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Chapter Title: Fiscal and Monetary Policy

Chapter Author: Susan M. Collins, Won-Am Park

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this system. The costs, which come in terms of limited influence over worker rights and work conditions, are very difficult to quantify.

A final point worth stressing is that tradeoffs between real incomes and competitiveness are only avoided once the investment-productivity gain cycle gets going. Korea cut real wages to give an initial boost and to get the "engine" moving both in the early 1960s and during adjustments in 1980–81.

11 Fiscal and Monetary Policy

In this chapter we assess the role of fiscal and monetary policy in Korea's experience with external debt. One important issue is the financing of fiscal deficits. Did the government borrow heavily from abroad or rapidly expand the domestic money supply in order to finance large budget deficits? Both factors figured prominently in the experience of many Latin American debtor countries, however, both turn out to play much smaller parts for Korea. Still they are of interest precisely because they highlight some of the aspects which distinguish Korea's debt history from the history of many other countries which have had less successful recoveries.

A second issue is the role of fiscal and monetary policies in achieving the phenomenal growth rates which have enabled Korea to service very large external debts. To summarize our conclusions at the outset, we argue that fiscal policies have been used countercyclically, but that they were not the predominant explanation for rapid growth. Monetary policies, on the other hand, have played a central role, although not through excessive inflation finance because the allocation of domestic credit has been a centerpiece in the government's industrial policies which have successfully targeted high-growth export industries.

11.1 Brief History

An overview of the development of Korea's financial and fiscal sectors provides a useful base for examining the current systems.[1] The key issues of the linkages between government finances, monetary policy, and external borrowing are not new, but emerged at the outset as Korea recovered first from World War II and then from the Korean War.

The developments through the early 1970s can be divided into three stages. In the early stage, prior to 1945, Korea enjoyed a very highly developed financial system run by the Japanese to mobilize resources for the colonial expansion and later to help finance military spending. The system

was modeled on Japan's, with the very close relationship between business and government which characterizes their approach and which has had significant influence on the current Korean system. In fact, statistics suggest that the fiscal and banking systems were more developed in 1940 than they were in 1975. Government revenues were 21 percent of GNP in 1940 as compared to 16 percent in 1975, while the ratios of M2 to GNP were 44 percent in 1940 and only 34 percent in 1975.

The second stage, between the collapse of the Japanese system in 1945 and the beginnings of an independent Korean system in the mid-1960s, was dominated by the role of foreign aid inflows and the interactions between the U.S. and Korean governments. The systems stood in market contrast to those that had collapsed, with "no money and capital markets in the accepted sense of the terms and no really adequate facilities for mobilizing such savings as are currently made and for channeling them into productive investments" (Mason et al. 1980, 301). Two critical problems were that the experienced money and fiscal managers had been Japanese and that hyperinflation had removed confidence in the organized banking system. The gap was partially filled by expansion of the unofficial money market. Unlike official institutions, the UMM could operate using U.S. dollars and U.S. military payment certificates. Such curb markets have continued to play an important financial role in Korea.

In this second phase, foreign aid flows and counterpart funds were the major sources of funding for the government, giving rise to a seesaw for control between the Korean and U.S. governments. On the one hand, the U.S. wanted a more western system with an independent central bank and a revised tax system to provide resources for government spending. They wished to have aid flows be conditional on the fulfillment of specified criteria—the government deficit and the growth of bank credit. The Koreans, on the other hand, pushed for continued aid, allowing the government continued control over the allocation of credit to finance reconstruction, and maintaining close ties with the business sector.

The decade from 1954 to 1964, which resembled a tug-of-war between the two approaches, can be divided into four periods. From 1954 to 1956 increasing government expenditures and bank loans were financed by significant aid inflows, while domestic (bank) savings declined relative to output. From 1957 to 1960 the situation was reversed, with aid, government spending, bank lending, and real growth all falling, and government revenues and bank deposits both rising relative to GNP. The initial years of the Park regime, 1961–62, were again expansionary, followed by another U.S.-imposed contraction in 1964–65.

The 1961–62 period is especially interesting. The new government instituted a number of financial reforms, all of which significantly increased bank credit. It reorganized agricultural financing institutions, created the Small and Medium Industry Bank, and authorized the KDB to guarantee foreign loans and to borrow abroad. It also regained ownership of the

commercial banks and brought the BOK under the control of the Ministry of Finance. In addition to the accelerated money growth (nearly 50 percent from June 1961 to June 1962), a rise in government spending from 18 to 24 percent of GNP pushed the budget deficit from 2 to 4 percent. An unfortunate consequence of the expansion was a revival of inflation. In response, the government attempted a currency reform in June 1962. A new currency was issued with limited conversion. However, the resulting lack of funds crippled all business activity so severely that the government began to relax the measures within one week, and within five weeks the measures had been totally eliminated.

The ineffective reform was succeeded by a U.S.-Korean stabilization plan which cut public expenditure from 24.1 percent in 1962 to 11.5 percent of GNP by 1964. M2 fell from nearly 15 percent of GNP in 1962 to barely 9 percent in 1964, as lack of confidence in the official banking system contributed to a new growth spurt in the unofficial money market.

By 1965 Korea had entered a third stage of financial/fiscal development in which external governments played a diminishing role in the decision making. The Park administration had formed a system with the financial sector firmly controlled by the government and with the government, through the allocation of (domestic and foreign) credit, firmly linked to business decision making.

The major remaining issue was how to replace the declining aid inflows, and the government turned to the problem of mobilizing domestic savings and nonaid external funds to finance government spending and investment. The system of foreign loan guarantees, combined with special incentives to exporters, had already begun to generate foreign (nonaid) inflows. The 1965 financial reform, which raised interest rates on bank deposits, was undertaken in the hope of stimulating private savings and channeling it to official financial institutions. As we have seen, both elements proved extremely successful. By the beginning of the 1970s, private savings had risen from 6 to 7 percent to 18 percent of GNP and foreign debt had jumped from 7 percent to over 30 percent of GNP.

The key pieces in the story continued to be investment, private savings, government savings, and foreign savings. Investment, private savings, and foreign savings have been discussed in previous chapters. Government savings (revenues and expenditures) and the role of fiscal policy in Korean macroeconomic performance are discussed in section 11.2 of this chapter. In section 11.3 we examine the financial system and the allocation of credit.

11.2 Fiscal Policy

11.2.1 Structure

Korea's public sector is quite complex. It is composed of a central government and five special public enterprise funds, which together make up

the consolidated public sector. In addition, there are local governments and a number of nonfinancial public enterprises. Because of data delays and revisions, and because of the difficulties of adequately accounting for intergovernmental transfers, the consolidated public sector excludes the local governments. We focus on the activities of the consolidated public sector.

The central government consists of the general account, which accounts for most of total revenues and approximately 80 percent of expenditures, fifteen special accounts, and twenty-four special funds. The public enterprise funds include the Grain Management Fund, which purchases and sells grains and which became very important during the disastrous agricultural output during 1978–82. Although their expenditures have been very large in some years, these funds contribute relatively little to the consolidated budget because only the net surplus or deficit of the public enterprise funds enters the accounts.

Table 11.1 shows the revenues, expenditures, and budget deficits for the central government and the consolidated public sector. The top panel of the table gives the figures in billions of won, while the bottom panel takes ratios of each variable to GNP. The net financial transactions column gives the deficit or surplus in the public enterprise funds, which is included with the central government deficit in the consolidated budget deficit. The last four columns of the table give the sources of deficit financing. The domestic bank financing is taken from the monetary, and not the fiscal, accounts and is identically equal to the change in banking sector credit to the government.[2]

11.2.2 General Trends

Figure 11.1 plots public sector revenues and expenditures relative to GNP from 1970 to 1985. It shows large swings in both series between 1970 and 1975. Since then, revenues have been considerably more stable than expenditures, rising gradually until 1981 and then tapering off slightly. Thus, recent changes in the budget were due primarily to changes in spending. As we shall see, there have also been significant changes in the composition of expenditures.

There has also been considerable variance in the sources of finance for the public sector deficit. The share financed by domestic banks has tended to increase as the size of the deficit has grown. In 1972, 1975, and 1981, approximately 45 percent of a deficit which was 4–5 percent of GNP was funded by domestic credit. Recoveries from each of the three debt crises have involved reductions in the total bank credit to the public sector.

In the remainder of this section, we look at spending and revenues more closely. In addition to table 11.1, the discussion refers to the fiscal statistics in the Data Appendix. These tables include a decomposition of revenues by type, and functional and economic decompositions of public sector expenditure.

For most of the 1970–86 period, the stance of Korean fiscal policy seems closely tied to the performance of the domestic economy. During the

Table 11.1 **Consolidated Public Sector Budget**

Year	Central Government			Net Financial Transactions	Consolidated Public Sector			Net Financing	Domestic		Foreign
	Revenues	Expenditures	Deficit		Revenues	Expenditures	Deficit		Bank	Nonbank	
Panel A (in billions of won)											
1970	—	—	—	—	487.60	512.30	−24.70	24.70	−28.50	26.60	26.60
1971	—	—	—	—	565.70	642.10	−76.40	76.40	−15.90	21.10	71.20
1972	—	—	—	—	654.00	846.50	−192.50	192.50	80.90	61.60	50.00
1973	—	—	—	—	757.70	844.70	−87.00	87.00	15.40	11.70	59.90
1974	1,038.70	1,203.00	−164.30	−136.60	1,117.70	1,418.60	−300.90	300.90	103.40	118.50	79.00
1975	1,653.60	1,765.30	−111.70	−354.40	1,692.50	2,158.60	−466.10	466.10	212.50	110.40	143.20
1976	2,326.60	2,518.90	−192.30	−206.00	2,511.40	2,909.70	−398.30	398.30	−44.30	217.10	225.50
1977	2,958.40	3,274.40	−316.00	−159.60	3,184.90	3,660.50	−475.60	475.60	−104.70	301.00	279.30
1978	4,107.70	4,408.00	−300.30	−315.50	4,385.20	5,001.00	−615.80	615.80	69.50	187.10	359.20
1979	5,445.40	5,990.00	−544.60	104.30	5,769.80	6,210.10	−440.30	440.30	−129.10	303.10	266.30
1980	6,833.20	7,682.00	−848.80	−324.90	7,280.80	8,454.50	−1,173.70	1,173.70	366.30	489.70	317.70
1981	8,604.80	10,189.00	−1,584.20	−526.70	9,246.70	11,357.60	−2,110.90	2,110.90	928.00	649.90	533.00
1982	9,983.20	11,639.20	−1,656.00	−566.10	10,074.30	12,296.40	−2,222.10	2,222.10	416.10	1,130.20	675.80
1983	11,537.50	12,200.10	−662.60	−288.00	11,595.50	12,546.10	−950.60	950.60	−245.30	797.10	398.80
1984	12,603.30	13,444.60	−841.30	−81.60	13,039.60	13,962.50	−922.90	922.90	−40.40	653.80	309.50
1985	13,638.30	14,653.90	−1,015.60	9.40	13,813.80	14,820.00	−1,006.20	1,006.20	40.00	506.70	459.50

Panel B (in percentage GNP)

1970	—	—	—	—	17.82	18.73	−0.90	0.90	−115.38	107.69	107.69
1971	—	—	—	—	16.76	19.02	−2.26	2.26	−20.81	27.62	93.19
1972	—	—	—	—	15.74	20.38	−4.63	4.63	42.03	32.00	25.97
1973	—	—	—	—	14.09	15.71	−1.62	1.62	17.70	13.45	68.85
1974	13.84	16.03	−2.19	−1.82	14.90	18.91	−4.01	4.01	34.96	39.38	26.25
1975	16.38	17.49	−1.11	−3.51	16.77	21.39	−4.62	4.62	45.59	23.69	30.72
1976	16.76	18.15	−1.39	−1.48	18.09	20.96	−2.87	2.87	−11.12	54.51	56.62
1977	16.33	18.08	−1.74	−0.88	17.58	20.21	−2.63	2.63	−22.01	63.29	58.73
1978	16.96	18.20	−1.24	−1.30	18.10	20.64	−2.54	2.54	11.29	30.38	58.33
1979	17.43	19.17	−1.74	0.33	18.46	19.87	−1.41	1.41	−29.32	68.84	60.48
1980	18.63	20.95	−2.31	−0.89	19.85	23.05	−3.20	3.20	31.21	41.72	27.07
1981	19.07	22.58	−3.51	−1.17	20.49	25.17	−4.68	4.68	43.96	30.79	25.25
1982	19.68	22.95	−3.26	−1.12	19.86	24.24	−4.38	4.38	18.73	50.86	30.41
1983	19.56	20.68	−1.12	−0.49	19.66	21.27	−1.61	1.61	−25.80	83.85	41.95
1984	18.98	20.25	−1.27	−0.12	19.64	21.03	−1.39	1.39	−4.38	70.84	33.54
1985	18.86	20.26	−1.40	0.01	19.10	20.49	−1.39	1.39	3.98	50.36	45.67

Source: EPB, *Korean Economic Indicators*, and MOF, *Government Finance Statistics in Korea*.

Note: — = not available.

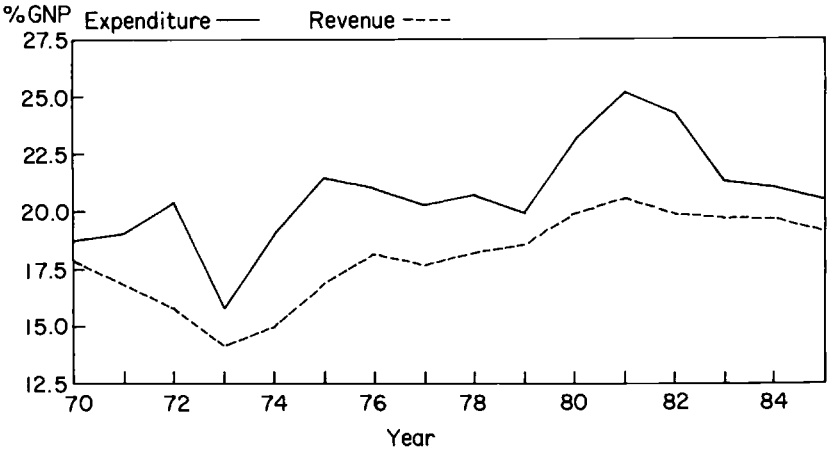

Fig. 11.1 Public sector revenues and expenditures (% GNP)

1970–72 economic slowdown following a period of high growth in 1966–69, revenues declined and government expenditures increased. The deficit was financed primarily from abroad during 1970–71, but as aid flows declined, the financing shifted toward domestic sources.

Expenditure was sharply contracted in the 1973 economic boom. At the same time, the government undertook a revision of the tax and tax collection systems. However, the fiscal deficit reemerged in 1974–75 during the aftermath of the first oil shock, despite a rise in revenues. Expenditures were increased back up to 20 percent of output. The period of economic recovery from 1976 to 1979 included the stabilization of government expenditures and rising revenues, particularly from the value-added tax (VAT) and from income taxes. There was some fiscal contraction during 1977 and 1979, as part of the Comprehensive Stabilization Plan (CSP) and because of government concern over rising inflation. The budget deficit fell from 5 percent of GNP in 1975 to just 1 percent in 1979.

The episode in 1979–83 is of particular interest. Social unrest, the bad harvests, and poor economic performance led the government to increase spending rapidly from 19 percent of GNP in 1979 to 23 percent in 1981, pushing the deficit back to 5 percent of GNP.

As shown in table 11.2, the rise coincided with a shift in the composition of spending toward social services.[3] Social services increased from 21.6 to 29.3 percent of total spending, with an almost comparable decline in the share of economic services. In 1980 the big increases came in expenditure for housing. In 1981 the additional expenditure was allocated to education, social security, and welfare (for old age disabilities and government employees). Expenditure growth slowed in 1982 as the size and definition of the public sector was reduced.[4] The removal of some activities from the

Table 11.2 **Composition of Expenditure**

Period	Defense	Economic Services	Social Services	
			Total	Education Only
1975–79	29.4	29.1	21.6	13.8
1980–85	27.9	22.1	29.3	16.3

public sector helps to explain the rapid drop in spending between 1981 and 1983. This shift toward social services, including housing and education, has been maintained during 1983–86.

One interesting point is that expenditures as well as revenues remained stable as a share of output during 1983–86, holding the deficit at just 1–2 percent of GNP. In contrast to previous episodes, expenditures were not increased (relative to output) as GNP growth slowed from 11 percent in 1983 to 8.5 percent in 1984, and to just 5.4 percent in 1985. Instead, as discussed in chapter 9, the government reacted to the slowdown by further depreciating the exchange rate in hopes of stimulating the export sector.

11.2.3 Fiscal Policy and the Business Cycle

We have seen that swings in public sector expenditures have brought about swings in the public deficit. Has the government actively used fiscal policies to influence economic activity? In fact, there is considerable evidence that fiscal policy has been used as a countercyclic policy tool, at least through 1983.

There are a variety of difficulties in computing an appropriate fiscal policy indicator for use in assessing the effect on policy. One simple indicator is the relationship between government expenditures and economic growth. This is shown in figure 11.2 in which we plotted the real economic growth rate and expenditures as a share of GNP from 1970 to 1985. The figure shows a clear inverse relationship between the two series.

Total expenditures are an inadequate reflection of fiscal policy because they include automatic stabilizers, are sensitive to inflation rate and interest rate changes, and because they do not incorporate changes in tax policy. In a recent paper, Corbo and Nam (1976) have considered alternative measures of "fiscal impulse" which adjust for some of these factors.[5] One measure is calculated using the IMF definition, which takes the difference between the actual budget deficit and a measure of the "cyclically neutral" deficit as a measure of fiscal stimulus, as given in equation (1).

$$FIS_t = (t_0 Y_t - g_0 Y_t^p) - B_t \tag{1}$$

B_t is the actual budget surplus, Y_t and Y_t^p are actual and potential income, and t and g are the ratios of revenue and expenditure to GNP in a base year (when actual and potential GNP were judged to be equal). The fiscal impulse

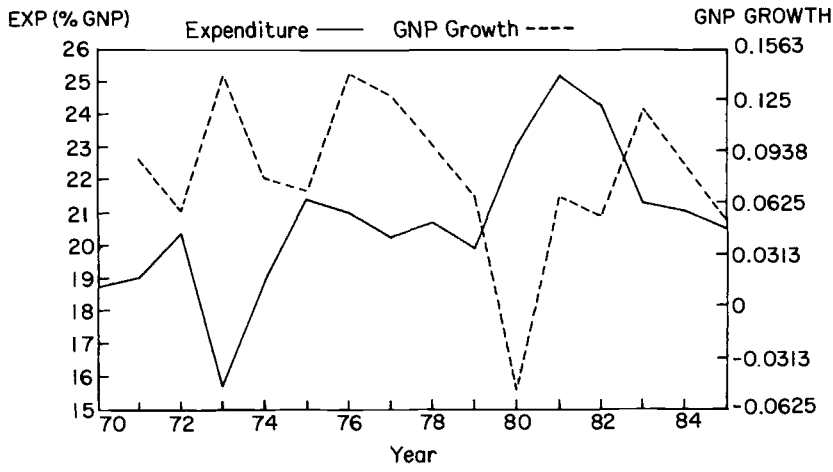

Fig. 11.2 Fiscal policy and economic growth

measure, then, is FI_t, the change in fiscal stimulus as a share of income (eq. 2).

$$FI_t = \Delta(FIS_t/Y_t) \tag{2}$$

Table 11.3 reproduced from the Corbo and Nam paper, shows the IMF fiscal measure together with real output growth, the actual budget deficit as a share of output each year, and the change from the previous year. Although the actual budget change and the IMF fiscal measure are nearly identical in some years (such as 1978 and 1982), it is clear from the table that cyclic factors were sometimes quite important. For example, the unadjusted measure overstates the expansionary stance of fiscal policy during 1971–72 and especially during 1980, when the adjusted indicator shows a contractionary fiscal policy instead of the strongly expansionary policy suggested by the unadjusted measure.

Despite these differences, the adjusted fiscal indicator retains a strong inverse relationship to economic growth over most of the sample period.[6] The only exception is the crisis in 1979–80 during which fiscal policy remained contractionary despite the slowdown in real growth. The policy reaction was delayed until 1981, when a strong fiscal expansion took place.

11.3 Monetary Policy and Financial Markets

11.3.1 Financial Markets

We begin with a brief overview of financial markets in Korea. Cole and Park (1983) give an in-depth analysis of the 1945–78 period, while Cole and

Table 11.3 Fiscal Impulse

Year	Real GNP	Actual Deficit (% of GNP)	Change	IMF Fiscal Measure	
				A	B
1971	8.8	2.3	1.4	0.7	1.3
1972	5.7	4.6	2.4	1.6	1.7
1973	14.1	1.6	−3.0	−2.2	−2.2
1974	7.7	4.0	2.4	2.1	2.1
1975	6.9	4.6	0.6	0.4	0.2
1976	14.1	2.9	−1.8	−1.0	−1.2
1977	12.7	2.6	−0.2	0.1	−0.1
1978	9.7	2.5	−0.1	−0.1	−0.0
1979	6.5	1.4	−1.1	−1.6	−1.1
1980	−5.2	3.2	1.7	−0.4	−0.1
1981	−6.2	4.6	1.5	1.7	1.6
1982	5.6	4.3	−0.3	−0.3	−0.5
1983	9.5	1.6	−2.7	−1.9	−2.1
1984	7.5	1.4	−0.2	0.2	0.1

Source: Corbo and Nam (1987b, table 9).

Note: The public sector includes the central government (general account, 12 special accounts, and 21 funds) and five public enterprise accounts (grain management, monopoly, railways, communications, and supply), together with two related funds (grain management and supply).

Fiscal impulse measure A uses potential GNP obtained from a regression equation, while measure B uses potential GNP from peak-through interpolation.

Cho (1986) and Y. C. Park (1985) provide additional details about recent developments. Readers are referred to these sources for further discussion. In addition to the text tables, we refer to the monetary statistics in the Data Appendix.

Korea's financial system is composed of three segments. Official banking institutions include five commercial banks and six special banks. These institutions have been strictly regulated since they were developed in 1950. Until 1982 the government operated the special banks and, as majority stockholder, indirectly managed the five nationwide commercial banks. Interest rates on deposits and loans were specified by the government. These rates have typically been low relative to inflation rates and to rates available elsewhere, creating a persistent excess demand for credit from the banking system (see app. table A4.4). Government officials have therefore directly influenced the allocation of loans to industrial sectors. Almost no credit from the banking system has been supplied to consumers—consumer loans come almost exclusively from curb markets. The Ministry of Finance has been de facto responsible for making these decisions which are actually carried out by the Monetary Board.[7] Liberalizations put into place since 1982 are discussed in section 11.3.5.

The second segment, nonbank financial institutions (development institutions, savings institutions, life insurance companies, and investment corporations) have been subject to limited supervision. The third segment is

the "unregulated" financial institutions, also called the curb market. While not subject to direct controls, government policies have sometimes had a significant impact on them as well.

11.3.2 Controlled Liberalization, 1966–72

The years 1966–69 were boom ones for Korea, with real growth rates averaging 11 percent. Cole and Park (1983) label this period "controlled liberalization" in financial markets.[8] There were three major developments.

The first was the very rapid growth of bank deposits (table 11.4). Deposits grew by just 19 percent per year during 1961–64 and by less than 3 percent during 1962–64. They grew by 81 percent in 1965 and by 58 percent during 1966–70, rising from 12 percent of GNP in 1966 to 29 percent in 1969. The main reason was the monetary reform of 1965, which had increased the

Table 11.4 **Deposits, Loans, and Foreign Loan Guarantees in the Major Banks, 1961–85**

A. All Banks[a]

	Deposits		Loans		Guarantees[b]	
Year	Amount	Growth	Amount	Growth	Amount	Growth
1961	26.4	—	52.3	—	1.6	—
1964	44.3	18.8	84.7	17.4	48.2	211.1
1967	208.4	67.6	230.4	40.0	196.0	59.6
1970	800.5	56.6	851.5	54.6	749.3	56.4
1973	1,766.0	30.2	1,906.0	30.8	1,381.3	22.6
1976	3,725.9	28.3	4,464.8	32.8	4,711.6	50.5
1979	9,878.1	38.4	11,115.7	35.5	10,109.0	29.0
1982	21,309.5	29.2	24,895.9	30.8	18,658.3	22.7
1985	31,221.2	13.6	40.724.6	17.8	20.489.0	3.2

B. Commerical Banks

	Deposits		Loans		Guarantees	
Year	Amount	% of Total	Amount	% of Total	Amount	% of Total
1961	19.3	73.1	12.8	24.4	1.4	87.5
1964	28.2	63.7	23.1	27.3	9.9	20.5
1967	137.0	66.0	105.6	45.8	50.3	25.7
1970	505.4	63.3	441.8	51.9	319.3	42.6
1973	1,179.2	66.8	987.5	51.8	585.3	42.4
1976	2,495.4	67.0	2,411.3	54.0	2,165.3	46.0
1979	6,042.8	61.2	5,634.9	50.7	6,217.6	61.5
1982	13,080.3	61.4	12,172.2	48.9	14,322.0	76.8
1985	18,157.0	58.2	19,800.4	48.6	16,382.4	79.5

Note: Data reported in billions of won and as average growth rate (%) over the preceding three-year period.

[a]Includes commercial banks, specialized banks, and the Korea Development Bank.

[b]Acceptances of special banks omits those of the Foreign Exchange Bank which are secondary guaranteees of acceptances of the other banks.

interest rate ceiling on time deposits from 15 to 30 percent. As a result, real interest rates on time deposits averaged 18.9 percent during 1966–69 as compared to −4.6 percent during 1962–64.

A second development was that the deposit growth was accompanied by equally rapid growth in loans from the banking system (see table 11.4). However, all industrial sectors did not have equal access to this credit. The government had begun to target specific export industries in conjunction with the first five-year plan. These were given preferential access to loans. Short-term export loans, which were 4 percent of total bank loans during 1966, jumped to 12 percent by 1971. During 1967–71, short- and long-term export loans accounted for 55 percent of the total increase in bank notes and 29 percent of the increase in the money supply (Hong 1979, 117–30).

Furthermore, preferential interest rates were established for exporters, for purchases of imported intermediates, and for equipment purchases by export and other target industries. Table 11.5 compares interest rates for export loans and discounts during selected years. As shown, the rates were equal in 1961. But in 1965, exporters paid only 27 percent of the standard discount rate.

It is also interesting to compare these interest rates to the costs of borrowing abroad or borrowing in curb markets. In chapter 3, we showed in table 3.6 that the average cost of borrowing in curb markets was 54 percent during 1966–70. With an interest differential of 12.1 percent, it was significantly more expensive to borrow at the domestic discount rate than to borrow aboard. However, the differential between borrowing domestically at the preferential export rate and borrowing abroad was −5.6 percent.

The third development was the massive inflow of foreign funds, guaranteed by the banking system. As discussed in chapter 3, commercial banks began to issue guarantees for loans which had been authorized by the government after 1966. However, these banks simply "facilitated" the

Table 11.5 **Export Promotion: Interest Rates**

Year	Loans for Export	Discount on Bills	Ratio
1961	13.9	13.9	1.00
1965	6.5	24.0	0.27
1972	6.0	15.5	0.39
1976	8.0	17.8	0.45
1979	19.0	18.5	0.49
1980	15.0	19.5	0.77
1981	15.0	16.5	0.91
1982	10.0	10.0	1.00
1984	10.0	10.0–11.5	—

Source: BOK, *Money and Banking Statistics*, 1984, pp. 384–87.

Note: End-of-year interest rates on discounts of deposit money banks. Discounts refer to rates for "superior enterprises," 1976–81.

loans. They did not evaluate them and, therefore, it was difficult to hold the banks responsible when firms ran into repayment difficulties. These foreign loan guarantees amounted to just 3 percent of total bank loans in 1961. By 1964 this figure had rise to 57 percent and by 1967, to 85 percent. The growth was especially rapid during 1966–70 (see table 11.4).

Thus, real growth was financed by a rapidly expanding financial sector. During 1966–71 domestic banks and nonbanks financed 40.5 percent of corporate sector borrowing, while foreign loans financed 31 percent (table 11.6).

As we have seen, difficulties emerged during 1970. Growth slowed, the current account deficit rose. Monetary growth was restrained in conjunction with an IMF standby arrangement. Korean firms began to have difficulties servicing their external debts. The difficulties were exacerbated by the devaluation undertaken in 1971 and 1972 to stimulate exports. These factors contributed to a financial crisis in 1972. The government responded by issuing a presidential decree on 3 August 1972. The purpose of the decree was to help out firms which were close to bankruptcy and to stimulate economic growth. In the process, the measure also eliminated many of the liberalizations which had been instituted since 1965.

There were five major elements of the decree.[9] New terms were established for all loans from unofficial lenders to licensed businesses, specifying a three-year grace period, a five-year repayment period, and a 1.35 percent monthly interest rate. More favorable terms were established for some short-term, high interest rate bank loans. A credit guarantee fund was set up to help small and medium-sized industries as well as agricultural businesses and fisheries. The government supplied 50 billion won to an industrial rationalization fund for long-term, low interest rate loans. Finally, interest rates in banking institutions were reduced. The time deposit rate was

Table 11.6 **Sources of Funds by Corporate Sector (in percentages)**

Sector	1966–71	1972–76	1977–79	1980–83	1984
Borrowing from monetary sources	40.5	43.3	50.4	33.3	54.4
Banks	(31.9)	(29.2)	(32.0)	(17.4)	(19.4)
Nonbanks	(8.6)	(14.1)	(18.4)	(15.9)	(35.0)
Securities	14.2	18.5	22.4	25.5	27.7
Bonds	(0.7)	(1.9)	(6.5)	(10.3)	(12.5)
Stocks	(12.0)	(15.2)	(14.5)	(7.7)	(12.1)
Capital paid in	(1.5)	(1.4)	(1.5)	(7.6)	(3.1)
Corporate bills	—	1.9	2.4	5.6	−0.7
Government loans	0.7	0.0	0.1	2.6	0.7
Borrowings from abroad	30.9	26.3	13.0	15.7	22.4
Total	100.0	100.0	100.0	100.0	100.0

Source: BOK, *Flow of Funds Accounts* and *Economic Statistics Yearbook.*

Note: Data include noncorporate enterprises and government enterprises since 1980.

lowered from 17.4 to 12.6 percent, while the rate on general loans (one year or less) was lowered from 19 to 15.5 percent.

One of the most important aspects of the decree was that it implied a significant transfer from lenders to the unofficial market to borrowers. The market seems to have almost disappeared for nearly a year following the decree, however, it reemerged after the rise in oil prices at the end of 1973.

The decree also provided the government with an unusual opportunity to collect relatively accurate statistics about the unofficial market as of August 1972. Unfortunately, comparable figures for other years are not available. As Cole and Park (1983, 163–54) discuss, many of the discoveries were surprising. In particular, the total volume of all informal loans amounted to nearly 80 percent of the money supply in 1972. Loans were made to large as well as to small firms, and the industrial distribution of the loans was similar to the distribution of loans from the banking system.

11.3.3 Intervention During the Big Push, 1973–80

Financial market developments during 1973–80 contrast sharply with the growth and liberalization of the late 1960s. Commercial and special banks were heavily regulated, with low nominal interest rates, implying negative real rates throughout much of the period. Consequently, the growth of the banking sector slowed considerably. M2 did not grow relative to GNP. At the same time, the government was in the midst of a major industrial restructuring and was actively promoting the growth of HC industries. Furthermore, interest rate developments significantly increased the attractiveness of bank loans to all domestic borrowers. The result was a substantial increase in government intervention to allocate bank credit, combined with increased expansion of the nonbank financial institutions.

As was shown in table 11.5, interest rates on export and other preferential loans continued to be subsidized. But discount rates had been reduced, while rates on loans to exporters had been raised. The subsidy on commercial bank loans to exporters narrowed from 76 percent in 1969 to 42 percent in 1974.

As verified in table 11.7, the average cost of borrowing (in sixty-eight manufacturing industries) fell from 18 percent during 1970–1971 to 12 percent during 1973–74, before rising back to 17 percent by 1979. Even more striking is that the variance in borrowing costs across industries ranged from 56–83 percent during 1970–71, but 14–21 percent during 1973–79. However, these figures do not include loans from unofficial sources and they do not incorporate the fact that many firms who would have liked to borrow from the banking system were unable to do so. The figures merely point out that, for those firms with access, the range of interest rates on bank loans narrowed significantly after 1972.

In chapter 3 table 3.6 showed that the interest differential between home and foreign markets fell from 12 percent during 1966–70 to 1 to 3 percent during 1972–80. Domestic credit had become much more attractive, relative

Table 11.7 **Cost of Borrowing in Manufacturing Industries (in percentages)**

Year	Average	Variance
1970	17.92	83.18
1971	18.40	55.73
1972	15.05	43.14
1973	11.49	14.38
1974	12.47	17.56
1975	13.59	15.60
1976	14.58	16.13
1977	15.16	18.96
1978	15.52	18.96
1979	17.17	21.44
1980	20.47	20.99
1981	19.50	13.20
1982	16.89	8.33
1983	14.33	8.05
1984	14.46	5.91

Source: BOK, *Financial Statement Analysis*, various issues, cited in Cole and Cho (1986, table 7).

Note: Data drawn from sixty-eight different industries and based on the four-digit code classification of the Korea Standard Industry Classification (KSIC).

to external borrowing, for those who had access to bank loans, even if the loans were not at subsidized rates.

Table 11.8 shows how additional banking sector credit was allocated across manufacturing industries during 1973–85. The figures clearly show the shift toward HC industries associated with the Big Push. During 1973–74, 66.1 percent of incremental credit went to light industries. The allocation was almost reversed during 1975–79, when 59.1 percent of the incremental credit went to heavy industry. In 1975 heavy industry accounted for only 42 percent of value added in manufacturing. By 1979 its share had risen to 51 percent.[10]

Table 11.8 **Incremental Credit Allocation of the Banking Sector (in percentages)**

Year	Heavy Industry	Light Industry
1973–74	33.9	66.1
1975–79	59.1	40.9
1980	59.8	40.2
1981	52.5	47.5
1982	68.4	31.6
1983	58.3	41.7
1984	56.3	43.7
1985	63.4	36.6

Source: World Bank (1987, table 2.5).

Note: These figures are the share of net credit increase of deposit money banks and the Korea Development Bank. Light industry includes food and beverages, textiles and apparel, wood and furniture, paper and printing, nonmetallic mineral products, and other manufacturing. Heavy industry includes chemicals, petroleum and coal, basic metals and fabricated metal products and equipment.

In 1977 the government switched from a positive list loan allocation system in which priority sectors were explicitly listed, to a negative list system; however, the excess demand for funds from the banking system continued to imply that loans were severely rationed.

Table 11.6 showed that loans from the banking sector continued to account for approximately 30 percent of total corporate sector financing during 1972–79. However, the importance of foreign borrowing had fallen to just 13 percent during 1977–79. Nonbank financial institutions became considerably more important, accounting for 18 percent of total corporate finance in 1977–79 as compared to 8 percent during 1966–71. As discussed above, a number of measures were undertaken during the 1970s to encourage the growth of the nonbanks, in the hopes of channeling funds away from the unofficial money market.

Deposit growth provides one measure of the increasing importance of this sector. While the growth of bank deposits slowed (see table 11.4 and A4.3), deposits in nonbank financial institutions increased from 16 percent of total bank and nonbank deposits in 1971 to 30 percent in 1980. The development is important because, as Cole and Cho (1986) discuss, the expansion of this partially regulated sector offset some of the effects of increased interventions in the banking sector.

11.3.4 Economic Crisis, 1979–81

Thus, 1973–79 was a period of considerable government intervention in financial markets. However, as discussed in chapter 5, concern over inflation and resource misallocations associated with the Big Push led to the CSP announced in April 1979. One of the plan's hallmarks was that, for the first time, it expressed the view that current government intervention was excessive and that, at Korea's present stage of development, it was appropriate to begin to liberalize both trade restrictions and financial markets.

We have already noted that one component of the CSP was a fiscal contraction. On the monetary side, the plan called for more restrictive monetary policy, increased nominal (and real) interest rates, and an improvement in the preferential loan allocation scheme. In fact, M2 growth slowed from over 35 percent per year during 1976–78 to 25 percent in 1979. There was also a slight increase in interest rates, but accelerating inflation meant that the real interest rate fell to 0.2 percent on discounts and to −9.3 percent on loans to exporters.

By the end of 1979, Korea was in the midst of an economic crisis. The second oil shock, the agricultural disasters, and the death of President Park all contributed to the severe difficulties in 1980. Resuming positive growth and reducing inflation and the debt burden became the government's top priorities.

A stabilization package was initiated in January 1980, supported by a two-year IMF standby arrangement. The package included the familiar

combination of devaluation, fiscal and monetary restraint, and higher interest rates. In addition, the higher oil prices were to be passed through to consumers.

The government raised interest rates in June 1980. The discount rate was increased by 1–2 percent, while the rate on loans to exporters was increased by 6 percent, substantially narrowing the differential (see table 11.5). However, inflation rose from 18 to 29 percent. Futhermore, the deteriorating situation led to a relaxation of some other policies. As discussed above, government expenditures on social services were increased. In addition, the target money growth rates were increased slightly. M2 grew by 26.7 percent in 1980 compared to 25 percent in 1979.

In 1981 there was some improvement in economic performance. Growth rates were positive, while inflation and the current account deficit began to decline. As we have seen, there was a further depreciation and a further fiscal expansion. However, monetary policy remained restrictive. M1 grew by just 4.6 percent compared to 18 percent during 1979–80. M2 growth remained relatively constant at 25 percent. The government also continued its financial liberalizations, this time reducing the discount rate (see table 11.5). Finally, price controls were eliminated on a number of key items.

11.3.5 Financial Market Liberalization, 1982–86

Two developments took place during 1982–86. First, the government continued to pursue a restrictive monetary policy, helping to reduce inflation to 2.3 percent. Second, additional steps have been taken toward financial liberalization. We conclude this chapter by discussing each development.

A new policy package to revive the domestic economy was initiated in January 1982. The package included further liberalization (to be discussed below), and also called for a loosening of monetary policy. In fact, a financial scandal in the curb market in May 1982 forced two large corporations into bankruptcy. The incident triggered a contraction in loans available from the curb market, threatening many other firms with bankruptcy. In order to bail out these firms, there was a major credit expansion—M1 grew by over 45 percent during 1982. (However, M2 growth increased only marginally.) Since then, monetary growth has been quite restrictive. M1 (M2) grew by just 17 percent (15 percent) in 1983 and 0.5 percent (8 percent) in 1985. It has remained low by historical standards during 1985–86.

Banking sector growth has slowed markedly since 1979. However, nonbank financial institutions (NBFI) have continued to grow quite rapidly. The ratio of deposits in NBFI to total bank deposits (demand, time, and savings) rose from 36.1 percent in 1979 to 71.7 percent in 1984, and then to 94.8 percent in 1986. The rapid expansion of this sector suggests that the slowdown in bank growth overstates the extent to which financial developments have constrained real activity. Although the annual growth rate

of M1 slowed from 23.9 percent during 1973–79 to 15.3 percent during 1979–86, M3 growth (which includes NBFI) slowed only slightly, from 27.9 percent during 1973–79 to 26.5 percent during 1979–86.

We turn finally to financial liberalization. The fifth five-year plan (1982–86), formulated during 1981, emphasized trade and financial liberalization and a commitment to more neutral government policies. In contrast to recent experiences in Latin America, the financial market liberalization was to be undertaken gradually. Although a number of steps have been taken, an evaluation of this policy shift remains premature.[11]

During 1981–83, the government sold its shares in the large commercial banks. It also attempted to restrict ownership by single shareholders to 8 percent. However, as shown in table 11.9, ownership of many of these banks is concentrated among the *chaebol*. The government has authorized two new commercial banks. It has also relaxed the restrictions on chartering NBFI and on the activities of the branches of foreign banks in Korea.

Interest rates were restructured in 1982, although the government continues to set ceilings for bank loans and deposits. As was shown in table 11.5, the subsidy to export loans was eliminated. In table 11.7, we also showed the decline in the variance of borrowing costs across industries, from 21 percent during 1979–80 to just 6 percent by 1984. The government also acted to redress the discrimination against small firms during the Big Push. Small firms have received slightly lower rates than large firms since 1982. In 1984 access to additional credit for the large conglomerates was restricted, increasing the availability of credit to small firms.

In 1982 the government also abolished direct credit controls for deposit money banks, switching to a monetary policy based on specified reserve

Table 11.9 **Conglomerate Ownership of Banks (in percentages)**

Conglomerate	Cho Heung	Korea First	Hanil	Bank of Seoul	Commercial Bank
1. Hyundai	2.14	9.35	7.27	11.93[a]	—
2. Daewoo	1.23	23.82[b]	2.22	5.29	4.48
3. Samsung	8.34	5.69	9.72	—	15.97[b]
4. Lucky Goldstar	1.71	5.30[a]	5.87[a]	—	—
5. Hanjin	—	—	8.45[b]	—	—
6. Taekwang	3.77	—	—	4.56	—
7. Ssangyong	5.57	—	—	—	—
8. Daelim	—	—	9.29[b]	—	—
9. Shindongah	7.98	7.24	—	9.90	—
10. Dong Ah	—	—	10.03	—	—
11. Hanil-Kukje	4.05	2.18	3.69[b]	—	1.91
Memo item: ownership by top 11	39.79	54.58	56.54	31.68	22.36

Source: Business Korea.

[a]Quasi-lead bank.

[b]Lead bank.

requirements, rediscounts, and open market operations. However, the government does continue to have considerable influence over the allocation of bank credit. It has intervened heavily to restructure industries which built up overcapacity during the Big Push. As was shown in table 11.8, this implied a shift in credit allocation bank to heavy industry during 1985.

Thus, Korea has made some steps toward financial market liberalization in equalizing borrowing costs across industries. Furthermore, as Cole and Cho (1986) point out, the expansion of the only partially regulated NBFI has contributed to a de facto liberalization of the overall financial system. However, authorities have proceeded cautiously, continuing to influence credit allocation. In this sense, the policy shifts may have been more a matter of degree than an "about face" in direction. This viewpoint is advanced by Y. C. Park (1985a). It is too early to evaluate the results of the liberalization, or to attempt to draw lessons from the experience. Korea may soon have some interesting lessons to teach about the economic consequences of a controlled financial liberalization.

12 Income Distribution

As we have studied in detail in previous chapters, Korea underwent a successful macroeconomic adjustment while maintaining high rates of growth. In many cases, rapidly expanding developing countries have been able to achieve remarkable increases in per capita incomes, but one of the costs has been the deterioration of an already skewed income distribution. Consequently, the gains have bypassed a large part of the population. This chapter examines distributive aspects of Korea's experience from the 1960s to the 1980s.

There have been a number of studies of income distribution in Korea. We will refer to them throughout the chapter. Those focusing on the first half of Korea's rapid growth (through the early 1970s) include Adelman and Robinson (1978), Rao (1978), Renaud (1976) and Mason et al. (1980). The studies consistently found that income was equitably distributed in Korea relative to other developing countries, and that Korea's economic growth did not require or result in a deterioration. In fact, the rapid economic growth fueled by expansion of labor-intensive export sectors was widely believed to have improved the distribution of income during this period. However, later studies caused considerable concern among policymakers because they seemed to show a noticeable deterioration of income distribution during the 1970s. See, for example, Choo (1977), Szall (1981), and Jung (1982).