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THE FORMATION AND DEVELOPMENT OF THE MODERN BANKING SYSTEM IN KOREA

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Abstract:
This article discusses the development and formation of the banking system in Korea. The history of the bank and today's development processes are covered.

Keywords: Korea, Japan, banking, money, history, system, XIX century, Korean Development Bank

Formation of a modern banking system, Korea began in the late XIX century under the influence of Japanese capital. In 1878, First National Bank of Japan has opened its branch in the port city of Busan. He has held various banking operations, including the issue of Japanese banknotes, although the country had circulation and Korean coinage. Soon, Japanese banks have created a network of branches in Korea.

National Bank of Korea was established in 1909, he received the right to issue domestic notes, passed to him from the First National Bank of Japan. In 1911, that is, one year after the formal annexation of Korea by Japan, the Korean bank was renamed Bank of Chosun. At that time, were discovered numerous commercial and specialist banks, and savings bank. Then stood Industrial Bank of Joseon, is engaged in long-term and mid-term lending.

In addition to the above mentioned banks, the Korean banking system until the liberation in 1945 consisted of two commercial banks: the Savings Bank of Joseon and the Federation of Financial Associations. The first is to invest mainly in Japanese government bonds for long-term financing. The second specialized in providing loans to farmers and small businesses. Thus, even during the Japanese occupation in Korea laid the foundation for a two-tier banking system. However, Korean banks have served the economic interests of Japan.

After the Korean War, 1950-1953 the main challenges facing the banks, was funding for industrial and agricultural projects for economic revival. To this end, in 1954, was established by the Korean Development Bank, the capital of which was fully funded by the Government, and in 1956 the Federation of Financial Associations was transformed into the Agricultural Bank of Korea.

In 1960 began the reorganization of the banking system due to the needs of accelerated economic development. In 1961, the majority of the share capital of

commercial banks was transferred to the government, and the law on the Bank of Korea has been amended to more effective implementation of monetary policy.

In the early 60's. Government has established various specialized banks to provide financial assistance as the least-developed and strategically important industries: the National Federation of Agricultural Cooperatives, the National Federation of fisheries cooperatives, the Bank lending to small and medium-sized enterprises and the National Bank for its citizens. In 1983, the institution of the National Federation of Livestock Cooperatives completed the formation of the modern system of specialized banking institutions.

Later, the banking system was reorganized in connection with the new needs of the economy. To maintain a balanced regional development banks were opened provinces. Along with the rapid growth of foreign trade and the internationalization of the economy, foreign banks were allowed to open their own branches.

Until 1992, foreign investors have the right to invest in Korean securities indirectly - through domestic funds, buying certificates and securities issued by domestic companies exclusively for foreign investors. Since 1992, foreign investors can invest directly in the Korean securities.

Number of non-bank MFI rapidly increased due to higher interest rates, which they are allowed to apply, and the fact that they have greater independence than the banks. The share of non-bank MFI on the amount of deposits increased from 15,1% in 1971 to 63,8% in 1992 is particularly noticeable increase in the proportion of investment and financial companies.

Thus, the development of the banking system, as well as non-bank MFI did not occur spontaneously, and with direct participation and under the constant supervision of the state. It has had the relatively high degree of efficiency of the banking system.

However, state control has been effective so long as the economy has remained undeveloped and simple in structure during the 1960-1970's with increasing economic growth and increasing complexity of the economic structure and the introduction of a market system. Therefore, from the early 80's were initiated large-scale structural changes in order to reduce state regulation of the economy and the introduction of a market system. This policy was aimed at strengthening the role of market mechanisms and the development of competition in every sector of the economy. In accordance with this taken various measures to liberalize and promote competition in the banking sector. At this time the government handed over four state-owned commercial bank in the ownership of the private sector: Hanil Bank (1981), Korea First Bank and Seoul Bank and Trust Company (1982), Bank Chohyn (1983),. Given that the Commercial Bank of Korea has been privatized in 1972,

deregulation was completed all five leading commercial banks. In December 1989, was privatized by the Korean Exchange Bank

When Park Chung Hee became president in 1961, he organized a highly centralized government with the power to direct the economy. Park quickly nationalized all banks, took control of foreign borrowing, and merged the agricultural cooperative movement with the agricultural bank. The government also took control of all forms of institutional credit, giving Park great control over the business community.

The government began to liberalize the banking system in the mid-1980s by denationalizing several banks, but refused to allow individual chaebol to acquire controlling shares in these banks. The government still maintained strong managerial controls over these banks through the Bank of Korea's Office of Bank Supervision and Examination, which, under the guidance of the Monetary Board, supervised and regularly examined banking institutions. Most of the credit provided by these banks went to the chaebol, but the banks also were required by law to make at least one-third of their business loans to small and medium-sized firms.

South Korea's financial sector in the late 1980s included a diversified commercial banking system, a securities market, and a wide range of secondary financial institutions. The banks kept pace with the rest of the economy, particularly after the liberalization and modernization of financial institutions in the mid-1980s and the establishment of the capital market system based on the Fifth Five-Year Economic and Social Development Plan.

The Bank of Korea was established as the central bank on June 12, 1950. Its major functions included the issuance of all currency; the formulation and execution of monetary and credit policies; the conduct of the bulk of foreign exchange control business; the research, collection, and preparation of statistics on many aspects of South Korea's financial system; and the supervision and regulation of the activities of private banks. The Bank of Korea engaged in loan and deposit transactions for the government; additionally, the bank transacted various government business activities. It also made loans to and received deposits from other banking institutions; all banks maintained their solvency through balances at the Bank of Korea.

South Korea's five major commercial banks (Chohung, Commercial, First, Hanil, and Seoul) were privately held. Together with two city bank joint ventures--the Kor-Am Bank and the Shin-Han (co-owned with the United States and Japan respectively)--there were 961 commercial bank branches across South Korea at the end of 1987. Local banks were found in every province.

The Bank of Korea regulated all commercial banking activities under the provisions of the General Banking Act passed in 1954. Commercial banks got their money

through deposits from the general public, international loans, and funds borrowed from the Bank of Korea. The lending activities of commercial banks focused on short-term loans or discounts because long-term lending was still the prerogative of such specialized banks as the Korea Exchange Bank, Korea Housing Bank, and National Agricultural Cooperatives Federation. In the late 1980s, the banking industry operated according to a "prime" bank system whereby each major South Korean bank was assigned one domestic commercial bank. Under specific legislation designed to achieve certain functions or to assist special markets, six special banks received funds from the government and from the sales of debentures.

Three other financial development institutions supplied credit for business and government projects. The Export-Import Bank of Korea extended medium- and long-term credit to both suppliers and buyers to facilitate exports of capital goods and services, major resources development, and overseas investment. The Korea Development Bank, which was the government's shareholder in state-run enterprises, raised funds from the government as well as from international financial institutions and foreign banks to fund key industries and infrastructure projects. The Korea Long-Term Credit Bank financed equipment investment.

South Korea. Initially South Korea seemed to be insolated from the currency turmoil sweeping through the region. As the world's 11th largest economy, and a member of the Organization of Economic Cooperation and Development, Korea was clearly in a different league from Thailand, Indonesia, and Malaysia. However, underneath the surface Korea too had serious problems

During much of the 1990s foreign banks had been eager to lend US dollars to Korean Banks and the chaebol. A significant proportion of this was short term debt that had to be paid back within a year. This money was used to fund investments in industrial capacity, which as suggested earlier, was often undertaken at the encouragement of the government. By late 1996 it was clear that the debt financed expansion was beginning to unravel. Economic growth had slowed, excess capacity was emerging in a number of industries, prices for critical industrial products such as semi-conductors were falling, and imports were on the rise (Korea ran a current account deficit of $23.7 billion in 1996).

The Korean debt problem started to deteriorate in January 1997 when one of the chaebol, Hanbo collapsed under a $6 billion debt load. A 1993 decision to build the world's fifth largest steel mill proved to be Hanbo's undoing. Costs for the project escalated from Won 2,700bn to Won 5,700bn while steel demand proved sluggish. Following Hanbo's collapse there were widespread allegations in Korea that the project had been funded only because of the government pressured Korean banks to

lend to Hanbo. Moreover, allegations soon surfaced that government officials had been bribed by Hanbo to pressure the banks.

The situation deteriorated further in July 1997 when Kia, Korea's third largest car company, ran out of cash and asked for an emergency bank loan to avoid bankruptcy. At about the same time Jinaro, Korea's largest liquor group, filed for bankruptcy. These events prompted international credit agencies to start downgrading the ratings of banks with heavy exposure to the chaebol. This raised the borrowing costs of the banks, and led them to tighten credit, making it even more difficult for debt heavy chaebol to borrow additional funds. By October 1997 it was clear that additional funds for Kia would not be forthcoming from private banks, so the government took the company into public ownership in order to stave off bankruptcy and job losses. This followed hard on the heels of a decision by the Korean government to invest an equity stake in Korea First Bank, to stop that institution from collapsing due to a its bad loans. The nationalization of Kia transformed its private sector debt into public sector debt. Standard & Poor's, the US credit rating agency, immediately downgraded Korea's debt, causing the Korean stock market to plunge 5.5%, and the currency, the Korean won, to fall to $1=Krw929.5. According to S&P, "the downgrade of.....ratings reflects the escalating cost to the government of supporting the country's ailing corporate and financial sectors."

The S&P downgrade was the trigger that precipitated a sharp sell-off of the Korean won. In an attempt to protect the won, the Korean central bank raised short term interest rates to over 12%, more than double the inflation rate. The bank also intervened in the currency exchange markets, selling dollars and purchasing won in an attempt to keep the dollar/won exchange rate above $1=Krw1,000. The main effect of this action, however, was to rapidly deplete its foreign exchange reserves. These stood at $30 billion on November 1st, but fell to only $15 billion two weeks later.

To make matters worse, the wave of bankruptcies continued among the chaebol. Haitai, Korea's 24th largest business, filed for bankruptcy protection at the beginning of November, and rumors suggests that New Core, another chaebol would soon follow. This meant that one-fifth of the country's thirty largest businesses had now filed for bankruptcy protection. Moreover, there was speculation that as many as half of the top 30 chaebol might ultimately have to file for bankruptcy. International lenders, fearing that Korea was about to become a financial black whole, refused to roll over short-term loans to the country, an action made all the more serious by revelations that Korea had about $100 billion in short term debt obligations that had to be paid within 12 months.

With Korea facing imminent financial meltdown, the prospect of an IMF led bailout of the country was being openly discussed. On November 13th, the Korean government declared that it "did not need help from the IMF", apparently believing that it would be able to arrange bilateral loans from the US and Japan. They were not forthcoming, and on November 17th, with the nation's foreign exchange reserves almost exhausted, the Korean Central bank gave up its defense of the won. The won immediately fell below the psychologically important $1=Krw1,000 exchange rate, and it kept going south. On November 21st the now humiliated Korean government was forced to reverse course and formally requested $20 billion in standby loans from the IMF.

The process was complicated considerably at this point by the fact that Korea was facing a presidential election campaign on December 18th. The IMF, therefore, had to negotiate terms with a lame duck President, Kim Young-sam, who has required to step down by the constitution, while the three main candidates criticized the process from the sidelines. As the negotiations progressed, it soon became apparent that Korea was going to need far more than $20 billion. Among other problems, Korea's short term foreign debt was found to be twice as large as previously thought at close to $100 billion, while the country's foreign exchange reserves were down to under $6 billion.

On December 3rd the IMF and Korean government reached a deal to lend $55 billion to the country. The IMF had tried to insist that all three Presidential candidates promise, in writing, to obey the agreement. However, Kim Dae-jung, the centre-left opposition leader, said he would refuse to sign any guarantee with the IMF because "it violated national pride," although he did signal general compliance with the measures. The agreement with the IMF called for the Koreans to open up their economy and banking system to foreign investors. Prior to the deal foreigners could only own 7% of a Korean company's shares. This was lifted to 50%. South Korea also pledged to restrain the chaebol by reducing their share of bank financing and requiring them to publish consolidated financial statements and undergo annual independent external audits. On trade liberalization, the IMF said South Korea will comply with its commitments to the World Trade Organization to eliminate trade-related subsidies and restrictive import licensing, and streamline its import-certification procedures, all of which should open up the Korean economy to greater foreign competition.

Initial reaction in the stock and currency markets was very favorable, with the Korean stock marketing registering a 7% gain, its biggest one day advance ever. However, the package started to unravel on December 8th when the Korean government said that it would take two trouble banks into public ownership, rather than closing them. On

the same day, Daewoo, one of the chaebol, announced that it would purchase debt laden Ssangyong Motor under a deal that forced Ssangyong's creditor banks to share much of the burden. Foreign investors saw these moves as an attempt to get around the harsh measures imposed by the IMF. Further compounding matters were criticisms from presidential candidate Kim Dae-jung. Kim argued that the IMF agreement represented a loss of national sovereignty and he promised that, if elected, he would renegotiate the deal to avoid job losses. In response to these developments, foreign banks refused to roll over short term loans investors sold out of the Korean stock market and won, and both dropped like stones. The won began a precipitous fall that was to take it down to the 2,000 level in two short weeks, a decline that effectively doubled the amount of won Korean companies would have to earn to finance their dollar denominated debt. By mid December foreign banks were only rolling over 20-30% of Korean short term debt as it matured, requiring that the rest be paid in full. Despite the IMF funds, foreign currency was leaving the country at the rate of $1 billion a day.

Following pressure from the other presidential candidates, Kim Dae-jung, reversed his position and sent a letter to Michael Camdessus, the head of the IMF, stating that if elected, he would comply with the IMF's terms. On December 18th, Kim Dae-jung was elected president of South Korea by a narrow margin. He immediately turned his attention to the debt crisis. His attention was heightened by the uncomfortable fact that Korea was on the verge of default. His first priority was to rebuild confidence and persuade foreign banks to roll over Korean short term debt, thereby staving off an immediate default. The international community was also concerned by the possibility that a Korean default would trigger a banking crisis in Japan, which held $25 billion of Korean debt, an event that would send economic shock waves surging around the world.

In the event, a second agreement was reached between Korea, the IMF, and a number of major American and British banks with large exposure to Korea. Singed on Christmas Eve, the agreement called for the IMF and eight major banks to accelerate a loan of $10 billion to Korea to prevent a debt default. For his part, Kim Dae-jung spelled out in clear language that Korean businesses and jobs could no longer be protected from foreign competition. Korea also agreed to an accelerated timetable for opening up its financial markets to foreign investors, permitting foreign takeovers, and allowing foreign companies to establish subsidiaries in Korea. The government also agreed to raise interest rates in order to attract foreign capital, force the chaebol to restructure their operations, selling-off loss making units and demanding clearer accounting. If the government follows through with these reforms, the effect could be

to transform Korea's economy from one in which the government plaid a major role in regulating and directing investment activity into one of the most market-oriented economies in Asia. In response, for now Korean stock and currency markets have stabilized, but it would be naive to expect anything approaching a full recovery until the country has put its house in order.

The situation in South Korea improved still further on January 28th, 1998 when a consortium of 13 international banks with exposure to Korea agreed to reschedule their short term debt to Korea. According to the Bank for International Settlements, In early 1998 South Korea was sitting on $74 billion in debt that was coming due for repayment in the next two years. This added up to a cash flow squeeze of major proportions that the earlier IMF deal had fully come to grips with. Under the plan South Korean banks will exchange short term debt valued at $24 billion for new loans with maturities of one, two, and three years, bearing interest rates of 2.23, 2.50, and 2.75 percentage points higher than the six month London Interbank rate. By effectively rescheduling so much of its short term debt, the deal gave South Korea some breathing room in which it could begin to rebuild confidence in its shattered economy.

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