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FINANCIAL LIBERALIZATION IN ASIAN NICs: A COMPARATIVE STUDY OF KOREA AND TAIWAN IN THE 1980s

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I. INTRODUCTION

Two Asian Newly Industrializing Countries (NICs), the Republic of Korea and Taiwan have many characteristics in common such as industrialization strategy, the role of government, and the financial structure.[1] In both countries the industrialization strategy was switched from that of "import substitution" to "export promotion" around 1960. The government has played a significant role in the process of industrialization, and government-owned commercial banks have dominated the financial structure, though the "unorganized financial market"[2] has been far from negligible.

Meanwhile, at least by 1980, there was some contrast in macroeconomic performance between these two countries, whereas both of them realized rapid real economic growth through an expansion in manufacturing exports. Taiwan attained a current account balance as early as the latter half of the 1960s and has been successful in maintaining moderate price inflation (except for two oil crisis periods) by means of relatively flexible monetary policy. On the other hand Korea gave a large current account deficit to be financed with continuous foreign capital inflow and recorded relatively high inflation through accommodative monetary policy.

Table I illustrates this in terms of economic growth rates (GNP), inflation rates (CPI), and external current surplus relative to GNP. That is, inflation rates in Taiwan were significantly lower than those in Korea during the 1960s and the latter half of the 1970s and Taiwan was almost in balance with respect to its external account after the latter half of the 1960s as contrasted with Korea in persistent deficit, though both countries realized remarkable real economic growth throughout the two decades.

These differences in macroeconomic performance were naturally reflected in the contrast in their patterns of financial development. Figure 1 depicts how

1 This observation seems to have been shared among many economists. For example, see Corbo, Krueger, and Ossa [4].

2 The unorganized financial market is one where financial transactions take place out of government financial regulations, sometimes through unlicensed financial agents and without record. These agents include money lenders, pawnshops, rotating credit associations, as well as friends and relatives, on the traditional side, and bill brokers, finance companies, and the like, on the modern side. See Cole and Patrick [3] for more extensive discussion.

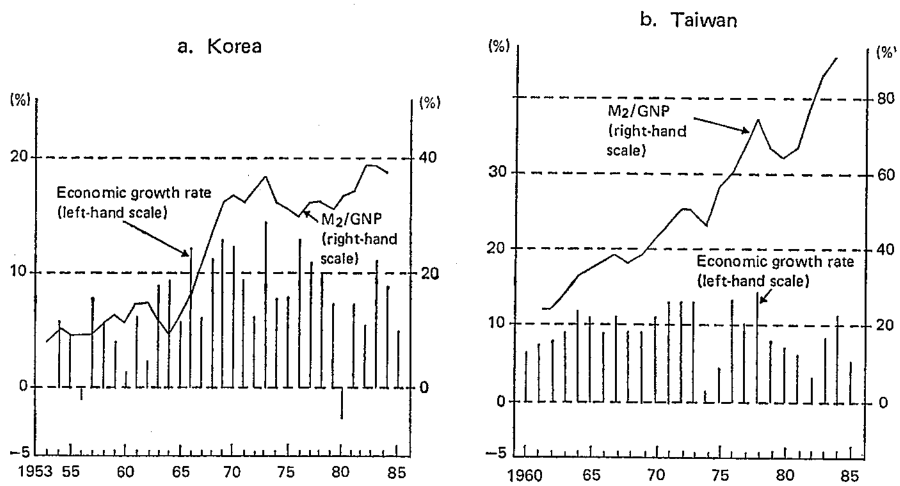
TABLE I
MACROECONOMIC PERFORMANCE OF KOREA AND TAIWAN, 1960–85

(%)

	Korea			Taiwan		
	Growth Rate	Inflation Rate	Current Surplus	Growth Rate	Inflation Rate	Current Surplus
1961–65	6.5	14.0	−8.9	9.5	2.4	−2.8
1966–70	10.4	11.4	−10.8	9.8	4.4	−1.0
1971–75	8.6	15.4	−8.0	8.9	13.3	−0.7
1976–80	7.6	17.3	−5.5	10.6	8.8	2.3
1981–85	7.5	7.4	−1.5	6.5	4.1	8.9

Sources: For Korea, Bank of Korea, *Economic Statistics Yearbook,* various issues; Economic Planning Board, *Major Statistics of Korean Economy, 1986* (Seoul, 1986). For Taiwan, Central Bank of China, *Financial Statistics Monthly,* various issues; Council for Economic Planning and Development, *Taiwan Statistical Data Book, 1985.*
Note: Growth rate=GNP, inflation rate=CPI, current surplus=(exports−imports)/GNP where exports and imports are on the basis of national accounts.

Fig. 1. Economic Growth and Financial Deepening



Source: Bank of Korea, *Economic Statistics Yearbook,* various issues.

Source: Council for Economic Planning and Development, *Taiwan Statistical Data Book, 1985.*

"financial deepening" or an expansion of domestic financial intermediation together with accumulation of financial assets has proceeded with economic growth in the two countries.[3] Particularly in the 1970s, while Taiwan accomplished steady

[3] Regarding broad money or M_2 as a means of transferring purchasing power from the ultimate lender to the ultimate borrower, M_2/GNP is regarded as one of the conventional indicators of the degree of financial deepening where GNP is used as a deflator representing the economic activity level.

financial deepening, Korea stagnated in this respect. The result was that Taiwan has faced problems related to creditor rather than debtor countries, while Korea found herself in a "debt trap" toward the end of the 1970s.

Many countries, both developed and developing, have tried to resort to economic liberalization as a way to survive the world-wide recession in the 1980s. Financial liberalization in developing countries these days would have something to do with this trend, though it is different from that in developed countries in some respects. In fact one could find such differences in motivation and background of financial liberalization in developing countries.

In this sense Korea and Taiwan, which have reorganized their financial system more or less in the 1980s, are not exceptions as we will see below. Furthermore, it will be shown that, while the liberalization movement, actually changed the financial structure in both countries, its impact presented not only a difference in the extent of reforms, but also, a contrast reflected both in macroeconomic performance and financial development.

As such, from the above viewpoint of comparative study, the purpose of the present paper is, first, to review background and motivation of financial liberalization in Korea and Taiwan, second, to scrutinize its impact on their flow-of-fund structures and, third, to examine the implication this liberalization might have on their financial development processes.[4]

In the following we deal with the above first two objectives, first, with Korea in Section II and then with Taiwan in Section III. Taking financial liberalization in Korea as a part of an overall reorientation of her macroeconomic policy management, Section II shows the key role of nonbank financial institutions. Section III ensures a relatively slow movement toward financial liberalization in Taiwan. In Section IV, dealing with the third objective, we examine whether those policies brought about the originally intended result. Summarizing the above discussion on similarities and dissimilarities in financial development in both countries, Section V refers to difficulties built in to their liberalization process.

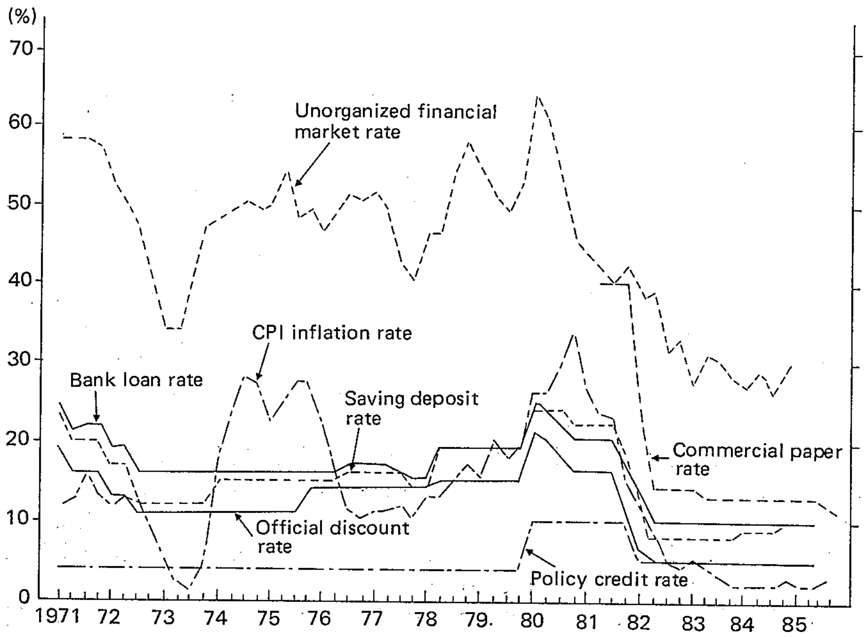
II. FINANCIAL LIBERALIZATION IN KOREA

A. *From "Intervention for Growth" to "Liberalization for Stability"—A Background*

Financial liberalization in Korea in the 1980s is interpreted as a part of the overall reorientation of her economic policy management. In view of the second oil crisis and the world recession thereafter it became apparent that Korea could hardly sustain the government-led rapid growth policy in the 1970s which placed such strategic emphasis on heavy and chemical industries. Through a painful adjustment process with negative real growth, policy management in the 1970s

[4] An overview of recent financial development in the Asian developing countries is found in Arndt [1] and Cole and Patrick [3]. Park [10] provides a comprehensive discussion on the macroeconomic development in the process of overall liberalization process in Korea in the 1980s, and Li and Chen [8] and Xu et al. [12] provide an extensive survey of Taiwan.

Fig. 2. Inflation and Interest Rates: Korea



Source: Same as Figure 1a.

faced serious criticism, which led to the following statement: "The causes of the current difficulties do not lie only in extra-economic factors such as the second oil shock, social unrest and a bad harvest. A more fundamental root can be traced to the fact that the Korean government failed to properly reorient its economic management strategy to the changing economic and social environment" [5, p. 10].

Policy management in the 1970s can be characterized by heavy and chemical industrialization with protection, mobilization of foreign saving or external borrowing, and overall control of fund allocation through "policy credits" or low interest rate credits for preferential sectors. One could name this an "intervention for growth" policy, as against a "liberalization for stability" policy, the latter of which aims at price stability, mobilization of domestic saving, and market allocation of resources and funds, i.e., trade and financial liberalization.

B. *Measures of Financial Liberalization*

As far as trade liberalization is concerned the average tariff rate declined and the rate of import liberalization accelerated in the 1980s.[5] Financial liberalization, on the other hand, placed more emphasis on domestic rather than external

[5] The import liberalization ratio amounted to 84.8 per cent in July 1984 as against 48.4 per cent in December 1975 and 68.6 per cent in July 1980. See Park [10, Table 2].

aspects,[6] which included (1) deregulation of interest rates, (2) partial lifting of entry barriers on commercial banks and nonbank financial institutions,[7] and (3) moderation of direct government control over management of financial institutions. We should note here that deregulation of interest rates and asset management deliberately came earlier and deeper to nonbank financial institutions than to commercial banks.

First, during 1981–82, selected businesses were permitted to issue "industrial papers" (a type of commercial papers) at market interest rates, corporate bond yields were deregulated, and the controlled interest rate on "policy credits" was abolished (Figure 2).[8] Second, in order to promote competition among financial institutions, the new entry of two commercial banks were permitted, and entry regulation was moderated on nonbank financial institutions to a significant extent for the period of 1981–83. Third, in addition to "denationalization" of government-owned commercial banks, autonomous management of financial institutions was strengthened in terms of both fund raising and fund using. Direct government control over every aspect such as personnel management, budgeting, lending, and other day-to-day operations of commercial banks was moderated. Reserve requirement ratios on deposits were significantly reduced during 1980–81, thereby leaving more room for fund use.[9] Moreover, other diverse financial activities were permitted for commercial banks, which included issuance of negotiable certificate of deposits (CD), sales of public bonds with repurchase agreements, and discounted commercial bills, trust banking, and ownership of nonbank financial institutions and securities companies as subsidiaries.

C. *Impact on the Flow-of-Fund Structure—Extended and Diversified Indirect Finance*

The flow-of-fund process has shown a remarkable change in the process of financial liberalization. Figure 3a depicts the behavior of the individual sector's or the main ultimate lender's portfolio selection. According to this figure its total financial assets outstanding relative to the economic activity level (GNP) remained around 40 per cent of GNP in the 1970s without any upward trend and the shares of various types of assets showed relatively little change. By contrast, the total financial assets accumulated rapidly in the 1980s amounting to 80 per cent of GNP at the end of 1984. Among the assets we see that nonbank

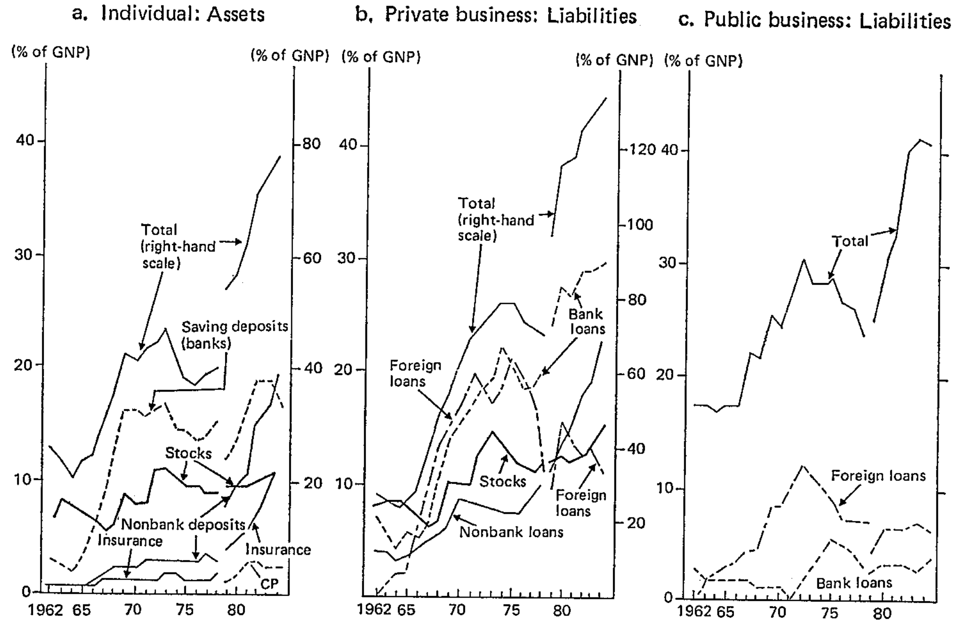
6 As for liberalization of external capital transactions, a cautious approach has been undertaken, which allows foreigners' security investment through the domestic investment trust system such as Korea Trust, and partial lifting of entry regulations on foreign securities companies.

7 Nonbank financial institutions are those financial intermediaries which do not supply narrow money or means of payments such as demand deposits as commercial banks do.

8 However, a ceiling was soon imposed on the CP rate by the authorities, afraid of its becoming higher. The preferential rate on policy credits was raised to a level identical with general loans in June 1982.

9 Minimum reserve requirement ratios on demand and saving deposits were reduced to 5.5 per cent in July 1981 from 14–27 per cent on demand deposits and 10–20 per cent on saving deposits during the period of 1972 through 1981.

Fig. 3. Flow of Funds in Korea (I)

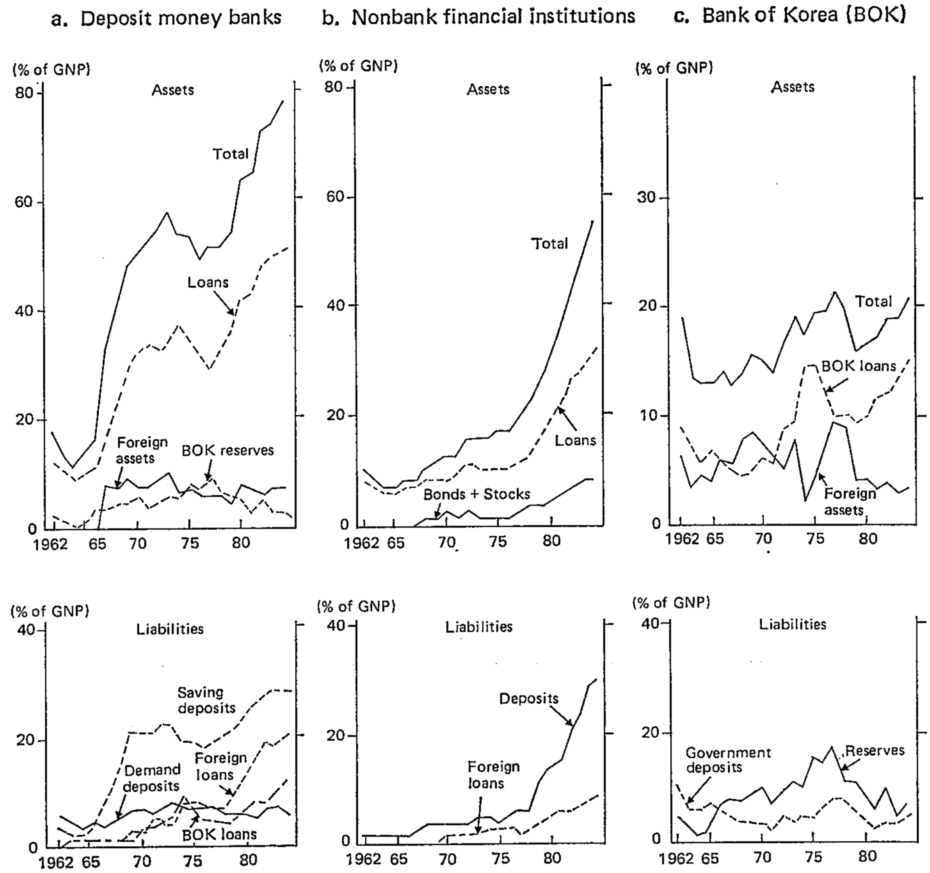


Source: Same as Figure 1a.
Note: Data is not continuous between 1978 and 1979 due to reclassification of sectors.

financial institutions' liabilities including deposits, insurance, and beneficiary certificates kept increasing rapidly, while bank deposits decreased its share after 1983 as did cash, demand deposits, and corporate stocks which showed a declining trend relative to GNP. As such we should note not only that the individual sector expanded the total share of indirect securities or liabilities on financial intermediaries, but also that the individual sector's asset shares changed significantly in the 1980s.

Next, changes in the liabilities' structure of the private business sector (including both corporate and non-corporate businesses), or the main ultimate borrower, are illustrated in Figure 3b. Corresponding to the above situation in the individual sector, its total financial liabilities as a ratio of GNP showed a rapid increase in the 1980s after the stalemate in the 1970s. Among the liabilities, primary securities such as corporate bonds and "industrial papers" (including commercial papers), loans from nonbank financial institutions (including insurance companies), and loans from banks increased, while foreign loans decreased. Relative shares of primary securities and domestic loans remained the same, though the share of corporate stocks in the former and that of bank loans in the latter shrank. The structure of liabilities of the public enterprise sector is depicted by Figure 3c, which shows some similarity to that of the private business sector with respect to changes of direction.

Fig. 4. Flow of Funds in Korea (II)



Source: Same as Figure 1a.

Thus we have seen that both the individual sector's financial assets and the business sector's liabilities remarkably increased not in the 1970s but in the 1980s and that, in particular, dominant roles were played by indirect securities issued by nonbank financial institutions for the former, and loans from nonbank financial institutions and issuance of specific primary securities, i.e., corporate bonds and industrial papers for the latter. Furthermore, if we note the fact that a significant part of these primary securities is held by nonbank financial institutions,[10] these primary securities' issuance can be considered to constitute indirect finance. Accordingly we could conclude that the change in the 1980s has been characterized by a relative expansion of indirect finance and a diversification of its channels with an extended role of nonbank financial institution. Indeed it is easy to see how rapid their expansion has been by comparing Figures 4a and 4b.

10 Their shares in industrial papers and corporate bonds holdings have been about 65 per cent and 70 per cent during 1979–85, respectively.

TABLE II

SHARES IN ASSETS, LOANS, AND DEPOSITS OF FINANCIAL INSTITUTIONS, 1976–84: KOREA

(%)

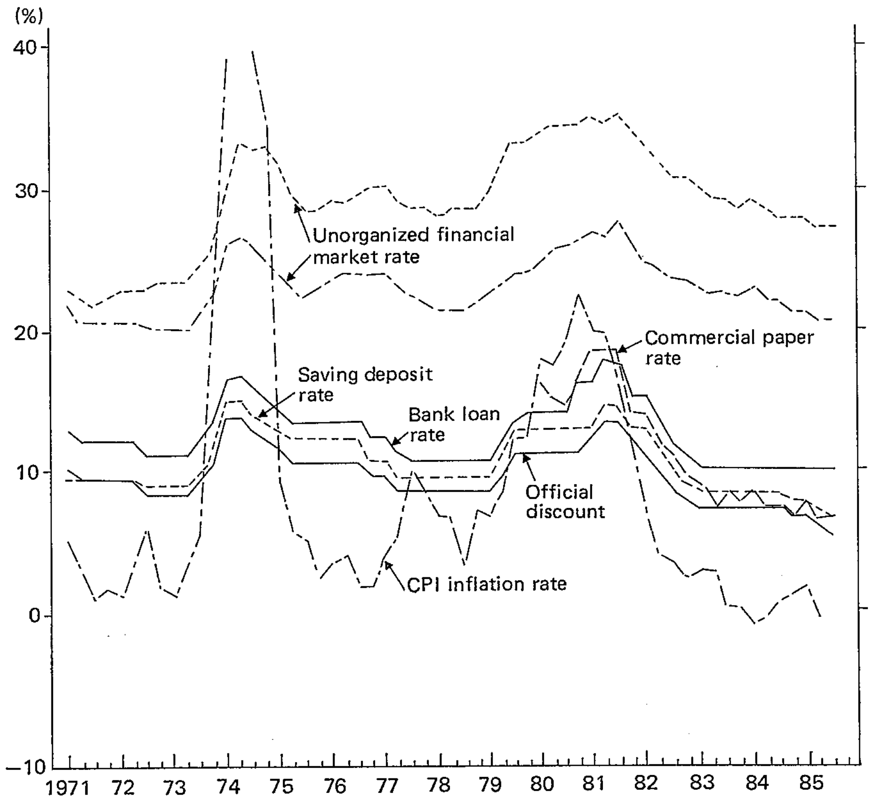
	Assets			Loans			Deposits		
	1976–80	1981	1984	1976–80	1981	1984	1976–80	1981	1984
Deposit money banks:	71.8	70.3	63.3	70.4	63.9	56.8	83.0	84.1	65.9
Commercial banks	45.2	44.7	40.6	45.0	40.1	34.0	52.3	47.5	39.8
Specialized banks	26.6	25.6	22.7	25.4	23.8	22.8	30.7	36.6	26.1
Nonbank financial institutions:	28.2	29.8	36.8	29.5	36.1	43.2	17.0	25.9	34.2
Development institutions	18.8	14.7	13.8	15.8	16.2	17.0	0.9	0.4	0.5
Investment institutions	4.0	5.4	9.1	5.8	6.2	9.0	8.6	11.6	19.4
Saving institutions	3.9	7.7	10.0	5.8	10.7	11.3	7.5	13.9	14.3
Insurance companies	1.5	2.0	3.9	2.1	3.0	5.9			

Source: Bank of Korea, *Economic Statistics Yearbook*, various issues.

Finally, one can naturally suppose that these structural changes in the flow of funds should be reflected in some way or other in the relative importance of financial institutions. In the financial system in Korea commercial banks or deposit money banks consisted of "commercial banks" and "specialized banks" occupying 72 per cent, 70 per cent, and 83 per cent in assets, loans, and deposits, respectively, during the period of 1976–80 (Table II). The table shows that their shares fell to 63 per cent, 57 per cent, and 66 per cent at the end of 1984, while those of selected nonbank financial institutions, i.e., savings and investment institutions and insurance companies, doubled to 23 per cent, 26 per cent, and 34 per cent from 9 per cent, 14 per cent, and 16 per cent each.

Note here that Figures 4a and 4b suggest that, while the expansion of nonbank financial institutions relied on mobilization of domestic savings via deposits or "inside money," a major part of that of commercial banks was through provision of "outside money," i.e., borrowings from the central bank and abroad. This implies that the role of nonbank financial institutions in domestic financial intermediation is larger than what the above share figures appear to suggest. Thus M_2/GNP is no longer an adequate measure of financial deepening because it fails to take into account the role of nonbank financial institutions.

Fig. 5. Inflation and Interest Rates: Taiwan



Source: Central Bank of China, *Financial Statistics Monthly,* various issues.

III. FINANCIAL REFORM IN TAIWAN

A. *Growth with Current Surplus and Monetary Control—A Background*

Taiwan has developed as quite an open economy through an export-led, rapid growth in the 1960s, and realized domestic saving rate exceptionally high for a developing country, which is at least partly due to a deliberate control of inflation which appears to have been almost indigenous since the 1950s. Indeed the national saving rate kept increasing from 12.7 per cent (1960) to 34.6 per cent (1973), and the individual saving rate increased from 8 per cent to 24 per cent, which resulted in consecutive current account surpluses in the early 1970s. So it is natural under a fixed exchange rate regime for most of the 1970s that external surplus occasionally caused an unexpected increase in money supply, which annoyed the authorities manipulating the money supply (for instance, in 1972 and 1978). Obviously the loss of monetary control magnified the impact of the first oil shock to generate a sore price increase in 1974.

Though the inflation rate in Taiwan was relatively lower than that in Korea in the 1970s, it was not only high historically as shown earlier in Table I but also volatile during the period as can be seen in Figure 5. The inflation brought about, first, a downfall of the flow savings, namely the national saving rate, by 7.7 per cent to 26.9 per cent (1975) and the individual saving rate by 8 per cent to 16 per cent, which, if left alone, would have been detrimental to the growth potential. Second, inflation combined with belated and inadequate interest rate adjustments in the organized financial market seemed to cause a stock shift from bank deposits toward postal savings with preferential tax treatment and individual loans or unorganized financial market assets with higher interest rates. This movement was likely to be strengthened by the fact that, particularly under macroeconomic instability, the steady accumulation of financial assets in the private sector gave an incentive for the public to diversify their assets among various forms due to a scale economy inherent in financial transactions.

As a result the unorganized financial market expanded rather than shrank in the 1970s, widening the interest rate differential between the organized and unorganized market assets [12, Table 6]. Though the unorganized market itself played a significant, complementary role in the financial system, its expansion at this stage was thought to erode the effectiveness of monetary policies as well as the tax base.

B. *Growing Money Market and More Flexible Interest Rates*

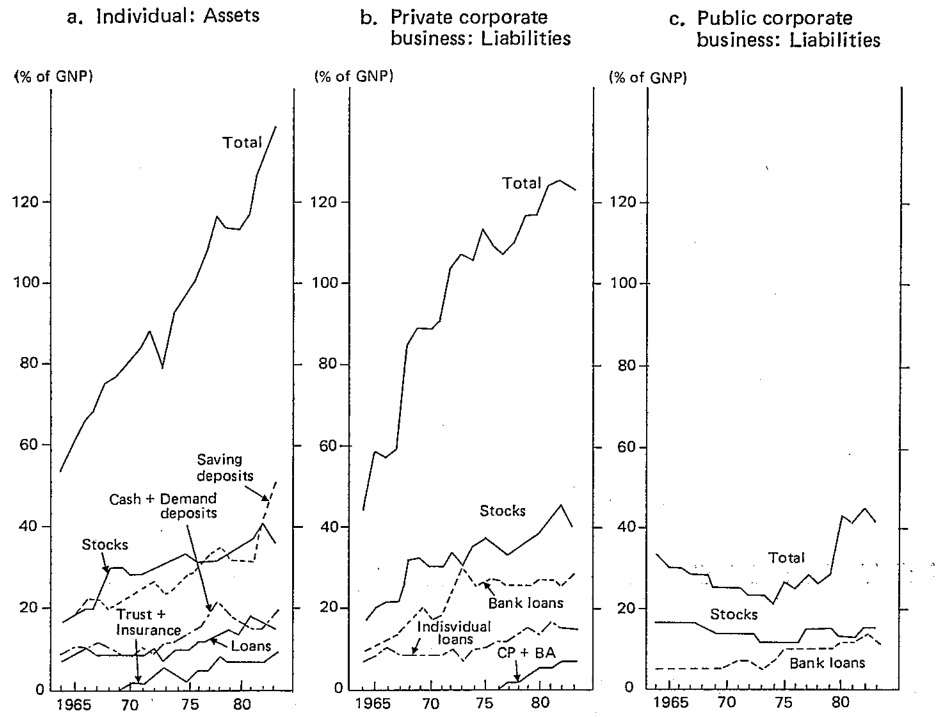
Coping with an external adjustment problem the authorities promoted capital outflow by lifting a ceiling imposed on foreign exchange exposure of commercial banks and allowed an exchange rate to adjust more frequently to external imbalances by adopting a managed float regime in 1978.

As compared with Korea where wide-ranging measures were taken in the 1980s, the movement toward domestic financial liberalization in Taiwan was regarded as modest despite lots of arguments and legislative measures on financial reform. The advocated reform had two targets. The first related to the banking system, taking shape in the revised Bank Law of 1975, where specialization of banks and deregulation of banking activities was pursued, though partially. The specialization was to allocate funds through reorganizing four banks into specialized ones and newly-establishing the Chinese Export-Import Bank in order for industrial restructuring which was expected to be inevitable. Then the deregulation was to improve banking efficiency by opening the way to more autonomous operations by commercial banks.

The second was to foster an open money market or a short-term capital market. Its purpose was (1) to promote flexible adjustment of interest rates to give a good indicator of the condition of the financial market to commercial banks as well as to the monetary authorities; (2) to provide additional means of short-term finance with the business sector as well as commercial banks; and (3) to mobilize funds in the unorganized financial market to the organized market (see Chiu [2]).

Since the first short-term finance company was established in 1976, the money market has made fairly rapid growth. For instance, if we look at the fund raising of the private and public corporate business sector, the share of funds raised via

Fig. 6. Flow of Funds in Taiwan (I)



Source: Same as Figure 5.

the money market kept increasing from 0.04 per cent (1975) to 10.9 per cent (1983). The money market instruments include treasury bills (TB), commercial papers (CP), bank acceptances (BA), and negotiable certificates of deposits (CD). Both their transactions and outstanding amounts grew with some supporting measures,[11] particularly remarkable were those of CP and BA whose interest rates are determined in an open market. Furthermore, the "call loan center" was established in 1980 to institutionalize an interbank money market.

In 1980, in view of the steady growth of the money market, the central bank announced the "Guideline on Interest Rate Adjustment." This decentralized the determination of interest rates on bank deposits and loans to the "Association of Banks" and allowed more autonomous commercial banks' management on their assets and liabilities by deregulating bills discount and CD rates. Thus interest rates on bank deposits and loans were expected to adjust flexibly with reference to market determined rates such as those on CP, BA, and call loans (Figure 5).[12]

[11] They include an imposition of the required liquidity ratio on commercial banks with these money market instruments regarded as liquid assets, a preferential tax treatment on interest income from holding these instruments, etc.

[12] Zhou [13] reports that correlation coefficients among the CP, call and unorganized financial market rates are more than 0.90 during 1979–82.

C. *Impact on the Flow-of-Fund Structure—Diversified Indirect Finance and Persistent Direct Finance*

Figures 6a, 6b, and 6c illustrate the behavior of the portfolio selection of the individual sector (including non-corporate businesses) and of fund raising of the private and the public corporate business sectors, respectively. We see from these that both the individual sector's assets and the private corporate business sector's liabilities relative to the economic activity level (GNP) have increased at a steady and rapid pace since the 1960s, while the public corporate business sector's liabilities slightly declined until the mid-1970s and thereafter followed an upward trend.[13]

The development of the money market appeared as a structural change in corporate finance. First, looking at the source of funds of the private corporate business sector or a primary ultimate borrower (Figure 6b), bank borrowings remained the same relative to GNP, while issuance of primary short-term securities such as CP and BA expanded. Meanwhile, corporate stocks[14] and borrowings from individuals grew steadily. Summing up, taking into consideration the fact that the main part of CP and BA were held by commercial banks (Figure 7a), we could say that both direct finance (stock issuance and borrowings from individuals) and indirect finance (bank borrowings and a main part of issuance of CP and BA) expanded and that the latter became diversified through expanded transactions of an open market type. While the relative weight of direct finance remained significant, expanded fund raising at the market interest rate would stimulate competition with alternative sources of finance, which might lead to an improvement in the efficiency of fund allocation. Note, however, Figure 6c suggests that the public corporate business sector, whose total liabilities amounted to one-third of the private counterpart, had a different scene. There, stock issuance remained the same, but bank borrowings grew.

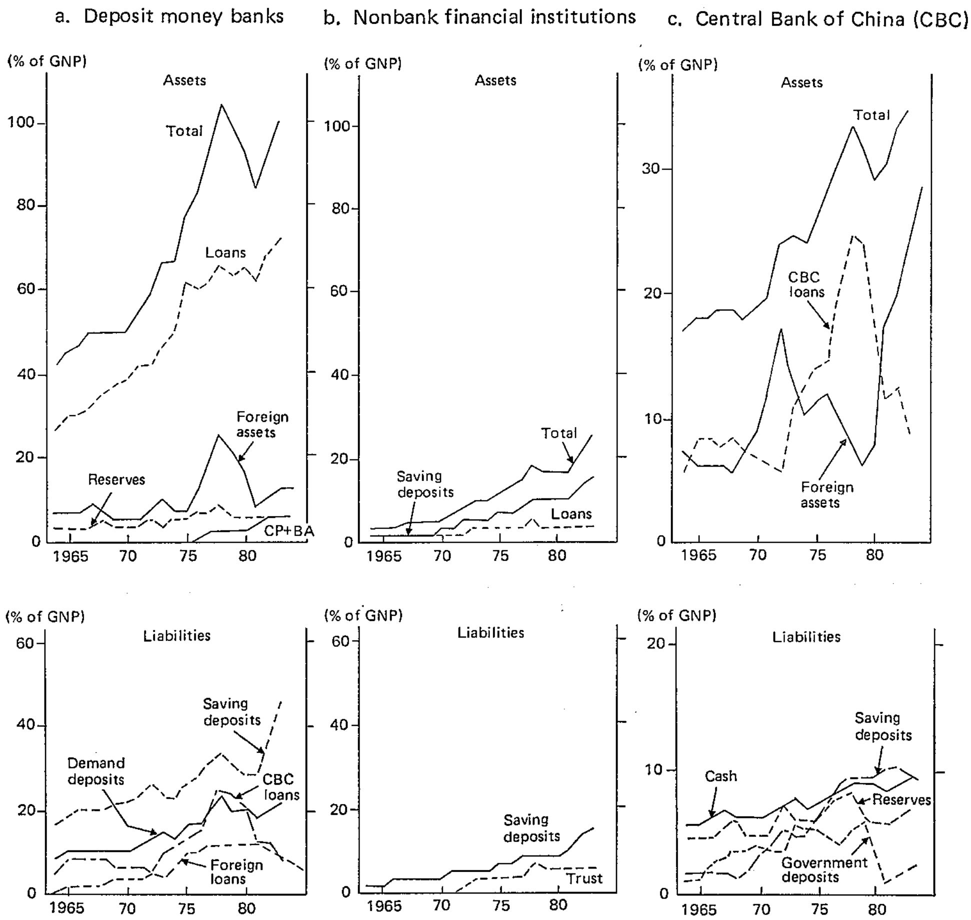
When we turn to the individual sector (Figure 6a), remarkable is a rapid increase in saving deposits in terms of GNP. Similarly corporate stock holding and individual loans increased steadily though less rapidly than saving deposits, while cash, demand deposits, trust, and insurance remained the same. The rapid growth of saving deposits corresponded to that of postal savings.[15] Indeed postal saving held by the individual sector relative to GNP grew 14.3 per cent annually during 1974–84 as compared with 6.1 per cent of bank saving deposits, thereby increasing the ratio of the former to the latter from 23.6 per cent (1974) to 49.6

[13] Note that a sharp increase in the total liabilities of the public corporate business sector in 1980 is mainly due to an unexplained statistical discontinuity in its trade credits.

[14] "Corporate stocks" is meant by the paid-in capital, in which the share of listed stocks is relatively small, e.g., 9.0 per cent (1971–75), 13.6 per cent (1976–80) on average, and 14.8 per cent (1983).

[15] The rapid increase in postal savings in the 1980s would be due to (1) a rapid expansion of its network in the area and (2) an accumulation of the individual sector's financial assets relative to the economic activity level. The latter is supposed to reduce transaction costs for stock shifts because of an economy of scale inherent in financial transactions.

Fig. 7. Flow of Funds in Taiwan (II)



Source: Same as Figure 5.

per cent (1984). As a result the share of indirect securities rose in the individual sector's assets. Nevertheless, indirect finance did not become relatively important in the private corporate business sector as we saw above. Before making clear why this happened, we have to look into the financial system.

The growth of the money market in Taiwan had little influence on the relative size of financial intermediation between commercial banks or deposit money banks and nonbank financial institutions, which is different from the situation in Korea. As a matter of fact, in terms of total assets, the share of deposit money banks fell, particularly that of dominant "domestic banks" declining from 70 per cent (1976–80, average) to 61 per cent (1984) (Table III). However, this was largely because of a rapid increase in postal savings (included in nonbank financial institutions), the share of which recorded 8 per cent (1976–80) and 14 per cent (1984).

TABLE III

SHARES IN ASSETS, LOANS, AND DEPOSITS OF FINANCIAL INSTITUTION, 1976–84: TAIWAN

(%)

	Assets			Loans			Deposits		
	1976–80	1981	1984	1976–80	1981	1984	1976–80	1981	1984
Deposit money banks:	85.8	83.5	79.0	94.0	94.6	94.8	78.8	76.3	72.7
Domestic banks	70.0	64.4	60.6	69.1	66.6	65.8	57.6	53.0	46.5
Foreign banks	5.2	6.8	3.9	7.8	9.3	5.3	0.3	0.4	0.8
Other banks	10.6	12.3	14.5	17.1	18.7	23.7	20.9	22.9	15.4
Nonbank financial institutions:	14.2	16.5	21.0	6.0	5.4	5.2	21.2	23.7	27.3
Investment trust	4.9	4.6	4.6	5.0	4.1	3.3	6.4	6.3	5.9
Postal savings	8.3	10.3	14.3				11.8	13.9	17.0
Insurance companies	1.2	1.7	2.3				2.9	3.5	4.4

Source: Central Bank of China, *Financial Statistics Monthly*, various issues.

While all postal savings were redeposited with the central bank until October 1982, a major part of the new additions thereafter has been redeposited in the four specialized banks among deposit money banks. Namely, these redeposits appear as both saving deposits and loans in the consolidated account of nonbank financial institutions (Figure 7b). To put it another way, postal savings "re-intermediate" between financial intermediaries and the ultimate lender. Thus, the share of deposit money banks in loans remained the same, i.e., 94 per cent (1976–80, average) and 95 per cent (1984), which implies that these banks have still dominated indirect finance at least in the economy as a whole.

Now we can figure out the reason why more indirect securities (saving deposits) have been held by the individual sector when the private corporate business sector has recently relied less on the deposit money banks with respect to a source of external funds. That is, it is not the private but the public corporate business sector or a secondary ultimate borrower who has raised funds more in the form of bank borrowing (Figure 6c) through the redeposit system of postal savings as stated above. We will discuss this point more in the next section.

IV. FINANCIAL LIBERALIZATION AND FINANCIAL DEVELOPMENT

Thus far we have reviewed the motivation and undertaking of financial deregulation in Korea and Taiwan and examined its impact on the flow-of-fund structure of each economy. In the present section we try to evaluate their performance in the context of financial development. Generally one could assess the working of a financial system with respect to both mobilization and allocation of funds. Here, particularly, we concentrate on (1) an efficiency of financial intermediaries and (2) macroeconomic adjustment needs. Because the former is the focus of the financial liberalization efforts and the latter is the main cause of the liberalization.

A. *Efficiency of Financial Intermediaries*

As we have seen in the previous sections, the authorities in both countries have taken several measures in order to promote competition particularly in management of government-owned commercial banks which have dominated the organized financial market. Among these measures are moderation of direct control by the authorities, privatization of those banks, and lifting of entry barriers for banks and nonbank financial institutions in Korea, and deregulation of commercial banks and fostering of open money markets to compete with bank loan markets in Taiwan. Note that Korea appeared to be enthusiastic about privatization and/or despecialization of financial institutions, while Taiwan has been cautious of such privatization and pushed toward specialization in favor of industrial restructuring.

In the case of Korea a fairly rapid change in the financial structure has been brought about by the "periphery approach." This approach aims to improve the efficiency of fund mobilization and allocation by introducing more competition among financial intermediaries through fostering nonbank financial institutions, which are supposed to be on the periphery of the financial market as opposed to the commercial banks in the center.

First, as already seen in Section II, the expansion of nonbank financial institutions was so great that competition with commercial banks has become intense. Next, the periphery approach is said to be successful in mobilization of funds from the unorganized financial market to the organized one via nonbank financial institutions, which could improve the efficiency of fund allocation as far as the organized financial intermediaries functioned properly. Indeed, this view seems to be supported by two facts, both of which imply the above stock shift taking place. One, despite the stagnant individual saving rate, the individual sector's accumulation of financial assets has been accelerated as seen in Figure 3a. Two, the interest rate differential between unorganized financial market assets and bank deposits has been narrowed to some extent in the 1980s from 24.1 per cent (1979) to 10.3 per cent (1984) (Figure 2).

Such a rapid change in the financial structure, however, may well be accompanied by some problems. One is a problem inherent to the transition process. Established commercial banks have held bad loans resulting from failed policy credits in the 1970s. In this sense their competition with newly entered financial institutions is not necessarily on an equal footing. The next problem is related to the trade-off between stability and efficiency of the financial system. Namely, if a rapid decline of established commercial banks be left alone, it would jeopardize the public's confidence in the system. This means that the authorities would ultimately have to give bail-out loans to these banks in order to maintain the "order of credits." The third problem is that denationalization of commercial banks may possibly lead to conglomeration of these banks by industrial groups, in such a small economy in Korea, despite the limited ownership of any single share holder.[16] The Latin American experience in the 1970s, that of Chile for instance, suggests that under certain conditions credits on specific groups by conglomerated banks are inclined to be excessive and to increase bad loans, because they are expected to be "socialized" ultimately by the authorities' bail-out.[17] This is a problem of "moral hazard."[18]

In the case of Taiwan, especially under the present situation with external surplus, saving mobilization in a quantitative sense could no longer be a priority objective of financial liberalization since her saving rate has been already high, i.e., 20 per cent and 32 per cent of the individual and the national saving rates, respectively, in 1983. Accordingly financial liberalization is supposed to focus on the efficiency of the financial industry. For this purpose an expansion of money markets with market-determined interest rates might have a favorable effect by enhancing competition between the bank loan market and the open money market.

However, when we observe the present situation where commercial banks are dominant suppliers of funds in both these markets on the one hand, and where there is no entry in commercial banking allowed as well as limited activity for foreign bank branches on the other, one can not necessarily assume adequate competition among the mostly government-owned commercial banks.[19] In other words, in order to improve managerial efficiency in banking through competition, there is every reason for privatization of banks, deregulation of branching and other activities of domestic banks and foreign bank branches and fostering of nonbank financial institutions.

Moreover, though a measure such as M_2/GNP indicates a steady financial deepening, the role of financial intermediaries has been rather limited than the measure suggests in Taiwan. As we saw in the previous section, direct finance by means of unlisted stocks and individual loans has accounted for a major part of financial transactions and shows no sign of shrinkage in the near future. There should be more scope for financial intermediation because that sort of direct finance has been conducted within fragmented or less integrated markets whose allocative efficiency may not be comparable to that of the organized financial market.

In the above context, redeposits of postal savings with specialized banks could be controversial in the longer run, though it has worked as a means of absorbing

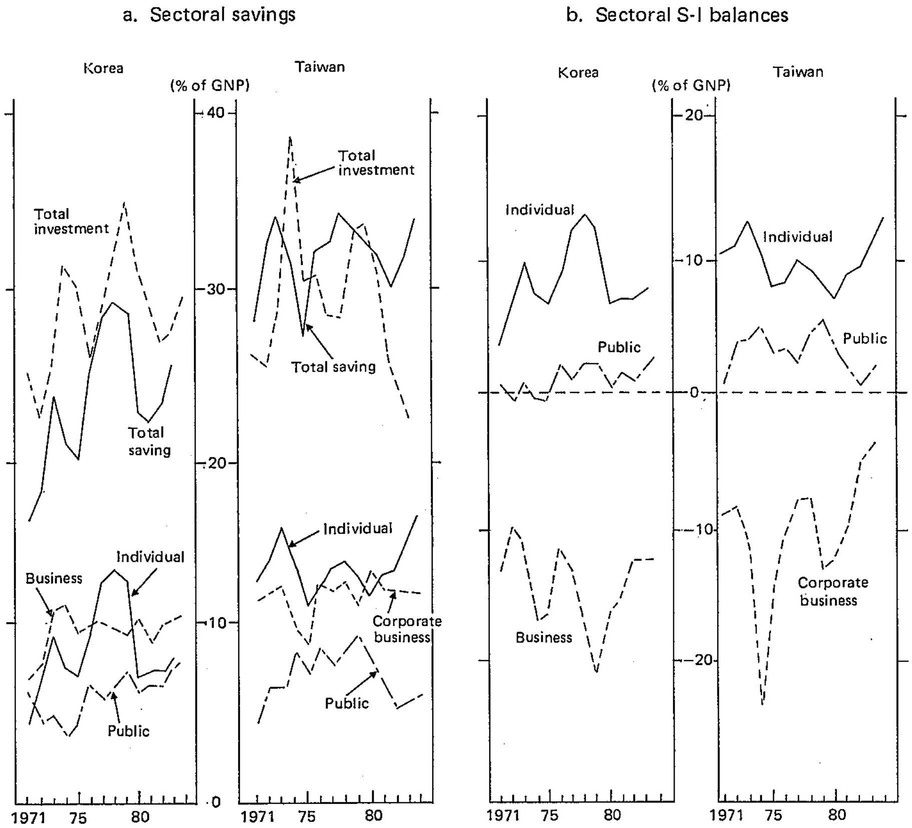
[16] Park [10] quotes from a newspaper that the thirty largest industrial groups accounted for nearly a half of manufacturing value added and 16 per cent of GNP in 1983.

[17] Macroeconomic instability and resulting hyperinflation would be a key factor. See McKinnon [9].

[18] This type of moral hazard is not limited to the case of conglomeration. Park [10] points out the possible distress financing for troubled firms simply to stay in business once the government's bail-out be very likely.

[19] At the end of 1982, four out of sixteen domestic banks, seven out of eight medium business banks, and six out of eight investment trust companies were privately owned.

Fig. 8. Saving-Investment Balances in Korea and Taiwan



Sources: Same as Figure 1a for Korea. For Taiwan, Directorate-General of Budget, Accounting and Statistics, *National Income in Taiwan Area,* December 1985.

an excess supply of funds at present. That is, since these redeposits were seen to be largely relent to public enterprises for which availability of market funds is limited, it *could* produce disintermediation by commercial banks, thereby possibly decreasing the overall efficiency of fund allocation. Because overall productivity of such public enterprises is generally known to be lower than private counterparts.[20]

B. *Domestic Saving Mobilization*

Domestic saving mobilization is one of the important objectives of financial liberalization in many developing countries. If we look at the sectoral saving-investment balances in Korea (Figure 8b), excess investment in the corporate business sector is found to be conspicuous. It is seen, for instance, that during

[20] Zhou indicates that public businesses were inferior to private ones in terms of overall value-added productivity in the 1970s [13, Table 2].

1976–79 its saving (=current surplus+capital consumption allowances) was 10 per cent of GNP, while its investment was 2.5 times larger than that, or it follows that the corporate business sector invested as much as 250 per cent of its internal funds. Note that the comparative figure of Taiwan was 180 per cent. Meanwhile, the individual sector's saving was 12 per cent of GNP for the period, which later declined. The gap between domestic investment and the above saving was filled by the foreign saving or capital inflow from abroad as well as general government saving. If the former could not be sustained at least for the time being because of the LDCs "debt problem," Korea cannot but raise her domestic saving rate in order to maintain her rapid growth.[21]

It was shown elsewhere that, in order for financial deregulation to be both growth-promoting and less inflationary than mere expansion of "outside money" such as through central bank loans and foreign capital inflow, it is necessary for deregulated interest rates to raise the flow saving rate (see Kohsaka [6]). In this respect, the recent decline in price inflation is favorable, although the domestic saving rate has only recovered its past peak of 1976–79. Also, we note that the individual sector's financial assets outstanding have been fairly low, i.e., 78 per cent of GNP in 1983 as compared to 136 per cent of Taiwan (Figures 3a and 6a). Thus there seems to remain ample room for increasing the individual saving rate which was only 11 per cent in 1983. And maintaining price stability would be indispensable, if not sufficient, to accelerate an increase in domestic saving.

As to saving mobilization, Taiwan's performance is exceptional. Not only the individual and the national saving rates, but the individual sector's level of financial asset accumulation are high. As a matter of fact the latter exceeded 100 per cent of GNP in 1976 and amounted to 136 per cent in 1983 (Figure 6a). Note, for reference, that in the case of Japan it was not until 1970 that the comparative figure exceeded 100 per cent, and the recent one was 180 per cent in 1983.

Compared to the case of Korea, sectoral saving rates as a ratio to GNP are seen to be higher in terms of both the individual and business sectors (Figure 8a).[22] Since the investment rate relative to GNP are around the same, one can see how large the business sector's excess investment has been in Korea (Figure 8b).

V. CONCLUDING REMARKS

There is no difference between developed and developing countries in that financial liberalization is intended to improve the efficiency of fund allocation over the whole economy by deregulation of (a) interest rates, (b) compartmentalized financial activities, and (c) separated domestic and foreign capital market transactions.

[21] This does not necessarily lead to the argument that Korea's "growth-cum-debt" policy was a wrong choice.

[22] Since the individual sector does not include uncorporated firms in the case of Korea, it follows that the difference in the individual sector's saving ratio between Korea and Taiwan is smaller than the Figure 8a suggests, and vice versa for that in the business sector.

As seen above, however, one could point out a few specific aspects that are shared in common in the processes of financial liberalization in Korea and Taiwan and are not found in developed economies. In both cases, first, it is the efficiency of financial intermediaries to be improved, which has been dominated by government-owned commercial banks. Second, the authorities more or less try to be market-oriented by reducing their *direct* intervention in determining interest rates, credit allocation, and others. Third, the liberalization effort has been taken in response to a need for industrial adjustments in the gloomy international environment.

Furthermore, despite these similarities, we have seen that their liberalization processes strike various contrasts reflecting differences in initial conditions and policy measures. In the 1970s, Korea has "not hesitated to sacrifice the objectives of balance of payments and price stability to the extent that foreign finance has been available" [11, p. 312]. That is, she had not paid much attention to domestic financial development, resulting in stranded financial deepening and domestic saving. Then the changing climate of the international environment compelled Korea to switch her development strategy to a stability oriented one, of which financial liberalization was one aspect. The "periphery approach" has given more discretion to the nonbank financial institutions than commercial banks, so that the former have played a prominent role in expanding financial intermediation and accumulating the public's organized financial assets. The consequent changes in the flow-of-fund structure was not only significant in degree but also fast in rapidity so that they have brought about some possibly serious transition problems.

By contrast the movement toward liberalization in Taiwan has been more gradual, which does not necessarily mean that it is less urgent than in Korea. Taiwan had managed her export-led economy with high saving and steady financial deepening until the early 1970s, but, thereafter found some difficulty in macroeconomic stabilization or inflation control. Without such dramatic change in policy strategy as in Korea, Taiwan tried to reinforce the long-established commercial banks on the one hand and to foster open markets on the other with respect to domestic finance. This, however, has not seemed to generate a favorable change in the financial system, and substantial progress still remains to be seen.

Finally it would seem necessary to mention a dilemma which financial liberalization is likely to face in the adjustment phase after the second oil crisis and subsequent prolonged world recession. In both Korea and Taiwan, the early 1980s were years when the economies were forced to cope with dismal prospects of their once-thriving manufacturing exports. Especially in the case of Korea, switching of a policy strategy away from heavy and chemical industrialization as mentioned above necessitated wide industrial restructuring as one of the top priority policies in the 1980s in such industries as shipping, construction, and textiles as well as heavy and chemical. Since such restructuring usually accompanies more or less intervention in credit allocation for those specific declining industries, it would counteract the liberalization process.[23]

[23] Some liberalization advocates in Korea argue in favor of prior industrial adjustments in the early stage of the long-run liberalization program. See Kim [6].

After a sharp decline in 1982, persistently low domestic investment demand in Taiwan (Figure 8a) has resulted in an accumulating external surplus, which caused some difficulty in monetary control. The central bank has tried to absorb excess liquidity by issuing CDs and "savings bonds" on the one hand, and to promote capital outflow through deregulation of foreign securities investment by the nonbank private sector on the other. Because of the prevalent expectation of future exchange rate appreciation, however, there seems to be little incentive to invest abroad even with favorable real interest rate differentials between domestic and foreign securities.

More generally, since the adjustment usually needs disinflationary policies, it is likely to generate an "overshooting" in real interest rates combined with deregulated nominal interest rates due to financial liberalization. The resulting high real interest rate as well as weak investment demand during the adjustment process would prolong the economic recession. This prolonged recession, in turn, could do such serious harm to the business activity of nonfinancial firms and then financial institutions themselves as to lead to bail-out intervention by the authorities, which might erode the basis of financial liberalization.

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