DEVELOPMENT FINANCE AND COMMERCIAL BANKS IN KOREA

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I. INTRODUCTION

EXCEPT in times of war, only a few nations have used policies of selective credit control as widely and thoroughly as has Korea. The country's past twenty years of rapid economic growth have been based mainly on the promotion of key industries: the chemical industry, heavy industry, and industry that is export-related. Financial policy, particularly selective credit control, has had a significant role in the growth process. During these two decades, large volumes of funds have been continually provided to key industries at preferential, low-interest rates.

What makes selective credit control in Korea significantly different from its application elsewhere is strict government control of commercial bank fund allocations to strategic sectors.[1] Korea's broad application of selective credit control has placed extensive limits on the workings of financial policy. Optimum fund allocation through the financial market mechanism has yet to become a reality because strong government regulation of lending activities, notably fund allocation, makes it much more difficult for the commercial banks to change the volume and conditions of credit in a way that makes credit more profitable and efficient. Preferential lending policy in the latter half of the 1970s and early 1980s to encourage chemical and heavy industry development did increase the national investment rate as intended, but it also reduced investment efficiency, expanded the macro demand-supply gap, decreased the rates of growth, and increased inflation.

In order to better understand the example of the development process provided by the Republic of Korea, it is important to provide an analysis of the effects of Korea's selective credit control on development, particularly the ramifications that the control has had on financial policy method and on the activities of the financial intermediary institutions, most notably the commercial banks.

II. MONETARY POLICY AND SELECTIVE CREDIT CONTROLS

The Bank of Korea's financial policy is divided into quantitative and qualitative (selective) credit control.

[1] See K. Itō [5] and Park Jae Yoon [10] on the activities of development finance institutions and other policy finance institutions.

Quantitative credit control is used to influence the demand and supply of funds in financial markets, and, ultimately, to influence the workings of the aggregate economy without influencing any specific sector. Quantitative credit control consists of indirect and direct control. Indirect control includes (1) interest rate policy, (2) reserve requirement operations, and (3) sales and purchases of securities. Direct control is the placing of ceilings on loans from financial institutions, which tends to give direct control the characteristics of selective credit control.

Selective credit control is the use of credit allocations for differential intervention by facilitating or restraining the supply of funds to a specific economic sector. In this sense it is qualitative credit control.

A. *Quantitative Credit Controls*

The features of Korean financial policy instruments, profit and loss, and commercial bank fund position, are such that regulations on the allocation of funds and the policy of differential interest rates have limited the workings of financial policy and worsened commercial bank profitability. The worsening of profitability has led to constraints on the workings of financial policy instruments.

1. *Policies on interest rates and loan ceilings*

The Monetary Board determines Korean interest rate policies, not just through the rediscount rate, the rate of interest the Bank of Korea charges for loans to financial institutions, but also through the setting of ceilings on rates that financial institutions charge for loans and give for deposits. These are the rates to which actual rates generally correspond. The Bank of Korea almost always lends at a rate lower than the financial institution lending rate.

The hike in interest rates on September 30, 1965 induced negative margins, in which lending rates were lower than deposit rates, and this led to worsened profits for deposit banks and increased loan costs for the corporate sector. Interest rates were adjusted downward in March 1968, October 1968, and June 1969 to eliminate the structure of reverse margins, but slight margins between lending and deposit rates remained that kept bank profits down. Table I shows that in order to promote exports and expand the use of commercial bills, Bank of Korea rediscounts on export-related bills and commercial bills were kept at lower rates than those of the commercial banks by an average of 4 percentage points each. There were no limits on the rediscount of export-related bills. Commercial bills had been rediscounted automatically before 1981, but in that year, ceilings were placed on rediscounts for deposit money banks. Except for the first half of the 1960s and the latter half of the 1970s, Bank of Korea rates on other general loans were set at punitive levels, rates higher than those for the deposit money banks. These interest rate policies are selective credit controls implemented through the application of discriminatory rates.

As long as the rediscount rate is lower than the deposit money bank lending rate, commercial banks will, naturally, ask the central bank for as many loans

TABLE I

INTEREST RATE DIFFERENTIALS

(%)

Year	Month	Discount Rates on Commercial Bills	Differential from the Bank of Korea Rediscount Rate	Export Finance	Differential from the Bank of Korea Rediscount Rate	Interest Rate on General Funds up to 1 Year	Differential from the Bank of Korea Rediscount Rate
1964	Mar. 16	14.0	3.5– 2.5	8.0	3.5	16.0	3.5– 0
	Jun. 8	14.0	3.5– 2.5	8.0	4.5	16.0	3.5– 0
1965	Sep. 30	24.0	13.5–12.5	6.5	3.0	26.0	13.5–10.0
	Nov. 16	24.0	3.0	6.5	3.0	26.0	3.0
	Dec. 1	24.0	–4.0	6.5	3.0	26.0	–2.0
1967	Jun. 29	24.0	–4.0	6.0	2.5	26.0	–2.0
1968	Mar. 1	24.0	3.0	6.0	2.5	26.0	–2.0
	Oct. 1	26.0	5.0	6.0	2.5	25.2	–2.8
1969	Jun. 1	24.6	2.6	6.0	2.5	24.0	–2.0
1970	Apr. 1	24.0	3.0	6.0	2.5	24.0	–2.0
	Dec. 3	24.0	5.0	6.0	2.5	24.0	–2.0
1971	Jun. 28	22.0	6.0	6.0	2.5	22.0	–2.0
1972	Jan. 17	19.0	6.0	6.0	2.5	19.0	0
	Aug. 3	15.5	4.5	6.0	2.5	15.5	1.5
1973	May 14	15.5	4.5	7.0	3.5	15.5	1.5
1974	Jan. 24	15.5	4.5	9.0	5.5	15.5	1.5
1975	Apr. 17	15.5	4.5	7.0	3.5	15.5	1.5
	Oct. 1	15.5	1.5	7.0	3.5	15.5	1.5
1976	Aug. 2	18.0	4.0	8.0	4.5	18.0	–1.0
1977	Jul. 1	16.0–19.0	6.0– 4.0	8.0	4.5	17.0	2.0
	Oct. 4	16.0–19.0	6.0– 4.0	8.0	4.5	16.0	1.0
1978	Jun. 13	19.0	4.0	9.0	5.0	19.0	–4.0
1980	Jan. 12	25.0	4.0	12.0	5.0	25.0	–2.0
	Jun. 5	24.0	4.0	12.0	5.0	24.0	–2.0
	Sep. 16	22.0	4.0	12.0	5.0	22.0	–2.0
	Nov. 8	20.0	4.0	12.0	5.0	20.0	–2.0
1981	Nov. 9	19.0	4.0	12.0	5.0	20.0	–1.0
	Nov. 30	18.0	5.0	12.0	5.0	18.0	–2.0
	Dec. 29	17.0	6.0	12.0	5.0	17.0	–2.0
1982	Jan. 14	16.0	9.0	12.0	5.0	16.0	–2.0
	Mar. 29	14.0	8.5	11.0	6.0	14.0	–4.0
	Jun. 28	10.0	5.0	10.0	5.0	10.0	–5.0

Source: Bank of Korea, *Monthly Bulletin.*

as possible. To control total liquidity, the Bank of Korea has suspended rediscounts, restricted lending, or changed the standards for bills eligible for discount. Since 1968, it has fixed the volume of general lending and allocated lending to each bank according to the size of the bank, the bank's situation of demand and supply for funds, and its reserve position.

General lending in Korea can be divided into two categories. The first category is the A limit fund determined by the Monetary Board. The A limit fund includes special low interest rates such as funds for supporting small- and medium-sized industries, financial support for investment, and loans for fostering local industries. (Loans for local business were abolished in 1981.) The other category, the B limit fund, consists of general lending exclusively for bank liquidity control. The A limit fund, in practice, supplied limitless amounts of high-powered money. Loans from the B limit fund were used to the fullest extent to offset chronic shortages in required reserves. The punitive interest rates of this fund, higher than those on general lending, have been applied from December 1965 to June 1971, from July 1976 to June 1977, and from June 1978 to the present. Those punitive rates were not placed into effect at any other time because of declining bank profits and severe shortage in bank reserves.

2. *Reserve requirement operations*

Before the financial reform of 1965,[2] the prevailing method of liquidity control was direct control, such as credit approval in advance. The reserve requirement was used only as an indirect instrument.

After the reform, there was a marked increase in funds in savings deposits at commercial banks. The treaty settlement with Japan in 1965, the enactment of a new foreign capital inducement law in 1966, and the widening difference between foreign and domestic interest rates increased the inflow of foreign capital. These factors contributed to increased commercial bank liquidity. To absorb that liquidity, the reserve requirement ratio was raised four times from 1965 to 1967, rising as high as 35 per cent on demand deposits, 25 per cent on long-term deposits, and 18 per cent on short-term deposits resulting in a sizeable suppression of bank profits. Taking note of this, the Bank of Korea paid interest on reserve requirements to improve the commercial banks' profit-loss situation. In March 1967, the central bank established a special deposit account (monetary stabilization account), at 5 per cent interest, to absorb excess liquidity.

The ratio of required reserves was set at a lower level for farming and fishing cooperatives than it was for the commercial banks and was varied according to type of deposit. (Preferential ratios were abolished in 1981.)

Although the commercial banks were able to offset their chronic shortages in reserves with loans from the Bank of Korea, the specialized banks were in a favorable liquidity position because they were able to use government fiscal funds. Deposit money banks, as a whole, have always borrowed more from the Bank of Korea than they have repaid, and excess borrowing by the commercial banks has been particularly large.

Reserve requirement operations are an ineffective means of liquidity control, when rediscount rates are set at lower levels than the interest rates charged by

[2] In September 1965, the Korean government undertook a financial reform which was highlighted by drastic increases in official interest rates on commercial bank time deposits and lending rates. The primary objective of the reform was to attract into the banking institutions private savings that had previously been directed into unorganized money markets or into real assets as a hedge against inflation.

banks and no ceiling is set on loans [1]. The Bank of Korea's free use of designated rediscounts and preferential loans rendered reserve requirement operations ineffective as a means of controlling the money supply.

3. *Securities sales and purchase operations*

To provide a temporary source of funds for the banks, the Bank of Korea issued monetary stabilization bonds for the first time in 1961. In 1962, the bond issue was stopped due to a worsening bank fund situation at the start of the first five-year plan. The bonds were again issued after the 1965 financial reform to absorb a continually growing flow of liquidity from foreign sectors. Only specialized banks such as the agricultural cooperatives, the Citizens National Bank, and the Housing Bank purchased the bonds, and recent purchases by the Korea Development Bank and the Export-Import Bank are on the decrease.

In 1969, national bonds, or government guaranteed bonds, were sold under repurchasing agreements to control liquidity. These operations are too small to be regarded as open market operations.

B. *Selective Credit Controls*

Selective credit controls were adopted to control the supply of funds to designated sectors and increase the efficiency of fund allocation in Korea. These credit controls were comprehensively enforced according to objective, type, and coverage.

The Monetary Board laid down guidelines in 1962 for efficient allocation of banking funds and government funds[3] that required the specialized banks to finance preferential sectors. The specialized banks were originally established under special laws and are dedicated to serving particular areas: basic, chemical, and heavy industry; small- and medium-size business; foreign exchange and international financing; consumer financing; and the financing of farming and fishing.

The government also controlled the fund allocation of commercial banks. Priorities were set on fund allocation according to the rated importance of a particular industrial sector. First priority went to industries that contribute to improving the balance of payments, i.e., those that earn foreign currency or are import-substituters; second priority to industries that produce daily necessities; third priority to industries that contribute to the growth of national product and increased employment; fourth priority to industries of national strategic importance such as chemical, heavy, arms-weapons, and machinery; and fifth priority to those contributing to rationalization of industry and development of high technology. Regulations on allocation underwent more than twenty changes, one of them being, notably, the requirement that 30 per cent or more of nationwide commercial bank loans go to small- and medium-size business. In 1980, that share was revised to 35 per cent and for local banks from 40 per cent to 55 per cent or higher.

[3] Banking funds consist of deposits, call money, loans from the Bank of Korea, and foreign loan funds; government funds include loans from the government.

In April 1974, working rules on selective credit for financial institutions were enacted that restrained bank loans from going to nonessential sectors. In April 1977, the rules were replaced by guidelines for selective credit of financial institutions, guidelines which have since undergone several revisions.

The guidelines provide that required foreign funds should be obtained principally from international borrowing or foreign currency lending and that required domestic funds should be obtained from loans from the National Investment Fund or the Korea Development Bank and from commercial bank long-term and medium-term installment repayment loans. The guidelines are also aimed at the promotion of direct finance through corporate bond issue and capital increases. In this way, regulations are provided for sectors to which loans are to be restrained and those to which loans are to be banned.

With detailed rules on fund allocation, each of the fund is to financially support preferential sectors. Commercial banks as well as specialized banks must engage in so-called institutional finance or they must give preferential credit to applicants that satisfy the requirements.

Types of funds vary widely and include financial support for exports, discounts on commercial bills, special low interest funds for small- and medium-size business, and funds for energy saving. The first two constitute a major part of funding. An additional fund type is the National Investment Fund, which was established in 1973. Commercial banks were required to hold bonds with the use of savings deposits, and acted as agents of the National Investment Fund in giving credit mainly to sectors such as machinery, shipbuilding, and plant export.

Financial policy instruments in Korea have become a selective support system for export industry, chemical industry, heavy industry, and small- and medium-size business. As such, they are a powerful tool for the implementation of policy objectives in fund allocation. The policies of quantitative and qualitative credit control strongly influence commercial bank behavior.

III. DEVELOPMENT FINANCE AND COMMERCIAL BANK BEHAVIOR

At the end of 1982, deposit money banks held 62.0 per cent of the assets of all securities companies and financial institutions (including those of the Bank of Korea); commercial banks held 39.8 per cent of the total; and the relatively important role of the specialized banks, such as the Korea Development Bank and the Korea Export-Import Bank, is shown in their 33.7 per cent.

The relative weight of deposit money banks in the financial market declined during the 1970s. Their share of quasi-money, according to the Financial Survey, dropped from 79.5 per cent in 1972 to 55.8 per cent in 1982, a decline brought on by the establishment of nonbanking financial institutions such as investment finance companies, mutual savings and finance companies, and credit unions. As national income grew and the government provided preferential treatment in interest rates, the nonbanking financial institutions and the trust and securities companies have rapidly increased their share of the financial market. The various government restrictions on commercial bank activities have led to a decline in commercial banking's share of the market.

A. *Characteristics of Commercial Bank Loan Operations*

The first five-year plan was begun in 1962 almost a year after the April 19, 1961 military coup d'etat. Demand deposits were the major source of funds for financial institutions at the start of the five-year plan. Savings deposits increased sharply after the 1965 financial reform, and their proportion as a fund source began, for the first time, to surpass that of demand deposits. Preferential lending by commercial banks increased because the government took heed of the conditions occurring in fund raising and adopted a policy of selective credit, emphasizing financial support for exports.

In the process of high economic growth incumbent upon the first and second five-year plans, planners in the 1970s realized that it was necessary to promote industrialization of the chemical and heavy industry sectors, and the lending of funds in the form of preferential loans got into full swing. The unified exchange rate system, established under the 1965 financial reform, replaced direct support for exports with indirect supports[4] such as the Bank of Korea's preferential rediscount facility that provided commercial banks with the most profitable operations. The various measures of the 1970s also facilitated discounts of bona fide commercial bills through automatic commercial bank discounts and Bank of Korea rediscounts.

Commercial bank activities in development finance have supported the Korea Development Bank through accepting its industrial finance debentures by using their time deposits, and handling KDB-guaranteed loans. In 1969, a fund for machine industry promotion was established to cater to the machine industry and promote its domestic production by using bank funds and government subsidies to make up for the difference between fund raising interest rates and preferential low lending rates.

In the 1970s, additional measures were taken to promote chemical and heavy industrialization and to advance the export industries. In 1971, the Middle- and Long-Term Installment Repayment Loan Regulations were adopted to unify the system for equipment loans, set the term-loan interest rates by period and lengthen the periods. In February 1973, a system of financial support was started to provide the export industries with funds so that they could purchase equipment. In December 1973, the National Investment Fund Law was enacted to foster the chemical industry and general heavy industry. Commercial banks began to accept bonds on national investment funds by using savings deposits and engaging in the lending operations of the fund.

From 1973 until the close of the decade, commercial banks increased their share in preferential lending as did specialized banks, a group of banks of which

[4] Loans for exports, loans in foreign currency for suppliers, loans for export preparation of agriculture and marine products, etc.

the major members are actually classifiable as deposit money banks. A limited supply of government funds led to a decrease in specialized bank lending of government funds as part of total lending, while their share of collected banking funds increased and made specialized bank business resemble more that of a commercial bank.

Since data exclusive to commercial banks is unavailable, the data used here is for deposit money banks. However, the activities of both groups have similar characteristics.

Table II shows the industrial trends in loans. Although loans for farming was almost 40 per cent of all loans in the first half of the 1960s, that share maintained a downward trend throughout the 1970s to become less than 10 per cent in 1980. Loans to the wholesale and retail trade, restaurants and hotels also decreased from around 15 per cent in the first half of the 1960s to less than 10 per cent in the 1970s. Large increases took place in manufacturing and construction where loans rose to the 60 per cent and 10 per cent levels, respectively, in 1980 and the combined share for these areas was 70 per cent. This shift in the 1970s shows the change in direction of selective credit control toward manufacturing.

Table III shows the situation of loans to manufacturing from the mid-1960s to 1980. The textile, wearing apparel, and leather share remained almost level at 30 per cent and the chemical, petroleum, coal, rubber, and plastic share stayed around 14 per cent. The percentage of loans for food, beverages, and tobacco decreased while that for basic metals and fabricated metal products, machinery and equipment increased. Of total loans to manufacturing in the first half of the 1960s, light industry had 60 per cent and the chemical industry and heavy industry the remaining 40 per cent. However, the picture has reversed since the second half of the 1970s, with the share for chemical industry and heavy industry higher than that for light industry. Since commercial bank funds are mainly short term, the increased percentage of loans to chemical industry and heavy industry was a heavy burden, particularly during the economic slump that began in 1979. During recession, with many borrowers in arrears on payments, the changed loan picture put pressure on bank profits.

As Table IV shows, the funds that deposit money banks raise consist of banking and government funds. Government funds are now less than 5 per cent of the total, an indication of how much the government needs banking funds for development purposes.

Table V shows the use of banking and government funds according to the two classifications of equipment funds and operating funds. Most government funds are used for equipment funds, the percentage of which is increasing in reflection of the government's economic development policies. Since government funds are limited in volume, various measures are being taken to induce bank funds into government designated sectors such as through the use of Bank of Korea preferential rediscounts, government-supported interest rate differentials, and guideline designated finance.

TABLE II

LOANS AND DISCOUNTS OF DEPOSIT MONEY BANKS BY INDUSTRY

(%)

Year	Agriculture	Mining	Manu-facturing	Con-struction	Electricity, Gas, and Water	Wholesale and Retail Trade, Restaurant and Hotel	Transportation, Storage, and Communication	Social Services	Others
1964	36.3	1.6	36.8	2.4	0.1	14.6	1.6	0	2.9
1965	29.0	1.6	43.0	2.3	0.1	18.1	1.4	0	1.9
1966	23.6	1.9	46.4	2.3	0.6	17.7	1.8	0	2.2
1967	17.5	2.5	47.8	6.0	0.7	17.5	1.8	0	2.2
1968	14.8	2.9	47.3	4.8	0.7	17.1	2.4	0	5.4
1969	12.8	2.0	50.4	7.0	0.8	18.0	2.7	0	2.9
1970	16.1	1.7	47.6	7.7	0.8	17.6	2.9	0	3.7
1971	14.6	2.5	49.5	9.8	1.1	10.9	2.6	5.5	3.4
1972	14.2	2.7	52.4	10.9	1.3	8.2	3.0	5.1	2.2
1973	13.5	1.5	56.9	10.2	0.4	7.3	3.2	4.9	2.1
1974	11.4	1.3	60.9	10.3	0.4	6.5	2.6	4.8	1.8
1975	11.0	1.3	60.3	8.9	0.5	6.9	3.9	5.0	2.0
1976	10.9	1.5	60.6	8.5	0.4	7.4	4.3	4.3	2.1
1977	11.4	1.2	59.8	8.5	0.3	7.7	4.4	4.2	2.5
1978	10.4	1.2	57.1	9.5	0.3	8.7	4.1	4.9	3.8
1979	9.5	1.4	56.8	11.7	0.3	7.6	3.9	4.3	4.4
1980	8.9	1.1	56.7	12.6	0.4	7.4	3.2	4.5	5.2

Source: Bank of Korea, *Statistical Yearbook*.

TABLE III

SHARE OF LOANS TO MANUFACTURING

(%)

Year	Light Industry					Chemical and Heavy Industry					Others
	Total	Food, Beverage, and Tobacco	Textiles, Leather	Wood, Wood Products	Paper, Paper Products	Total	Chemical, Petroleum, Coal, Rubber, Plastics	Nonmetal Mineral Products	Basic Metals	Fabricated Metal Products, Machinery and Equipment	
1964	57.7	15.2	28.1	5.5	8.9	35.9	17.8	4.0	2.5	11.6	6.3
1965	55.0	14.2	28.2	4.9	7.7	37.7	18.2	4.3	2.7	12.5	7.3
1966	53.5	12.9	27.4	5.5	7.7	39.2	17.4	5.2	3.7	12.9	7.2
1967	49.8	12.9	25.5	5.2	6.2	40.6	21.2	4.9	3.0	11.5	9.6
1968	51.6	12.3	25.8	5.8	7.7	39.4	19.3	3.5	2.6	14.0	9.0
1969	48.9	11.8	25.9	5.4	5.8	41.8	23.5	2.8	3.0	12.5	9.3
1970	48.2	12.0	24.3	6.1	5.8	45.2	22.9	3.2	3.7	15.4	6.7
1971	49.9	9.9	24.1	10.1	5.8	39.4	16.8	4.8	4.1	13.7	10.7
1972	49.6	10.8	24.2	8.2	6.4	38.3	14.1	5.8	4.9	13.5	12.1
1973	55.3	10.6	30.5	8.2	6.0	36.7	12.2	4.9	5.4	14.2	8.1
1974	59.4	12.5	32.9	8.1	5.9	35.2	11.9	4.5	6.0	12.8	5.3
1975	52.6	11.8	30.1	5.3	5.4	41.1	14.1	5.1	5.7	16.2	6.5
1976	65.4	10.2	31.3	4.4	5.0	44.3	14.5	4.4	8.5	16.9	4.7
1977	50.0	9.1	32.1	3.9	4.9	50.1	14.2	4.0	8.3	19.6	4.0
1978	47.8	7.6	31.1	4.4	4.7	48.8	14.7	4.2	8.5	21.4	3.3
1979	44.6	6.6	28.8	4.2	5.0	51.0	14.3	4.1	9.0	23.6	4.5
1980	42.5	6.0	27.0	4.1	5.4	52.4	15.9	4.2	7.6	24.7	5.1

Source: Bank of Korea, *Statistical Yearbook.*

TABLE IV

THE COMPOSITION OF DEPOSIT MONEY BANK LOANS

(%)

Year	Banking Funds	Government Funds
1969	90.1	9.9
1970	91.4	8.6
1971	92.4	7.6
1972	93.1	6.9
1973	93.4	6.6
1974	94.7	5.3
1975	95.1	4.9
1976	95.7	4.3
1977	95.1	4.9
1978	95.2	4.8
1979	96.0	4.0
1980	95.7	4.3
1981	96.0	4.0
1982	95.5	4.5
1983 (Aug.)	95.4	4.6

Source: Bank of Korea, *Monthly Bulletin.*

TABLE V

FUND COMPOSITION BY SOURCE AND USAGE

(%)

Year	Total Equipment Funds	Total Operating Funds	Banking Funds		Government Funds	
			Equipment Funds	Operating Funds	Equipment Funds	Operating Funds
1973	17.9	73.5	13.5	77.4	82.0	18.0
1974	16.0	78.6	11.5	82.7	83.6	16.4
1975	17.6	78.0	12.6	82.7	85.5	14.5
1976	18.4	74.7	12.6	80.0	88.4	11.6
1977	20.0	76.3	13.1	82.8	86.1	13.9
1978	20.4	77.8	13.6	84.4	84.8	15.2
1979	21.0	78.0	14.6	84.3	93.4	6.6
1980	19.6	79.7	13.7	85.5	92.9	7.1
1981	22.1	75.7	17.0	80.5	93.0	7.0
1982	20.9	77.4	15.1	83.0	95.2	5.6
1983 (Aug.)	21.4	77.2	15.2	83.3	94.0	6.1

Source: Bank of Korea, *Monthly Bulletin.*

Table VI compares the percentages of preferential loans and general loans that do not receive any preferential treatment. The largest part of the Bank of Korea's preferential rediscounts went to support export financing. Expanded support for export financing and sustained promotion of chemical industry and heavy industry since 1973 has continued to raise the percentage of preferential loans (column D) until it is now almost 50 per cent. During the same period, however, general loans (column A) have remained in the 50–60 per cent range.

TABLE VI

SHARE OF PREFERENTIAL LOANS AND GENERAL LOANS IN TOTAL LENDING

(%)

Year	General Loans (A)	Preferential Loans (I) (B)	Export Supports (C)	Preferential Loans including Bank of Korea Rediscounts (II) (D)
1969 (Dec.)	69.9	24.8	(3.3)	26.3
1970	64.8	25.7	(3.8)	31.0
1971	63.4	25.7	(5.0)	32.6
1972	52.5	28.9	(8.9)	35.4
1973	51.2	36.0	(16.3)	40.2
1974	55.3	35.2	(17.3)	40.1
1975	59.4	33.7	(14.0)	38.0
1976	54.8	36.4	(14.9)	41.3
1977	58.2	37.9	(14.1)	42.0
1978	56.9	39.0	(14.9)	43.0
1979	58.1	38.8	(14.7)	44.3
1980	55.6	39.8	(14.8)	46.1
1981	50.7	40.4	(14.9)	48.8
1982	53.9	36.0	(12.8)	45.5
1983 (Aug.)	52.5	38.6	(13.1)	47.5

Source: Bank of Korea, *Monthly Bulletin*.

It should be noted that the share of support for export financing remained level at 15 per cent over the past decade, occupying the largest portion of all preferential loans. The share of preferential loans remains high, although commercial bank lending of preferential loans has decreased and some loan types in this category have been abolished.

The importance of preferential loans in providing equipment funds is shown in Table VII. About 40 per cent of all preferential loans are used for equipment funds and about 80 per cent of equipment funds are provided for by preferential loans.

Figure 1 compares the supply of preferential loans to the supply of general loans during the business cycle. Although preferential loans are lent in line with supply and demand and other factors, Korea apparently uses them during economic recession to stimulate business activity, and the chart shows a pattern of lending behavior for preferential loans in the economic slowdowns of 1970–72, 1976, and 1981 that is different from that of general loans. During economic upswings, preferential loan behavior does not contribute to the prevention of overheating. On the contrary, general loans are suppressed during boom times, suggesting a "crowding out" of those loans. The pronounced drop in the growth of preferential loans since 1982 may reflect the abolition of some preferential loans handled by commercial banks and the decrease in interest rate differentials between general and preferential loans.

Preferential loans provided to government-designated industries in the latter half of the 1970s, without any consideration to their profit or efficiency situation,

TABLE VII

SHARE OF PREFERENTIAL LOAN EQUIPMENT FUNDS

(%)

Year	Proportion of Equipment Funds in Total Preferential Loans	Proportion of Preferential Loans in Total Equipment Funds
1973 (Dec.)	37.2	83.3
1974	34.6	86.0
1975	39.9	84.6
1976	39.7	86.1
1977	41.7	83.9
1978	41.8	84.2
1979	40.6	82.3
1980	37.6	85.5
1981	38.7	83.2
1982	36.6	77.1
1983 (Aug.)	36.8	78.8

Source: Bank of Korea, *Monthly Bulletin*.

brought on excessive investment in chemical and heavy industry and an imbalance between export and domestic sectors.

Commercial and specialized banks are allowed to finance development with government funds and Bank of Korea loans and rediscounts, but they are given little scope, even when using their own deposits, to judge the borrower's profitability and efficiency.

B. *Assets and Liabilities, Profits and Losses*

When preferential lending was strengthened in the 1970s, borrowing and foreign debt increased as a proportion of total commercial bank liabilities (Table VIII).

Unlike the specialized banks that handle a large amount of government fiscal funds, the commercial banks have customarily had to borrow from the Bank of Korea to cover reserve shortages.

As foreign trade expanded in the 1970s, foreign debt in the form of refinancing and bank loans increased. In line with the increase in preferential loans, the share of loans borrowed by commercial banks as a part of total liabilities increased from 19.0 per cent in 1970 to 39.8 per cent in 1981. There was an especially high percentage increase in Bank of Korea loans as a part of total bank funds, from 12.2 per cent in 1970 to a high of 19.9 per cent in 1974. This proportion took a drop to 14.0 per cent in 1981.

Percentages for deposits, the largest items in total liabilities, continued a downward trend. Demand deposits decreased from 15.7 per cent in 1970 to 5.6 per cent in 1981, and although savings deposits increased after the 1965 financial reform to a high of 66.3 per cent in 1969, they declined to 39.6 per cent in 1981.

The largest portion of all funds used was held by loans, which have remained

TABLE VIII

A. Commercial Bank Liabilities

(%)

Year	Demand Deposits	Time and Savings Deposits	Securities	Financial Debentures	Stocks	BOK Loans	Other Borrowings	Government Loans	Foreign Debts
1962	45.5	29.8	5.8	0.0	5.8	4.8	1.9	1.0	0.0
1963	46.3	28.0	14.1	0.0	14.1	10.9	0.3	1.0	0.0
1964	44.0	29.1	13.6	0.0	13.6	13.9	0.6	0.9	0.0
1965	38.6	41.2	8.3	0.0	8.3	5.5	2.4	0.6	0.0
1966	26.9	53.1	4.5	0.0	4.5	4.1	5.6	0.3	0.0
1967	23.3	50.7	5.6	0.0	5.6	4.5	9.3	0.2	0.6
1968	21.3	59.1	7.0	0.0	7.0	5.5	9.7	0.1	0.2
1969	19.2	66.3	5.0	0.0	5.0	5.8	4.0	0.1	0.7
1970	15.7	60.9	4.1	0.0	4.1	12.2	1.6	0.0	5.2
1971	14.4	57.4	3.3	0.0	3.3	10.8	0.6	0.0	5.0
1972	15.4	53.5	2.6	0.0	2.6	12.5	1.5	0.0	4.9
1973	16.1	50.6	3.2	0.0	3.2	13.0	0.4	0.0	4.1
1974	13.0	41.0	3.3	0.0	3.3	19.9	1.0	0.8	10.6
1975	11.6	39.7	3.3	0.0	3.3	14.4	0.9	1.1	12.2
1976	11.7	40.3	3.9	0.1	3.7	11.8	1.2	2.1	12.4
1977	13.5	38.8	4.4	0.6	3.8	9.6	0.5	2.5	14.1
1978	10.4	39.0	3.1	0.1	2.9	12.4	0.2	2.7	13.9
1979	9.4	37.5	3.0	0.0	3.0	15.5	0.3	2.9	17.1
1980	8.0	38.0	3.0	0.0	3.0	13.9	0.3	2.4	23.0
1981	5.6	39.6	3.1	0.0	3.1	14.0	0.2	2.1	23.5

TABLE VIII (Continued)

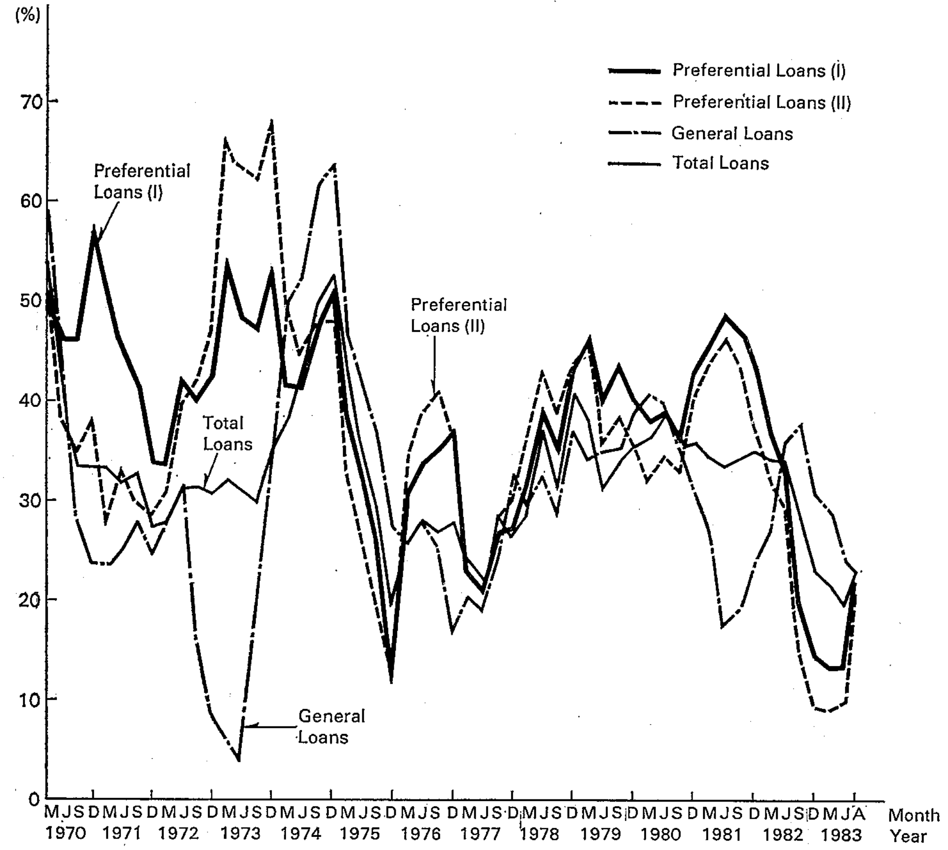
B. COMMERCIAL BANK ASSETS

(%)

Year	Currency	Deposits with BOK	Time and Savings Deposits	Securities	Government Bonds	Financial Debentures	Debentures	Stocks	Bank Loans	Gold and Foreign Exchange Holdings	Foreign Claims
1962	4.8	17.3	0.0	5.1	1.6	1.0	0.0	2.6	67.0	0.6	0.0
1963	4.2	9.6	0.0	7.7	1.9	1.0	0.3	4.5	73.3	0.6	0.0
1964	3.7	5.6	0.0	9.0	3.4	0.9	0.3	4.3	73.4	0.0	0.0
1965	2.8	13.6	2.1	5.6	2.6	0.4	0.2	2.4	70.8	0.6	0.0
1966	0.7	21.3	6.1	7.7	1.3	4.9	0.1	0.1	60.2	0.4	0.0
1967	2.9	15.6	0.5	8.9	3.5	4.0	0.2	1.2	62.6	7.8	0.0
1968	2.4	14.9	2.1	6.8	1.7	2.4	0.1	2.6	65.9	5.5	0.0
1969	2.3	12.3	1.3	6.6	0.6	3.5	0.2	2.3	71.2	3.6	0.0
1970	1.6	14.8	1.9	4.0	0.4	1.3	0.4	2.0	70.7	5.0	0.0
1971	1.1	7.7	0.2	4.4	0.4	1.9	0.4	1.6	71.4	8.3	0.0
1972	1.0	11.4	0.0	6.3	0.4	3.6	0.6	1.7	65.3	8.7	0.0
1973	1.2	12.7	0.1	6.3	1.4	2.6	0.4	1.8	62.7	10.4	0.0
1974	0.9	11.4	0.1	4.4	1.6	1.3	0.3	1.2	67.1	11.9	0.0
1975	0.8	17.5	0.1	4.8	2.4	0.8	0.2	1.4	60.0	14.4	0.0
1976	0.8	16.5	0.1	6.4	4.1	0.4	0.3	1.6	60.1	13.3	0.1
1977	0.7	15.5	0.0	7.0	4.2	0.5	0.3	2.0	59.1	13.9	0.2
1978	0.8	11.8	0.0	6.1	2.3	0.8	0.5	2.5	64.8	12.9	0.4
1979	1.1	11.2	0.0	5.7	2.1	0.9	0.5	2.2	66.7	11.0	0.3
1980	0.7	7.5	0.0	8.5	3.8	2.3	0.6	1.8	66.7	11.1	0.3
1981	0.6	3.9	0.0	10.0	4.1	3.6	0.9	1.3	69.3	11.4	0.2

Source: Bank of Korea, *The Flow of Accounts in Korea.*

Fig. 1. Changes in Total Loans, Preferential Loans, and General Loans of Deposit Money Banks (Annual Increase)



in the 60 to 70 per cent range. The share of securities-on-hand rose from a little less than 10 per cent in the latter half of the 1970s to 10.0 per cent in 1981, with the majority of those securities being in national and public bonds and bank debentures and a very small portion in corporate stocks and bonds.

Deposits with the Bank of Korea increased when reserve requirement ratios were raised sharply to absorb excess liquidity after the 1965 financial reform and after the first oil price hike. Those deposits have decreased to less than 5 per cent since 1980. The recent decrease was brought about by the lower demand for funds in the recession after the second oil price hike and subsequent drops in the reserve requirement ratio.

Loans are the largest assets of nationwide commercial banks and, in the latter half of the 1970s, those in the more-than-one-year maturation category reached 30 per cent of the total and those in the more-than-three-year maturation category went above 10 per cent (Table IX) partly because of a new term loan scheme

TABLE IX
CHANGES IN CITY BANK LOAN MATURITY

(%)

Year	1961 Mar.	1966 Mar.	1971 Mar.	1976 Mar.	End of 1980
Less than 3 months	76.7	69.4	49.3	31.9	29.2
3–6 months	10.8	16.4	23.6	14.1	9.7
6 months–1 year	12.1	11.0	19.1	27.5	30.3
More than 1 year	0.4	3.2	8.0	26.5	30.8
(1 year–3 years)				(13.2)	(20.5)
(More than 3 years)				(13.3)	(10.3)
Total	100.0	100.0	100.0	100.0	100.0

Source: Lee Jungsoo [8].

in 1970 and new long-term loan schemes, such as the National Investment Fund, in 1973.

Commercial banks in Korea use their funds mainly for loans; the funds available to them for stock and bond purchases are quite limited. This is the combined result of (1) the promotion of preferential lending, which leads to shortages in investable funds, (2) the inability of commercial banks to take the initiative in managing the underwriting syndicate, and (3) the minimal number of safe, profitable stocks and bonds.

Table X compares the profit and loss of two nationwide commercial banks in financial intermediary business, securities, commissions, handling charges, and foreign exchange business.[5] Financial intermediary business provides 80 per cent of the revenues and takes 90 per cent of the expenses. However, the largest share of the profit and loss situation is taken by commissions, handling charges, and foreign exchange and securities.

The composition of assets and liabilities shows that loans account for 60 per cent of total assets and that securities a little less than 10 per cent. Although the share for foreign exchange, including loans in foreign currency and foreign currency on hand, is difficult to calculate, it is estimated at less than 10 per cent.

Judging from the composition of assets and liabilities, the net profit from intermediary business for all nationwide commercial banks, as a part of total net profits, is probably very small. Corresponding shares for Taiwan are given for reference and are much larger than those for Korea (Table XI).

As shown by Table XII, low profits of Korean commercial banks in financial intermediary business come from a negative, or low positive, margin between deposits and lending rates.

Table XIII gives the interest rates in Taiwan. Here, even under official control, the margin between deposit and loan rates for deposit money banks continued

[5] Income from financial intermediation is interest income; expenses are interest payments on deposits and borrowings. For securities, income means interest, dividends, and capital gains, while expenses are capital losses, etc.

TABLE X

SHARE OF PROFIT-LOSS OF SELECTED CITY BANK OPERATIONS: KOREA

(%)

	1979			1980			1981			First Half of 1982		
	Income	Expenses	Net Profits	Income	Expenses	Net Profits	Income	Expenses	Net Profits	Income	Expenses	Net Profits
(A Bank)												
Financial intermediary	77.8*	90.0	42.0	70.4	89.5	11.3	77.8*	93.4	29.1	67.4	95.9	−131.7
Securities	1.6	0.8	3.9	6.7	1.1	24.1	1.3	0.8	3.1	10.8	0.0	86.7
Commission, handling charges, and foreign exchange	20.5	9.1	54.1	22.9	9.4	64.6	20.8	5.9	67.8	21.7	4.1	145.0
(B Bank)												
Financial intermediary	75.2	96.4	15.6	75.1	97.2	15.8						
Securities	7.9	0	29.9	7.5	0	27.3						
Commission, handling charges, and foreign exchange	17.0	3.6	54.5	17.4	2.8	55.8						

Source: Calculated from each bank's annual report.
* Including securities, interest, and dividends.

TABLE XI

Share of Profit-Loss of Selected City Bank Operations: Taiwan

(%)

	1979			1980			1981			1982		
	Income	Expenses	Net Profits	Income	Expenses	Net Profits	Income	Expenses	Net Profits	Income	Expenses	Net Profits
(C Bank)												
Financial intermediary	87.3	99.8	67.1	88.1	99.7	65.0	86.2	99.8	55.5	84.7	99.6	47.7
Securities	6.5	0	17.4	6.6	0.1	19.6	8.0	0	26.0	9.7	0.0	33.7
Commission, handling charges, and foreign exchange	6.1	0.2	15.5	5.3	0.2	15.4	5.8	0.2	18.5	5.6	0.3	18.6
(D Bank)												
Financial intermediary	83.8	98.7	66.4	83.7	98.8	65.1	85.3	98.8	67.7	78.9	98.9	41.1
Securities	10.0	0	21.7	10.2	0	22.9	9.9	0	22.1	16.4	0	47.5
Commission, handling charges, and foreign exchange	6.2	1.3	11.9	6.0	0.9	11.9	4.8	1.2	10.2	4.7	1.1	11.4

Source: Calculated from each bank's annual report.

TABLE XII

INTEREST RATE DIFFERENTIALS BETWEEN LOAN AND DEPOSIT RATES OF KOREAN DEPOSIT MONEY BANKS

(%)

Year	Month	Time Deposit Interest* (A)	Loan Rate of General Fund† (B)		Differential Interest (B−A)	Call Loan Rate
1962	Feb. 1	15.0	17.52		2.52	13.87
	Apr. 1	15.0	16.43		1.43	13.87
	Dec. 1	15.0	15.59		0.59	13.87
1963	May 17	15.0	15.7		0.7	13.87
1964	Mar. 16	15.0	16.0		1.0	12.0
1965	Feb. 5	15.0	16.0		1.0	12.0
	Sep. 30	30.0	26.0		−4.0	22.0
1968	Apr. 1	27.6	26.0		−1.6	22.0
	Oct. 1	25.2	25.2		0	22.0
1969	Jun. 1	22.8	24.0		1.2	21.0
1971	Jun. 28	21.3	22.0		0.7	19.0
1972	Jan. 17	17.4	19.0		1.6	19.0
	Aug. 3	12.6	15.5		2.9	15.0
1974	Jan. 24	15.0	15.5		0.5	15.0
			(a)	(b)		
1976	Aug. 2	16.2	17.0	18.0	1.3‡	20.0
1977	Jul. 1	16.2	16.0	17.0	0.3	20.0
	Oct. 4	14.4	15.0	16.0	1.1	20.0
1978	Jun. 13	18.6	18.5	19.0	0.15	22.0
	Dec. 7	18.6	18.5	19.0	0.15	19.0
1980	Jan. 12	24.0	24.5	25.0	0.75	25.0
	Jun. 5	24.0	23.5	24.0	−0.25	24.0
	Sep. 16	21.9	21.5	22.0	−0.15	22.0
	Nov. 8	19.5	19.5	20.0	0.25	20.0
1981	Nov. 9	18.6	18.5	19.0	0.15	19.0
	Nov. 30	17.4	17.5	18.0	0.35	18.0
	Dec. 29	16.2	16.5	17.0	0.55	17.0
1982	Jan. 14	15.0	15.5	16.0	0.75	16.0
	Mar. 29	12.6	13.5	14.0	1.15	16.0
	Jun. 28	8.0	10.0		2.0	

Source: Bank of Korea, *Monthly Bulletin*, and *Statistical Yearbook*.
* Interest rate on time deposits for one year or more.
† Interest rate on loans of general funds up to one year.
‡ Difference between (A) and the average of (a) and (b).

downward after 1970. Although rates were partially liberalized in 1980, and ceilings and floors on loan rates were imposed (the floor rate equaling the deposit rate), the margin kept narrowing due to diversification and stronger competition between financial institutions.

Interest rate margins in Korea however show no such tendency nor do they reflect changes in the profit-loss situation or in management efficiency. Commercial bank general loans are more than 50 per cent, on average, of all loans

TABLE XIII

INTEREST RATE DIFFERENTIALS BETWEEN LOAN AND DEPOSIT RATES OF TAIWAN DEPOSIT MONEY BANKS

(%)

Year	Month	Deposit Rate* (A)	Loan Rate† (B)			Interest Rate Differential (B − A)
1970	Dec. 22	9.72				
1971	May 29	9.25				
1972	Jul. 1	8.75		11.25		2.5
	Jul. 26	9.5		12.0		2.5
1973	Oct. 24	11.0		13.25		2.25
1974	Jan. 27	15.0		16.5		1.5
	Sep. 19	14.0		15.25		1.25
	Dec. 13	13.5		14.75		1.25
1975	Feb. 22	12.75		14.0		1.25
	Apr. 21	12.0		13.25		1.25
1976	Oct. 23	11.25		12.5		1.25
	Dec. 15	10.75		12.0		1.25
1977	Apr. 1	10.0		11.25		1.25
	Jun. 10	9.5		10.75		1.25
1979	May 16	11.0		12.5		1.5
	Aug. 22	12.5		14.5		2.0
			(a)	(b)	(a − b)	
1980	Nov. 17	12.5	16.2	13.5	2.7	3.7
1981	Jan. 6	13.0	16.8	14.0	2.8	3.8
	Jun. 15	14.5	18.0	15.25	2.75	3.5
	Aug. 25	14.5	17.4	14.5	2.9	2.9
	Oct. 21	13.5	16.0	13.5	2.5	2.5
	Dec. 17	13.0	15.25	13.0	2.25	2.25
1982	Feb. 26	12.5	14.75	12.5	2.25	2.25
	Apr. 17	11.5	13.75	11.5	2.25	2.25
	Jul. 12	10.5	12.5	10.5	2.0	2.0
	Sep. 18	9.75	11.5	9.75	1.75	1.75
	Dec. 30	9.0	10.75	9.0	1.75	1.75
1983	Mar. 16	8.5	10.25	8.5	1.75	1.75

Source: Central Bank of China, *Financial Statistics Monthly, Taiwan District.*
* Interest rate on fixed savings or savings deposits for one year.
† Interest rate on secure loan for one year and less.

after 1970. Savings deposits account for around 45 per cent. Therefore, loan and deposit rate levels are the most influential factors on bank profits and are given to banks exogenously. Due to the small margin between deposit and loan rates, commercial banks are increasingly required to handle preferential loans, including Bank of Korea preferential rediscounts.

Table I in Section II shows the margins between interest rates obtained when Bank of Korea preferential loans are given to commercial banks and interest rates obtained when punitive rates are applied. Under this system, commercial banks are likely to encourage support for export financing and discounts of eligible commercial banks so that they can secure profits and facilitate preferential loans on which domestic credit ceilings are not imposed.

Commercial banks increased loan volume to meet the strong demand for funds during periods of low interest rates and continued to borrow from the Bank of Korea to offset the resulting reserve shortage. The Bank of Korea continued its support by paying interest on reserve requirements according to the profit and loss conditions at the time of the settlement of accounts. However, this type of support is irregular and banks are unable to include it in their profit plans. The 5.9 per cent in 1981 and the 6.9 per cent in 1982 are examples of how much this support was a part of nationwide bank net profits [6].

IV. SUMMARY AND CONCLUSION

The major feature of Korean financial policy for the past twenty years has been the use of preferential fund supplies for export-related, chemical and heavy industries. To implement this policy, deposit money banks were compelled to direct their deposits, which were limited in volume and under severe inflationary pressure, into economic development. The government also set the allocation for preferential fund allocation and provided incentives such as Bank of Korea rediscounts and fund support for interest rate differentials. Interest on loans was set at low rates to reduce the cost of borrowing by corporations and interest on bank deposits was set at high rates to absorb funds from the curb market and from nonproductive investment.

The result was an extreme suppression of financial institution profits, especially the profits of the commercial banks. Financial intermediation was no longer the principal source of profit for these banks, foreign exchange became more preponderant, and there was greater dependence on international transactions. Commercial banks offset their reserve shortages by borrowing from the central bank. The central bank supplied funds so the commercial banks could pay interest on reserve requirements and maintain profits.

Korean financial policy has suppressed the reasonable profits of the commercial banks and prevented them from growing into their rightful role in the financial system. The commercial banks must gain self-determination in management and normalize their activities and must be allowed the function of allocating funds. The Bank of Korea's system of lending to the commercial banks must be improved so that the central bank's liquidity adjustment function can be expanded.

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