted.

*c) Sectoral activities and competition*

As a consequence of long-term industrial policy South Korea was characterized by economic imbalances in terms of significant sectoral differences in the mid-1990s. On the one side there are the large *jaebol* that were successful exporters in their main product sphere.<sup>11</sup> On the other side we find a vast number of small companies, much less competitive and frequently not able to offer the necessary intermediate goods for *jaebol*'s export (a major reason for South Korea's current account deficit in the 1990s). To increase small and medium-sized companies' efficiency and competitiveness further investments – and consequently more credit – were necessary. Thus, the survey also aimed at differences regarding foreign banks and domestic banks in the sectoral allocation of funds. A clear difference was identified (see table 5).

For domestic banks (nationwide commercial banks), Korean small and medium-sized companies were obviously more important as debtors than other groups (including large companies, the *jaebol*). On the other hand, for foreign banks the *jaebol* dominated fund allocation: 17 out of 24 surveyed foreign banks named *jaebol* as their main debtor group. However, for some foreign banks the financial system (other banks and non-bank financial institutions) or foreign companies from banks' home countries (that operate in South Korea) were their main debtor. Although no Japanese bank named customers from their home country as their main debtor, especially Japanese banks still

<sup>11</sup> As could be seen in recent years, there were also some weaknesses regarding the diversification strategies of *jaebol*.

had close ties with Japanese companies in the mid-1990s. Three out of the five surveyed Japanese banks allocated at least 20 per cent of all their funds to companies that originally came from their home country; a behavior that could be observed only for three non-Japanese foreign banks (out of 19 surveyed non-Japanese banks). Only one foreign bank allocated funds primarily to individuals. This was the US-American bank Citibank, which operates several branches especially in Seoul but also in Pusan. Citibank is currently the only foreign bank in Asia running a retail-business strategy. Domestic small and medium-sized companies played only a minor role for foreign banks. This was because foreign banks were relatively free to choose credit customers compared to domestic banks that were forced to follow government priorities. Therefore, it can be concluded that the majority of foreign banks did so far not contribute to the reduction of inequalities in competitiveness and credit-access between the large jaebol on the one side and small companies on the other.

Table 5  
Credit allocation of foreign and domestic banks: Main debtors<sup>a</sup>

	Domestic large companies (jaebol)	Domestic small and medium-sized companies	Banks and other financial institutions	Foreign companies from the bank's home country	Korean individuals
All foreign banks	17	-	5	2	1
From:					
USA and Canada	5	-	1	1	1
Japan	3	-	3	-	-
Europe	6	-	-	1	-
Asia without Japan	3	-	1	-	-
With year of entry:					
1967 – 1972	5	-	3	-	1
1973 – 1985	8	-	2	1	-
Since 1986	4	-	-	1	-
Domestic banks	2	4 and 2 JV	-	-	1

<sup>a</sup> Both foreign and domestic banks – including two joint-venture-banks (JV) – were questioned about their main kind of debtor. The data in the table indicate how many banks had their main debtors in domestic large companies, domestic small and medium-sized companies etc.

Source: Survey.

Smaller differences between foreign and domestic banks have been identified for the fund allocation to economic sectors (see table 6). As most domestic banks, the majority of foreign banks allocated funds to the manufacturing industry (16 of 24 foreign banks – among them all European banks) but some other banks, especially American banks, were highly engaged in the trade sector. Financing private consumption was the main business area only for Citibank. However, Citibank's contribution to financing private households and consumption should not be ignored: Because Citibank was the largest foreign bank in South Korea during the mid-1990s (and still is today) and – as most foreign banks – also domestic banks allocated funds mainly to companies and non-

consumption uses, Citibank was an important credit-source for private households and private consumption.

Table 6  
Credit allocation of foreign and domestic banks: Main sectors<sup>a</sup>

	Manufacturing industry	Trade	Service	Private consumption	Other
All foreign banks	16	5	1	1	1
From:					
USA and Canada	3	3	-	1	1
Japan	4	1	-	-	-
Europe	7	-	-	-	-
Asia without Japan	2	1	1	-	-
With year of entry:					
1967 – 1972	5	2	-	1	-
1973 – 1985	9	-	1	-	1
Since 1986	2	3	-	-	-
Domestic banks	6 and 2 JV	-	-	1	-

<sup>a</sup> Both foreign banks and domestic banks – including two joint-venture-banks (JV) – were questioned about the areas they mainly financed. The data in the table indicate for how many banks the manufacturing industry, trade etc. represented the main sector for fund allocation.

Source: Survey.

The just noted importance of Citibank influences also the competition of foreign and domestic banks. The domestic banks were asked about foreign banks' competition in different segments of the financial system. Although most foreign banks did not engage in retail business, eight domestic banks (among them the two joint-venture-banks) felt foreign banks' competition in financing Korean individuals and private consumption (see table 7b and c) and confined these "foreign" competition explicitly to Citibank.

Regionally, a competition of foreign banks existed for the majority of the surveyed domestic banks only in Seoul (see table 7a). Other cities – even Pusan – and especially rural areas were obviously not really touched by foreign banks' business. This cannot be attributed to former regulations which restricted foreign banks' presence to Seoul (and Pusan) because since the early 1990s branches can be established in South Korea relatively unrestricted; however no foreign bank (including Citibank) has opened a branch in another city than Seoul or Pusan.<sup>12</sup> Even Pusan, where branches have been allowed since 1977, was no place to do business for the bulk of foreign banks or it was not any longer. In fact, during the early 1990s several foreign banks closed their branches in Pusan. Obviously, they preferred to confine their activities to South Korea's economic and financial capital Seoul.

On the debtor side, sectoral competition of foreign banks was felt by domestic banks primarily for the segment of large domestic companies: Seven domestic and two joint-venture-banks reported a competition with foreign banks in this market segment.

<sup>12</sup>In the early 1990s, Citibank had plans to establish branches in other cities than Seoul or Pusan (see Dedy/Kiernan 1991, p. 29) but did not implement them.

Competition existed also – but to a lesser extent – in other segments as tables 7b and 7c illustrate. That only six Korean banks (four completely domestic and two joint-venture-banks) felt foreign banks' competition in the financing of foreign companies can be attributed to the fact that only a few domestic banks were engaged in this kind of business. Sectoral competition of foreign banks was highest for trade, the manufacturing industry, private consumption (as mentioned, this was caused by Citibank) and the service industry. It was low or almost insignificant for house construction, agriculture, forestry, fishing and mining.

Table 7  
Foreign banks' competition with domestic banks in different market segments<sup>a</sup>

a) Region

Seoul	Other cities	Rural areas
8 and 2 JV	3	1

b) Debtor

Large domestic companies	Small and medium-sized domestic companies	Foreign companies	State-owned companies	Korean individuals	Foreign individuals	Other banks or financial institutions
7 and 2 JV	5 and 1 JV	4 and 2 JV	2	6 and 2 JV	2	4

c) Sector

Trade	Manufacturing industry	Private consumption	Service industry	House construction	Agriculture, forestry and fishing	Mining
7 and 2 JV	6 and 2 JV	6 and 2 JV	4 and 2 JV	1 and 1 JV	1	-

<sup>a</sup> The domestic banks (including two joint-venture-banks; JV) were asked in which market segments they felt foreign banks' competition. The data in the table indicate how many domestic banks reported a competition with foreign banks in the market segment named in the head row.

Source: Survey.

These results underline that in general foreign banks still had a significant impact on the financial system of South Korea at the time of the survey (1995) despite a decreasing market share since 1985. Nevertheless and despite different deregulations, since the early 1980s it has to be taken into account that until recently credit markets in South Korea were "seller's markets" – banks had no problems to find customers for their credits. Therefore, as a consequence of government's remaining influence, competition between banks was limited and foreign banks' competition was limited, too – even if their market shares would not have decreased since 1985.

d) *Market performance*

The influence of foreign banks on the Korean financial system entails a potential for a more favorable, efficient and sound intermediation. This can be identified by investigating different indicators of performance for both foreign and domestic banks (see table 8). An important aspect of financial intermediation is to which extent banks

allocate funds to non-profitable investments. These misallocations normally do not only reduce the efficiency of intermediation but also threaten intermediaries' solvency, and therefore can imply risks for the stability of the financial system. An indicator for this allocation inefficiency of banks (in absence of positive or negative spillovers for the credit-financed investments) and the risk of an instability of the financial system is the share of non-performing loans relative to all of the banks' assets.<sup>13</sup> According to central bank data, foreign banks were burdened with non-performing loans to a much lesser extent than domestic banks throughout the 1990s (table 8 contains the data for 1996). However, it must be considered that these data do not illustrate the whole burden of bad loans. In fact, in the past especially domestic nationwide commercial banks had frequently undertaken cover-ups of balances and write-offs of non-performing-loans which resulted in low – and during the 1990s declining – shares of non-performing-loans.<sup>14</sup> This behavior was encouraged by the government, which had forced banks to reduce non-performing-loans but without reducing instrumentalization of these banks for industrial policy. Thus, apart from write-offs, purely cosmetic measures were used to whitewash bank balances. And despite these practices, even according to official central bank data presented in table 8, nationwide commercial banks and, moreover, regional banks were much higher burdened with non-performing loans than foreign banks. The financial crisis – which became obvious in autumn 1997 – confirmed these solvency problems of domestic banks.

Empirically, the real problems for domestic banks and the better efficiency performance of foreign banks in South Korea were more obvious thanks to another indicator: Return on assets. Domestic banks (especially former state-owned nationwide commercial banks) had an extremely weak profit performance – mainly a result of frequent write-offs of non-performing-loans. Among foreign banks, especially US-banks had a favorable profitability for almost the entire period they did business in South Korea and with an increasing distance to domestic banks during the 1990s. A similar favorable profitability can be seen in 1996 for British banks. However, apart from a single foreign bank – which had a loss in 1996 – nearly all foreign banks enjoyed a better profitability than the "average" (domestic) nationwide commercial bank.

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13 "It is when the private and social rates of return on investment projects coincide (i.e. when external economies or dis-economies of projects are negligible) that the proportion of non-performing loans in financial institutions can serve as an accurate indicator of allocative efficiency" (Akyüz/Kotte 1991, p. 13).

14 Thus, bad loans for nationwide commercial banks were much higher than 0,8 per cent of all assets that were reported in official statistics (see table 8).



Table 8  
Performance indicators

	Efficiency, solvency and profitability <sup>a</sup>		Productivity <sup>b</sup>		
	Non-performing loans/all assets	Return on assets	Assets per employee	Credit volume per employee	Operating profit per employee
	in per cent		in Mill. Won		
Former state-owned nationwide commercial banks	0,8 <sup>c</sup>	0,08	1.727	1.285	62
New nationwide commercial banks			1.808	1.376	59
Regional banks	0,9	0,47	1.259	823	29
Foreign banks	0,1	1,53	5.949	2.181	138
From:					
USA	0,15	3,4	3.828	2.060	137
Japan	0,01	0,7	12.520	3.886	242
France	0,04	0,7	10.448	2.295	103
United Kingdom	0,09	2,6	3.970	1.671	112
Canada	0,02	1,1	4.233	2.208	82
Singapore	0,57	0,9	5.029	1.632	103
Australia	0,06	0,7	3.564	1.428	47
Netherlands	0,00	0,8	6.617	1.847	119
Other countries	0,09	1,5	3.899	1.295	109

<sup>a</sup> In 1996; b) In 1994; c) Data was available only for all nationwide commercial banks.

Source: Based on data of the Bank of Korea.

There are different reasons for a higher allocation efficiency of foreign banks, but in the end all these reasons can be related to government influence on financial institutions (by direct business guidelines, the regulation-caused weak competition between banks and an implicit state-guarantee for the survival of domestic banks):

- Despite deregulation, in the mid-1990s a strong government influence on financial institutions and especially on domestic banks' credit allocation still remained. With this influence, funds were misallocated to an enormous extent and a large number of non-performing-loans resulted. It is true that there was a positive influence of financial regulation on economic development, too, because credits for private households were discriminated and, thus investment rates flourished.<sup>15</sup> However, in all, a less state-influenced selection of investment projects would have been more efficient. In fact, as empirical analyses show, South Korea's economic growth record in the past was not a result of an efficient intermediation but caused by a huge accumulation of savings (Kim/Lau 1994), both national and foreign savings. Of course, foreign banks'

<sup>15</sup> Discrimination of credits for private households had two positive effects on economic growth in South Korea. Firstly, more credit was directly available for investments in the industrial sector instead of consumption spending (although various of these industrial investments were inefficient). Secondly, because private households could hardly receive credits from banks they had no other choice than to build up own savings to finance their necessities (house construction etc.). Thus, similar to Japan and Taiwan the saving rate increased in South Korea (Patrick 1990).

branches were not completely free of government influence on credit allocation (or implicit state expectations regarding market conduct) but constraints were more severe for domestic banks and, thus foreign banks' efficiency in intermediation was less damaged.

- In South Korea business is influenced by personal relationships (crony-economics): Common roots of business partners (e.g. family relationships, joint military service, studying at the same university or coming from the same city or province) play a significant role in business and can displace such factors as prices or quality of products. Consequently, also in South Korea's not very competitive financial system credits were frequently allocated to companies where bank managers had such relationships. For foreign banks, this form of credit allocation was less important. Firstly, because foreign banks' branches were supervised by headquarters in the home country, branch managers were primarily profit oriented. Secondly, foreign banks' branch managers were either foreign (mostly sent from the banks' home country) or Korean people who had spent some time abroad (for study or work). Thus, they were not as much integrated in the Korean society as managers of domestic banks. For foreign banks' managers, close relationships existed at best to managers of foreign companies, but this would mean a too limited market to make relationships a major criterion for allocating funds.
- Despite growing international activities, in the mid-1990s domestic banks in South Korea were still not as competitive as foreign banks with regard to their ability to evaluate creditworthiness (Aliber 1994, p. 347). As far as the credit allocation was not influenced by government-set priorities or personal relationships of bank managers mainly the existence of guarantees determined credit allocation. Compared to foreign banks, domestic banks failed in evaluating investment projects' expected profitability. Thus, even highly efficient investments failed to receive domestic banks' credit when no guarantee was available. This weakness in credit evaluation was favored by a (regulation-induced) low competition, which meant no pressure for banks to identify the most profitable investments (in order to be able to pay the highest interest rates in the mobilization of savings). Foreign banks, on the other hand, could fall back on staff from their international network (foreign or – increasingly – Korean) who learned and practiced banking (including credit evaluation) in a more competitive environment.
- In case of financial problems, domestic banks could rely on central bank assistance for preventing insolvency. Until 1997, no troubled Korean bank was closed. This implicit guarantee for the survival of domestic banks made depositors unconcerned about the quality of these banks' credit management (Aliber 1994, p. 350). It gave managers of domestic banks not just the freedom to allocate credits according to personal relations (or bribery). Moreover, domestic banks' managers often ran a strategy that was more focussed on asset-growth than on profitability and efficiency (Park 1993, p. 137f.). For foreign banks, only assistance of the headquarter was avail-

able to prevent insolvency and branch managers in South Korea could not generate losses without risking their job.

Further information on foreign banks' performance compared to that of domestic banks concerns productivity (see table 8). For these productivity indicators – assets, credit volume and operating profit relative to the number of bank employees – foreign banks again performed better. This was partly a result of foreign banks' focus on wholesale business, but it was also caused by a more rationalized financial intermediation – therefore, foreign banks' intermediation can be interpreted also as technically more efficient. Domestic banks were highly leveraged with excessive personnel. Like employees of *jaebol*, until recently the staff of Korean banks enjoyed the guarantee of life-long-employment regardless of the quality of their work and the banks' changing manpower requirements.

Thus, it can be concluded that foreign banks were more efficient (in allocation as well as technically) and sound in terms of non-performing-loans, profitability and productivity compared to domestic banks.

#### **IV. CONCLUSION**

The case of foreign banks' financial intermediation in South Korea gives empirical evidence for what can be achieved by increasing foreign influence in a financial system that has to support industrial policy because of regulations. Several results were found:

- There was a change in entry motives of foreign banks. While at the beginning of the financial opening foreign customers from a bank's home country (that operated in South Korea at that time) had stimulated foreign banks' entry, since the mid-1970s doing business with Korean companies dominated as the major entry motive.
- Foreign banks' refinancing was concentrated on headoffice borrowings transformed by swap-transactions into Korean Won (swap-transactions were offered to foreign banks at special rates in order to compensate them for regulated low interest rates compared to interest rates in international fund markets). Foreign banks did scarcely mobilize domestic savings in South Korea. Thus, foreign banks' market shares had increased almost continuously until the mid-1980s when the current account was in deficit and foreign savings were in great demand. This changed with the first significant current account surplus in 1986 but partly also during the 1990s when the current account ran into deficit again: Foreign banks' market shares declined until recently because an increasing access of domestic banks and *jaebol* to international financial markets had become substitutes for foreign banks' lending.
- Most foreign banks confined their presence and activities regionally to the capital Seoul – only a few foreign banks did limited business in Pusan. Foreign banks favored specific market segments like large domestic companies (*jaebol*) and avoided other areas (especially retail banking was no market for most foreign banks). Compared to domestic banks, foreign banks were more engaged in trade finance but their main business area was the manufacturing sector.

- However, foreign banks' market behavior was not uniform. Citibank is a special case because it started a retail banking strategy in the late-1980s and does until today most of its business with individuals (instead of companies like most foreign and domestic banks). Another exception were Japanese banks that had allocated a large number of credits to Japanese companies in South Korea.
- Domestic banks felt the competition of foreign banks in different market segments but especially in Seoul (kind of region), for large domestic companies (kind of customer), for trade and the manufacturing industry (kind of sector). Nevertheless, the activities of Citibank (the largest foreign bank in South Korea) caused competition also in the credit allocation to individuals and for private consumption.
- Performance indicators revealed a higher efficiency of foreign banks' intermediation both in allocation and in technique. Here, foreign banks profited from being involved in industrial policy only moderately and from a more qualified staff that was not just better educated but also less integrated into personal relationships (which influence domestic banks' credit allocation). Moreover, domestic banks were burdened with excessive staff.

It was in November 1997 when South Korea had to declare the inability to repay debt and to beg the IMF for financial assistance. The longstanding weakness of the regulated financial system now became obvious and could no longer be ignored by politics. Several nationwide commercial banks burdened with non-performing loans were not able to survive. The government forced mergers in the banking sector between more competitive and less competitive intermediaries. In a similar fashion, a need for consolidation existed for non-bank financial institutions. Different mergers and closures already occurred but the process of restructuring is not yet finished – not least because various Korean corporations (among them large jaebol like Daewoo) still have serious financial problems). Among foreign banks with a bad-loan-problem in autumn 1997 or foreign banks that ran into bad-loan-problems after the outbreak of the financial crisis (when even various competitive Korean companies went bankrupt), funds from their foreign head-office guaranteed solvency, and thus no danger for financial instability arose.

Of course, international banks' generous flow of funds to South Korea was excessive and growing economic problems were ignored far too long. However, two kinds of foreign lending have to be separated here. On the one side, there are funds offered by foreign banks that operate within the country (through branches in South Korea) – these funds were allocated directly to specific customers by these foreign banks. On the other side, foreign funds exist which are borrowed by domestic (Korean) banks and companies from foreign banks or other creditors that are located abroad – this kind of lending belongs to international financial markets. It was the latter of these two kinds of foreign lending which characterized South Korea's increasing debt overload. So it is noteworthy that before the crisis for almost a decade foreign banks' importance in domestic credit allocation had decreased nearly continuously while the overall foreign

debt of South Korea increased. That this was detrimental for South Korea can be seen in the fact – shown in section III d – that credit allocation of foreign banks' branches was more efficient than those of domestic banks. Consequently, the main conclusion for development policy is that it is wiser to integrate foreign banks into a country with a regulated and, thus less competitive financial system (like in South Korea) and let foreign banks allocate funds directly to final customers through their own branches rather than letting domestic banks attract these funds in international markets and allocate them.

Altogether, this study can increase the knowledge about the potential outcomes of integrating foreign banks into a developing country's or newly industrialized country's financial system that is – despite various deregulations – still used by the government for industrial policy. It can be seen that in this environment foreign banks are able to implement a more efficient intermediation than domestic banks. Nevertheless, without a less regulated environment competition remains limited and domestic banks have therefore no real incentive or pressure to become more efficient. However, there are also limitations: Firstly, only some – but major – aspects of foreign banks' business were investigated and only a limited time horizon has been used. Secondly, the case of South Korea can only serve as an example for a country that experienced foreign banks' business in an environment of – despite the recent crisis – dynamic growth (that might have been promoted but, of course, was not entirely caused by foreign banks' presence and international finance). It will remain unclear what happens when economic growth is weak – as in various African and Latin American countries – and what would happen in a less regulated environment. Therefore, further research is necessary.

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