(First Draft)

Institution Building in the Financial Sector: The Korea's Case

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I. Introduction

Institutions provide the basic infrastructure and affect overall economic performance. Such impact of institutional development on economic growth has increased in parallel with globalization since the 1980s. As economies become more and more intertwined with the rest of the world, there is a general need for a broad basis of institutions that will implement appropriate measures. The ideal financial institution will ensure macroeconomic stability through effective supervision and regulation. As recently stated by Alan Greenspan, openness to trade and integration with other economies, successful measures for economic stability, and efficient institutional infrastructure are the three pillars of economic growth. Given this significant role of institutions in today's world, institution building is a complex measure that requires careful planning and thorough analysis of the economy.

In the past, Korea took a government-ruled economic system in which the government directed financial institutions and firms to a designated area, based on financial and industrial polices. As this system began to deteriorate market discipline, however, firms were loosely managed and the financial institutions lost competitiveness, weakening the financial sector. In globalization, the role of the government is to become a judge who sternly supervises financial institutions and checks whether the firms abide by market rules. In other words, financial institutions continue to monitor debt service ability of firms as a creditor and should ask for troubled firms to be restructured. In conclusion, the role of the government is to supervise the functions of financial institutions mentioned above in order to improve the soundness of financial institutions.

The basic policy of institution building lies in consolidating market orders so that self-regulating management of financial industries is secured and the efficiency and competitiveness of financial institutions are strengthened. In order to attain this, prudential supervision should be executed sternly and the independence of management and personnel at financial institutions should also be guaranteed.

To consolidate competitive and efficient institution building, several stages are necessary; to take step by step method for many years, to establish policy priorities in each step, to attain the target in an efficient way, to increase the participation of private sector, etc. In the first stage, market credibility should be restored by completing financial restructuring and presenting what will be a vision, a desirable system, and agenda relevant to financial industries. In the second stage, capital market should be developed through the introduction of long-term financial products and risk management skill of market participants should be improved. In the third stage, the infrastructure of finance should be advanced through the improvement of economic system, deregulation, the developments of credit evaluation bureau and IT (information technology). In the final stage, leading financial institutions should be developed to change the financial industry towards a strategically important one.

Several basic principles in financial restructuring are as follows. First, financial restructuring should be implemented to minimize costs. Under this principle, only viable financial institutions should be supported by the government, while non-viable ones should be resolved or liquidated through decisive and prompt restructuring measures as early as possible. Second, the principle of self-accountability should be applied in the process of financial restructuring along with self-rescue efforts so as to prevent moral hazard arising in the course of resolving troubled financial institutions. Third, priority should be placed on restructuring major financial institutions, including commercial banks, so as to minimize the financial market disorder that could take place at the same time. Finally, financial restructuring should be implemented in line with transparent and objective criteria to avoid the likelihood of subsequent dispute. To comply with this requirement, guidelines for evaluating management conditions of financial institutions should be set up corresponding to international standards.

The goal of this paper is to present an overview of financial reform including the role of the government before and after the financial crisis, economic performance after financial reform, the future of the financial system, and the financial polices in Korea. In Section II, we will review the role of government and process of institutional development in the financial sector; the main forces accelerating these changes, the sequence followed in the creation, consolidation of the institutional framework, and the problems faced during the process. In particular, we will pay special attention to the time when we experienced the financial crisis. In section III, we will review the institutional changes for the development of domestic debt and capital markets, and will suggest several reasons why the capital market has underdeveloped. In Section IV, we will observe the impact of institution building in the financial sector on economic performance, In Section V, the future of financial industries and financial polices in institution building will be described, and Section VI concludes the paper.

II. Korea’s Financial Reform Processes

1. The Role of the Government before the Currency Crisis

Since the 1960s, the structure of the Korean financial institution has evolved towards a growth-oriented foundation that can efficiently support the government’s economic development plans. In order to successfully provide for the necessary economic development funds, specialized banks were established: National Agricultural Cooperative Federation (1961), Industrial Bank of Korea (1961), Kookmin Bank (1963), Korea Exchange Bank (1967), The Korean Housing Finance Corporation (1969). Also, for the establishment of a private capital mobilization scheme, the stock exchange law and insurance law were enacted in 1962. As for the development of regional economics, regional banks such as the Pusan Bank and the Daegoo Bank were established in 1967.

In the 1970s, the government began to concentrate on the diversification of finance; it mainly focused on such sub-sectors as the development of private sector financial institution. These efforts bore fruit in the form of various necessary laws; the Short-term Finance Law, the Mutual Credits Bank Law, and the Credit Union Law – collectively known as three laws for developing curb market (1972) – along with the Merchant Bank Law (1975). These laws provided the basis upon which various forms of corresponding non-banking financial institutions were built or improved. They include Investment Financial Corporations, Mutual Credits Banks, Credit Unions, and Merchant Banks. Along with this, in order to support private company funding through direct financial market, the stock exchange market was also completely modernized. The Public Corporation Inducement Act (1972), which forced private companies to go public and the stock assets to be dispersed, was enacted. Korea Investment Trust Corporation, a professional investment trust company, was established in 1974, and the Korea Organization of Securities Commission and the Securities Supervisory Board were also established three years later, providing the structure for fair play.

From the 1980s, the government economic policy and its main objective shifted from economic growth to stability; accordingly, a series of liberalization and open economy policies were implemented in the finance sector. Between 1981 and 1983, the government privatized all the banks in the market in order to promote a self-regulating management scheme and guarantee free internal management without government intervention in the banking sector; various regulations and other forms of government intervention were thus rescinded. Even in terms of monetary management, the government shifted its stance from direct intervention to indirect regulation that was centered on Private Credit Ceiling System. To encourage unfettered competition between financial institutions, the government loosened its market entrance regulations and promoted new financial services. First, the business domain of deposit money banks · investment financial corporations · securities companies was effectively enlarged, and the introduction of new financial services was guaranteed by law. As a result, the banking sector was able to newly introduce credit cards (1980), commercial loans and private loans (1982), negotiable certificate of deposits (1984), and bank trust (1984). Investment financial corporations also introduced credit purchase of bonds (1981), commonly known as factoring, and the brokering and purchase/sale of negotiable certificate of deposits (1984). Such liberalization trend continued through the 1990s, witnessing over 20 new merchant banks and the introduction of money market loan; the business domain of financial institutions such as foreign currency exchange was enlarged to a greater extent.

In the same vein, in order to provide a solid basis of finance liberalization, the government launched its 'private banking liberalization scheme' in 1980 that spanned decreasing government intervention in finance, especially internal management in the banking sector, disposal of insolvent bonds, and banking privatization. From December 1988, the government widely introduced interest rate liberalization on a large scale, rescinding all the interest ceiling regulation of credit interest rate and long-term deposit interest rate of more than two years maturity and lending interest rate apart from policy finance. Unfortunately, price level instability and the ensuing sudden rise in the interest rate made interest rate regulation inevitable, making it impossible to effectively implement rate liberalization. Meanwhile, in the 1980s, in tandem with interest rate liberalization, the process of market opening to the outside began to steadily take effect. Foreign banks and insurance companies were allowed to open branch offices, joint companies and branch office were established, and indirect foreign investment through beneficial certificates for foreigners and investment corporations for foreigners was allowed.

In the 1990s, due to the general opinion that excessive government intervention was stifling competition and efficiency and also strong pressure from developed markets, such as the US, to open up the financial market, financial liberalization and market opening was accelerated even more. In August 1991, the government announced its '4 Level Interest Rate Liberalization'. Between November 1991 to November 1995, Most of the interest rate was liberalized through three stages, and, in July 1997, along with the liberalization of interest rates on savings deposits of less than three months, the entire interest rate was entirely liberalized. In April 1994, the economic needs test (ENT) that regulated the opening of foreign bank branch offices was discontinued. One year later, the policy of actual office requirement in the case of branch opening was also rescinded. Also, in February 1997, the policy that required the foreign bank to be in the top 500 worldwide in terms of aggregate assets in order to open branch was rescinded as well. After the Asian economic crisis, the regulations of bank stock holding rights by foreigners was loosened in order to bring in more foreign capital to national banks.

2. Reform Forces Accelerating the Changes

In Korea, since the early 1980s, financial liberalization has been progressively pursued in various ways. However, in observing the development of the financial industry in the 1990s, despite all the efforts and numerous policies, the essential financial liberalization is progressing very slowly. The most obvious reason behind the sluggish performance is poor loan screening in the banking sector, which is the essence of financial liberalization. Most of the hastily put together financial policies of the 1960s and 1970s in the early financial development stages are now gone. However, in mid 1990s, when there were hardly any industrial policies, the Korean chaebols, conglomerates, began to grow and develop. Banks were not able to fend off the direct and indirect pressure of such corporate strength; they provided for chaebols overstrained expansion. Bank loans to chaebols became uncontrollable as the size of corporations became the only benchmark of success, without much consideration of efficiency; effectively, the financial sector was dragged into the wreck, making it even more difficult for fair and free regulation of loans. Such situation turned out to be the very fuse of the overall economic failure.

In line with the globalization and liberalization in the 1990s, large conglomerates and financial companies tired to expand their businesses in developing countries, including South East countries, Latin America, Russia, and East European countries. But, they were not well prepared to profit from those areas for it lacked the necessary advanced financial technique. Although the rapid growth of international financial activity greatly benefited countries by allowing easy access to capital, it also raised problems as the financial markets began to be closely interconnected with each other. A currency shock in one country, for example, can have destructive rippling effects on all debt-ridden countries due to the globally interwoven financial market. The 1997 currency crisis plunged a bulk of marginal firms to going bankrupt and many financial institutions, including banks, merchant banks, investment trust companies, etc., collapsed shortly after; the currency crisis in 1997 triggered strong reform of the financial sector in Korea.

It is said that there were two main causes of the crisis: the misalignment of macroeconomic policies and lack of market discipline. In the past decades, Korea paid little attention to the importance of the market mechanism and was instead engrossed in a high-growth strategy. A highly leveraged, unhedged financing strategy allowed Korean firms to expand their businesses without due consideration of the overall risks, and the government unwittingly consented to share the risk of large corporations through exchange rate stabilization.

Korea also blindly reaped the benefits of financial liberalization without proper financial supervision over the financial system. Economic performance was not tied to profit maximization and efficient market mechanism, but was rather dependent upon exploiting unrealized opportunities without assuming any responsibility for the resulting increase in risk exposure. As for the policy response, major steps have been taken to make the economy function properly again. Namely the financial, corporate, and public sectors in Korea were restructured after the introduction of the IMF stabilizing package in December 1997. The first stage of reform was intended to rescue the financial system from the potential danger of a system collapse.

3. Financial Restructuring after the Currency Crisis

1) Institutional Infrastructure

In order to ride out the unprecedented financial depression in 1998, the government decided to inject a significant amount of public funds into the economy, after establishing institutional infrastructure, including FSC/FSS, KAMCO, and KDIC. With this money, many non-viable financial institutions were expelled from the market through P&As, liquidation, mergers, etc.

The IMF and the Korean authorities agreed on a comprehensive financial reform program. The program not only established an institutional setting but also secured the necessary resources to support the financial restructuring process. Since early 1998, the Korean government has attempted a drastic financial structural reform with a view to establishing an institutional foundation to clean up insolvent firms and financial institutions.

First, the statutory infrastructure for financial restructuring was laid out. In December 1997, the Financial Industry Restructuring Act was amended to establish relevant regulatory framework, where prompt corrective action provision was formally instituted. Also, according to the Act on the Establishment of Financial Supervisory Authorities newly enacted in December 1997, the Financial Supervisory Commission (FSC) was established in April 1998 as an independent consolidated financial supervisory authority for banks, security houses, and insurance companies. The FSC set the principles and developed the resolution plans for non-viable financial institutions in accordance with international standards. It also drew a full supporting scheme for other financial institutions that had a chance to return to normal operations. Subsequent to the establishment of the FSC, the FSS (Financial Supervisory Service) was introduced to integrate the existing supervisory authorities. With the birth of this new, unified supervisory authority, the activities of all financial institutions operating in Korea were put under a more strict and efficient supervision.

In addition, Korea Asset Management Corporation (KAMCO) was also established in November 1997, and NPL resolution fund was created within KAMCO to purchase NPLs at financial institutions. The KAMCO was reorganized as the Korean version of the Resolution Trust Corporation (RTC). In addition, the Korea Deposit Insurance Corporation (KDIC) extended 3 year temporary blanket guarantee on deposits of financial institutions in November 1997. The KDIC was charged with recapitalizing financial institutions, loss coverage, and depositor protection.

In the financial and corporate restructuring process, the FSC, together with the Ministry of Finance and Economy (MOFE), played the role of a control tower.

2) Banking and Non-Banking Sectors

In the past, Korean banks suffered from extremely low profitability due to poor asset quality, regulated interest rates, excessive competition for deposits, poor asset-liability management, etc. Accordingly, most Korean banks encountered the 'twin' banking problem after the crisis. That is, (1) worsening asset quality and (2) under-capitalization. The bankruptcies of large business conglomerates, triggered by over-investment and highly-leveraged financial operations, resulted in the deterioration of Korean banks' loan portfolios. The resulting increase in NPLs (Non-performing Loans) caused widespread fears over bank failures, thereby making depositors search for better-quality banks.

In response to widespread fears over the collapse of the banking system, a rigorous rescue and rehabilitation plan was implemented by the government. Accordingly, the first stage reform focused on closing down troubled financial institutions and disposing their NPLs. In particular, after the diagnostic reviews concerning the viability of Korean banks, 5 banks whose BIS capital adequacy ratios were below 8% were liquidated through P&As. Their assets were transferred to other financially sound banks. The remaining banks launched self-rescue efforts to regain their soundness through mergers, injection of foreign capital, and issuance of new stocks. During this process, 5 banks were merged with other banks, and Korea First Bank, one of the two nationalized banks just after the crisis, was sold to U.S. New Bridge Capital.

Non-bank financial institutions also faced similar fate. Among those, the most severely hit were merchant banks. Merchant banks in Korea engaged in a wide range of businesses, including limited deposit taking and loan extending, trust account management, securities investment, international financing, and leasing. However, when Hanbo Group, one of the largest business conglomerates, declared bankruptcy in March 1997, they were suddenly left with the crushing burdens of rising NPLs. Each successive major bankruptcies further eroded market confidence in merchant banks, exacerbating their borrowing difficulties both at home and abroad. There were a total of 30 merchant banks operating in Korea before the crisis. Among them, 14 insolvent merchant banks were suspended of business in December 1997. Later, the licenses of 22 merchant banks were revoked, and their assets and liabilities were transferred to a bridge merchant bank. Also, three merchant banks were merged into others.

Securities companies recorded net losses for the three consecutive fiscal years before the crisis, mainly due to the bearish stock market and the rising operational and financial expenses. As the government lifted the regulation on the opening of branch offices in 1996, most brokers increased their branches relentlessly. These new investments resulted in higher operating costs and decreased net profits. Moreover, many securities companies experienced a sharp increase in the cost of funding due to increased short-term borrowing and a drop in customer deposits.

From April 1, 1998, domestic and foreign securities companies were allowed to set up new securities houses. During the second half of 1998, the capital adequacy regulation was put into effect. This regulation was designed to force inefficient and incompetent securities firms to exit the market, to prevent investors from being excessively exposed to insolvency or bankruptcy risk, and to promote the soundness and stability of the securities industry.

A large number of other incompetent non-bank financial institutions, including insurance companies, investment and trust companies (ITCs), mutual savings and finance companies, credit unions, and leasing companies, had to exit the market through mergers and/or liquidations.

Finally, the rigorous financial restructuring removed a large number of insolvent and incompetent financial institutions from the market. By July 2003, 725 financial institutions were closed or merged, which accounts for 34.5% of the institutions before the financial crisis. In the banking sector, 15 out of 33 banks were either closed through P&As or merged with other banks. Korean banks' cost-saving efforts resulted in the industry-wide 39% average reduction in the number of employees along with 1,307 branches (21.8%) that were shut down as of June 2001.

<Table 1> Restructuring of Financial Institutions

	Total (97.12)	Revoking Licenses	Merger	Others[1)]	New Entry	Total (2003.7)
Bank	33	5	10	-	1	19
Merchant Bank	30	22	7	-	1	3
Securities Companies	36	5	3	2	18	44
Insurance Companies	50	8	6	2	13	47
Investment and Trust Companies	30	6	1	-	9	32
Mutual Saving and Finance Companies	231	100	27	1	12	115
Credit Unions	1,666	2	107	466	9	1,100
Leasing Companies	25	9	2	-	4	17
Total	2,101	157	163	472	67	1,376

Note: 1) Including dissolution, business transfer, selling.

Source: Financial Supervisory Commission.

The first round restructuring ended with the formation of the FSS. But, it takes time and public funds to remodel the financial system into an excellent one. Unfortunately, some obstacles surfaced along the way. The first major obstacle was the collapse of Daewoo Group, one of the largest conglomerates in Korea. This shock caused a pile-up in the financial market; the government worked hard to clear it up. The next problem was the moral hazard of the firms, financial institutions, and people involved in the reform process.

With these sudden obstacles, the second round of financial restructuring was launched in September 2000 with an objective of removing the remaining problems that may potentially hamper the financial system. This included the closing of insolvent enterprises and the disposal of NPLs held by non-bank financial institutions. Also in this stage, the software part of restructuring, designed to improve the ownership structure, as well as the management system of financial institutions, was implemented.

In the second round of restructuring, there was a big shift in the role of the government. While the first round was under the initiative of the government, the second round encouraged the market to actively participate in the reform process. Accordingly, the government's role was limited to the creation of an institutional environment that facilitates restructuring efforts by the market participants and compensates them with what they deserve.

After the two rounds of restructuring, a new financial sector environment where industrial efficiency has improved significantly was established. To name a few of the institutional changes observed during the reform process:

(1) A strengthened prompt corrective action system (PCA), such as the BIS capital ratio for banks and the operational net capital ratio for securities companies, is now being fully implemented.
(2) All financial institutions are now subject to the new disclosure system. It requires regular disclosures to be made twice a year and strictly penalizes false or dishonest disclosures.
(3) The deposit insurance system was amended to prevent depositors and/or financial institutions from moral hazard. Also, the mark-to-market valuation practice of securities is being strongly enforced.
(4) The loan classification standards and provision requirements were achieved in conformity with international best practices. The forward looking criteria (FLC) in measuring asset qualities of financial institutions was also adopted.

Non-performing Loans (NPLs) = substandard + doubtful + estimated loss.

Substandard: Amount expected to be collected from customers who have credit arrears of at least 3 months.

Doubtful: Portion of assets in excess of the amount expected to be collected from customers who have credit arrears of at least 3 months but less than 12 months.

Estimated Loss: Portion of assets in excess of the amount expected to be collected from customers who have credit arrears in excess of 12 months

(5) In October 2000, the National Assembly passed into law the bill allows for the establishment of financial holding companies. With this legal foundation, Korea's financial system was expected to benefit from the synergy effects that the financial holding companies can create, such as cost reduction and the efficient management of organizations and human resources. In March 2001, the first financial holding companies, Woori Financial Group, was created with the merger of four banks whose outstanding equities are largely owned by the government. This holding company is expected to be privatized by 2004 at the latest. Shinhan Financial Group was created in September 2001. In November 1, 2001, Kookmin Bank and Housing & Commercial Bank were merged. These movements towards mergers, driven by market forces, will in turn bring about a new landscape in the banking sector where a small number of competitive and financially sound banks lead the industry.

3) Structural Weaknesses to Be Resolved

Korea's financial sector reform until now has been, in large part, successful. But there are still unresolved structural weaknesses underlying the Korean economy. Korea has identified four major priorities in the next several years.

First, we should try to reduce the amount of public funds injected into the economy and raise the recovery rate as high as possible. Large-scale restructuring required a huge amount of the taxpayer’s money. Up until April 2003, 160.4 trillion won in public funds has been injected into the Korean economy. Its distribution was allocated in the following: 60.2 trillion won in equity participation, 16.9 trillion won in capital contributions, 29.2 trillion won in deposit payoffs, 15.0 trillion won in asset purchase, and 39.1 trillion won in acquiring bad loans. As the recovery rate is expected to be low and injection of public funds has several intrinsic problems, the fiscal account might be exacerbated in the future because the government carries the burden of payoffs when repayments are not made.

Second, we should make effort to reduce potential NPLs at banking sector in advance. After the currency crisis, the engine running the economic growth was based on a rapid rise in private consumption, largely buttressed by the low interest policy. The overnight call rate went down from 31.7% in December 26, 1997 to 4.0% in September 2001 and 3.75% in July 2003. A record low interest rate policy connected to a surge in household lending, invoking a boom in real estate market in 2002. Bank lending to the household sector increased sharply since the second half of last year, which was triggered by the decreasing lending rate combined with soaring real estate prices. By the end of 2002, the household credit at banking sector reached 439.1 trillion won, 2.4 times that of 1998 when the financial crisis was nearing its end in Korea. From 1998 to 2002, the average growth rate of household credit was 24.4%. As of the end of March 2003, the total level of debt for all credit card companies combined was 88 trillion won, in the form of bonds, commercial papers, and ABS. The credit card industry has been plagued by skyrocketing default rates and falling profits since the second half of 2002. Entering this year, delinquency ratio of household debt is rising swiftly, connecting to a burden on banks.

<Table 2> **Household Credit**

	2002.3	6	9	12	2003.1	2	3
Credit Card Delinquency Ratio (%)	2.9	3.8	5.1	6.6	8.4	10.4	9.6

	2000	2001	2002	2003.4
Number of Consumer Credit Delinquents (Thousand)	2,084	2,450	2,636	3,086

In addition, many conglomerates, such as SK Global, Hyundai Construction and Engineering, Hynix, and Ssangyong Cement, still hold a large amount of debt. According to the Flow of Funds by the BOK, corporate debts reached 671 trillion won at the end of 2002, amounting to 113% of the nominal GDP. Firms with an interest coverage ratio of less than 100% accounted for 23.6% of the total firms; they borrowed about half of the total lending at financial institutions. The debt burden has brought forth a credit crunch centered at larger conglomerates, except for Samsung.

Third, the capital market should be further developed to provide the lowest cost of capital financing for customers and increase the efficiency of the financial system. In 2002, the size of capital market accounted for only 26.6% of the financial intermediation in Korea. The advanced capital market will be achieved by: (1) creating a liquid and efficient debt, equity and foreign exchange markets, (2) promoting a deeper investor base, and (3) leveraging intermediaries' interests to broaden markets.

Finally, restructuring in the financial sector should be kept consistent. In this regard, the future financial sector reform should be focused on eliminating potential factors that could destabilize the market. This requires loss sharing, accountability of management, and establishment of risk management infrastructure. The infrastructure, including legal support, is also required to develop capital markets and to remove all the elements that disturb the market principle. At the same time, financial institutions should be more closely monitored through the practices of strict corporate governance and asset classification criteria. Furthermore, financial institutions should strengthen their monitoring of the corporate sector. This will induce the corporations to continue improving their capital structures and enhancing core competence and transparency.

III. Development of Domestic Debt and Capital Markets

1. Institutional Changes

The Korean capital market has, to date, developed in both quality and quantity through the essential role of providing the necessary capital to various industries thereby promoting economic growth. With the establishment of the Daehan Stock Exchange, the predecessor of the Korea Stock Exchange (KSE), in March 1956, the Korean capital market became organized while the legal basis for its operations was provided by the Securities and Exchange Act that came into effect in January 1962. With the implementation of the second five year economic development plan, and as public corporation inducement policies began to take effect, the Korean capital market rapidly flourished from its early stages to new heights with an increasing number of listed companies. A tax preference system for public corporation was introduced by the enactment of the Capital Market Promotion Law in November 1968. Through this, the government was able to guide firms that took a financial support to open to the public by enactment of the Public Corporation Inducement Law in December 1972. With the conclusion of the Credit Management Agreement for a group of affiliated company in 1974, moreover, the financial support for firms that would not go public was reduced and the new firm commitment system was introduced.

The bond market, however, did not play an important role until the late 1960s as capital market promotion policies were mainly based on the stock market. Both the government and corporate sectors relied mainly on overseas and local bank loans for financing, not direct financing through the capital market. In the case of corporate bonds, the system for guaranteed bonds and public offerings was introduced in February 1972. The issue of bond with subscription warrant and convertible bond was admitted in 1976, but the actual results of issuing were sluggish. Since the promulgation of bond market promotion plan in February 1977 that included uplift of diversifying of bond classes, application of conditions of issuance, bond liquidity and coordinating for issuing, corporate bonds market developed in earnest. Conditions of issuance of guaranteed bond were relaxed, and qualification of issuance of non-guaranteed bond was tightened in February 1979. The restriction of total amount of debenture for listed companies was expanded in December 1979. Dealing in RP in the security corporation was permitted in February 1980. After then, the primary market of corporate bond was improved and the base of demand was expanded.

In the 1980s, improvements in various kinds of system, which were related to going public and corporate bond market, for activation of stock market was promoted. The condition of going public and listing requirement for superior corporation was relaxed in July 1983, and the limit of authorized capital expanded from two times to four times that of paid-in capital with the amendment of the Commercial Law in April 1984. With the amendment of the Capital Market Promotion Law, the Securities Supervisory Board was able to select a suitable corporation for capital increase with consideration and recommend of going public. In relation to corporate bond market, with the amendment of the Commercial Law in April 1984, the restriction of total amount of debenture expanded from less than equity capital to less than twice the equity capital. With the enactment of Bonds Trade in Over-the-counter Market Regulation in July 1984, bonds trade in over-the-counter market was permitted. The conditions of issuance of non-guaranteed bond and exchangeable bond were relaxed in May 1985. The conditions of issuance of guaranteed bond also became autonomous in March 1986, and a legal foundation of new kinds of bond was accomplished in November 1987.

In the early 1990s, the focus of policies shifted to the stabilization of the capital market and the expansion of base of securities demand. In February 1990, the majority shareholders were restricted from changing their interest before going public and the screening system for going public was introduced. The conditions of going public were strengthened in terms of paid-up capital and equity capital requirements in August 1991. As Securities Market Stabilization Funds was founded in May 1990, the base of demand in stock market was expanded, and Coordinating for Issuing Conference was established in January 1992, with the object of management of volume of corporate bond and specific laws bond issuances. Since the onset of the financial crisis in late-1997, as credit crunch was deepened by the shrinkage in bank lending, the limit of corporate bond issuance increased four times the equity capital for financing of firms in December 1997. The security corporation was made to keep the firm commitment system in August 1998. With the enactment of the Law on Asset Securitization (September 1998) and the Law on MBS Securitization Company (January 1999), it was able to raise the capital through issuing of ABS. That the inter-dealer market for national bonds was established in March 1999 and the primary dealer system for national bonds was introduced in July 1999, was conducive to absorption of government bond and activation of the secondary market for government bond. As the money market was shaken by Daewoo's lack of liquidity after July 1999, the money market stabilization plan, such as the countermeasure for redemption of beneficiary certificates of the investment trust companies, was propelled. After then, as the money market became stable, improvement in the system of the capital market, such as the establishment of bonds intermediation company among dealers, introduction of fungible issue of national bonds, introduction of mark-to-market system, and introduction of a prompt corporate bond underwriting plan, were accomplished in earnest since February 2000.

‘A prompt corporate bond underwriting plan’, a new credit guarantee supply scheme, was introduced on December 26, 2000, in order to address the expected credit crunch caused by a bulk of matured corporate bonds in 2001. In brief, after the government promptly acquires all corporate bonds from cash-strapped firms, the state-run Korea Development Bank (KDB) kept 10% of the bonds and distributed the rest: creditor banks (20%) and primary collateralized bonds obligations (P-CBO) and collateralized loan obligations (CLO) (70%); all guaranteed by the credit guarantee fund. A prompt corporate bond underwriting plan, only effective in 2001, seemed to be a variant of the previous Bond Market Stabilization Fund.

Since the Capital Market Internationalization Plan was launched in January 1981, the Korean capital market has been opened to abroad, but the area of investment was limited on indirect investment such as beneficiary certificate only for foreigners’ sale in October 1981, foundation for Korea Fund in August 1984, and issuing of foreign convertible bond in December 1985. After 1988, however, the openness was expanded to direct investment and foreign security corporations and then the capital market opening was propelled systematically through the third phase deregulation and market openness plan in June 1996 and the capital liberalization plan in September 1996. Since the direct investment of foreigners was permitted to less than 10% of total share outstanding of individual issues, the opening to stock investment was expanded step by step. In December 1997, especially, the limit of direct investment of foreigners was expanded largely to less than 55% of total share outstanding of individual issues. In May 1998, except for public enterprise, limit of the listed stock investment was abolished, and, in July, foreigners' investment to stocks that were not listed or registered into KSE and KOSDAQ was liberalized. Thereby foreigners' aggregate value of listed stock increased rapidly from 4.9% in 1992 (end of period) to 18.6% in 1998 and 35.6% in June 2003.

The opening of the bond market was delayed because of the gap between domestic and international interest rate and poor condition of domestic base for bond demand. After foreigners were able to buy non-guaranteed convertible bonds of small and medium industries in July 1994, the opening to foreigners was expanded gradually and the limit of foreigners' investment to all of listed bonds was abolished in December 1997. For example, issuance of non-guaranteed corporate bonds of small and medium industries that was restricted for foreigners was permitted in January 1997. In June 1997, foreigners were allowed to purchase non-guaranteed medium and long-term corporate bond issued by small and medium enterprises and large conglomerates were allowed to purchase non-guaranteed CB issued by large conglomerates.

The amount of foreigner's investment in the Korean bond market, despite complete opening of the bond market in December 1997, is very small compared to that of the total bond market. In June 2003, considering that foreigners' aggregate value of listed stock was 35.6%, total amount of bonds held by foreigners reached a mere 0.25% of the total listed bonds. The sluggish bond investment by foreigners can be attributed to the risk of credit and liquidity, institutional inertia of the bond market, etc. Not only does the Korean bond market suffer from corporate bond credit risk, but it is also threatened from the particularity of a divided country. There are two essential factors behind such poor performance. First, long term bonds of more than 10 years maturity do not exist in the market, considerably limiting the variety of bonds to invest. Also, there is a basic structural problem of the bond investment risk being much higher than the expected rate of return, due to the unusually high level of transaction costs.

<Table 3> Shareholdings Ratio by Foreigners

(Unit: Bil. won, %)

	1998	1999	2000	2001	2002	2003.6
Market Capitalization	135,555 (18.0)	366,696 (21.7)	186,208 (30.2)	255,850 (36.6)	258,681 (36.0)	277,999 (35.6)
Listed Amount of Bonds	334,034 (0.3)	364,419 (0.3)	424,684 (0.2)	504,730 (0.1)	563,944 (0.1)	586,786 (0.3)

Note: Figures in parentheses indicate shareholding ratio by foreigners

<Table 4> Deregulation and Improvement of Infra-structure

Year	Contents
1956	▶Establishment of the Daehan Stock Exchange: the predecessor of the Korea Stock Exchange (March)
1962	▶Enforcement of the Securities and Exchange Act (January)
1968	▶Enactment of the Capital Market Promotion Law (November)
1972	▶Introduction of the system for guaranteed bonds and public offerings (February) ▶Enactment of the Public Corporation Inducement Law (December)

1979	►Expansion of the restriction of total amount of debenture for listed companies (December)
1984	►Permission of bonds trade in over-the-counter market with the enactment of Bonds Trade in Over-the-counter Market Regulation (July)
1987	►Establishment of a legal foundation of new kinds of bonds (November)
1990	►Restriction of the majority shareholders from changing their interest and the screening system (February) ►Establishment of Securities Market Stabilization Funds (May)
1997	►Corporate bond ceiling issuance raised (December): from two times to four times of paid in capital ►Full-scale opening of bond market to foreign investors (December)
1998	►Abolishment of control over new issuance of bonds (April) ►Enactment of the ABS (Asset-Backed Securities) law (September) ►Mark to market system (November): A step by step implementation of system (full scale application from July 2000)
1999	►DVP (Delivery-Versus-Payment) (November): Reduction of settlement risk in OTC (Over-The-Counter) trade ►Introduction of high yield fund and subordinate debt fund (November): tax benefit and privilege offering in stock allocation in IPO (Initial Public Offering)
2000	►Introduction of the IDB (Inter Dealer Broker) system (February): IDB specializes in OTC trade among institutional investors.
2001	►Prompt corporate bond underwriting plan (from December 2000 to December 2001) : 20% of conversion issuance covered by own fund and 80% by the scheme (20% by commercial banks, 10% by KDB (Korea Development Bank), and 70% by P-CBO, CLO)
2002	►Repo market opened at KSE (Korea Stock Exchange) (February) ►Settlement period changed (December): T+0 ~ T+14 to T+1 ~ T+30 (OTC), T+0 to T+1 (KSE); actual implementation from June 2003

2. Performance and Problems

Since the financial crisis in 1997, the Korean bond market has undergone the following significant changes: First, the bond market grew sizably as the government issued bonds to implement reforms and restructuring process in the financial, corporate and public sectors, as well as in the labor market. With the government bonds issuance growing, the trading of government bonds became more significant than corporate bonds. This was due primarily to the issuance of government bonds on a regular basis; corporations, on the other hand, had difficulty issuing bonds on such a basis due to increased risks.

Second, in the corporate bond market, issuance of non-guaranteed bonds increased considerably, while the issuance of guaranteed bonds sharply decreased. Currently, non-guaranteed bonds dominate the corporate bond market, and provide the benchmark yield in the market. With increasing insurance of non-guaranteed bonds, the role of credit rating agencies has also become increasingly important.

Last, the bond market has been developed by the new system including the introduction of the mark-to-market valuation of new funds, new bond lending systems, measures to ensure proper disclosure of bond trading information, etc. In addition, the bond market has benefited from the continuing introduction of new instruments to enhance its performance and development. In April 1999, for example, a new futures exchange was officially opened and, in July 1999, a futures market for government bonds was launched. To reduce settlement risk, the Korean government introduced the delivery-versus-payment (DVP) system in July 1999 and, in July 2000, the mark-to-market system was fully introduced. With these measures, foreign investors can avoid both exchange and settlement risks.

<Table 5> Issues of Principal Government, Public and Corporate Bonds

(Unit: Billion won)

	1997	1998	1999	2000	2001	2002	2003.4
Government Bonds	28,542.6 (15.4)	41,572.8 (16.0)	61,168.3 (22.0)	71,225.7 (22.2)	82,390.1 (22.3)	98,271.7 (22.1)	103,822.3 (22.4)
Financial Debentures1)	43,622.5 (23.5)	49,150.6 (19.0)	45,492.9 (16.4)	49,318.3 (15.4)	53,912.7 (14.6)	81,535.0 (18.4)	86,973.3 (18.7)
Corporate Bonds	90,107.3 (48.5)	122,682.3 (47.4)	119,661.7 (43.1)	133,648.6 (41.7)	154,400.4 (41.7)	180,048.5 (40.5)	180,861.6 (39.0)
Monetary Stabilization Bonds2)	23,470.9 (12.6)	45,673.3 (17.6)	51,489.2 (18.5)	66,377.7 (20.7)	79,121.3 (21.4)	84,277.9 (19.0)	92,559.6 (19.9)
Total	185,743.3	259,079.0	277,812.1	320,570.3	369,824.5	444,133.1	464,216.8

Notes: 1) Includes industrial finance debentures and financial bond issued by the banks.

2) Amounts of public offerings.

Source: The Bank of Korea.

Despite significant changes in the capital market, there are many problems mentioned below. First, while it is true that the Korean capital market has shown rapid growth in both the stock market and the futures market, it was based on some blue-chip stocks and derivatives. Government bond market, over the counter market of derivatives, and Repo market do not represent the economic development well and show limitations in many areas when compared with other developed nations markets. Also, the private sector participation level in the capital market is again below par in comparison to the developed economies. While foreign investment in Korea grows steadily every year, national investment into other economies is not as developed as it should be; international trade is rather sluggish.

Second, settlement costs of trading, clearing and deposit are relatively high when compared to those of the developed countries. Also, management in general, especially in the IT sector, is dispersed and, as a result, inefficient. In observing the Korean securities companies, it is clear that they are not only relatively small in size compared to other international companies but have weak management structure by running business with low profits or high risks, including dealing, brokerage, etc.

Third, because of the insufficiency of protective system for minority shareholders such as Class Action, shareholders centered management cultivation has a bottleneck and investors prefer short term investment by high turnover rate to long term investment for value creation. Also, the increase in size of trade, diversification of stock exchange and trade avenues, and growth of international trade all contribute to growing risk/danger. Yet, the Korean market does not have the necessary structure and basis for risk management. The fact that it lacks transparency and suffers from unstable price fluctuations compared to other stronger markets is another problem at hand.

Fourth, despite the fact that confidence is the most important immaterial factor in successful infrastructure, the Korean market still lacks a systematic structure of investor protection. It is only through a solid basis of consumer-based culture that the financial sector can prosper to a level of successful business operation.

Fifth, in this globalization age of international trade in which international market competition becomes ever more fierce, relying mainly on only the national market will substantially weaken the companies as they may be relegated to only regional dominance. Because the Korean market is divided into various sub-markets, such as the exchange market, KOSDAQ and futures market, combined with overlapping IT investment, it becomes increasingly inefficient. For example, spot and future-linked products will not be easily developed because of lack of convertibility in computer system, and this will be a weak point in maintaining competitiveness in the global market. Therefore, in order to bring the Korean market to a globally competitive level, restructuring of the basic trade environment becomes an absolute necessity.

Finally, the establishment of fair mark-to-market system was devoted entirely for improvement of the secondary market that was indispensable condition to activate the primary market and convert the securities companies to the investment banks. In addition, securities companies specialized in primary dealers in the issuance of bonds should make efforts in advancing transparency and maintaining liquidity by providing bid/ask quotes. The secondary market in Korea, especially, is based on the government bonds and a few of superior corporate bonds and the rest of corporate bonds seem to face a problem of lack of liquidity.

IV. Economic Performance After Financial Reform

The efficient financial institution can ensure macroeconomic stability through effective supervision and regulation. But it is not easy to evaluate the impact of institution building in the financial sector on economic performance. The reason is that economic performance is affected by institution building, macroeconomic policies, the global economic situation, etc. But the Korea's case is a good example to measure economic performance because Korea's fundamentals had been sound before the currency crisis with the exception of large amount of current account deficits.

Before the currency crisis in 1997, Korea had pursued high economic growth with a high inflation for more than four decades since the 1960s, accumulating significant foreign borrowings, causing the snowballing of external debts. Shortly after the currency crisis, the Korean economy dropped to a severe recession with the GDP growth rate of minus 6.7% with a high inflation of 7.5% in 1998.

The sweeping financial restructuring in late 1997 and 1998 contributed to restoring the real sector. Several of positive macroeconomic indicators are mentioned below. First, the Korean economy attained high economic growth in 1999 and 2000 with low CPI inflation. The current account recorded surpluses for five consecutive years; US$40.4 billion in 1998 and US$6.1 billion in 2002. During this period, automobiles and IT products such as semiconductor, computer and wireless communication equipment strongly led the exports, while imports grew at a slower pace due to the dwindled investment sentiments. The capital account surplus recorded US$2.0 billion in 1999, US$12.1 billion in 2000, and US$1.5 billion in 2002 as a result of a bulk of FDI and foreign portfolio investment. The shortage of foreign exchange was completely resolved with the official foreign exchange reserve amounting to US$123.8 billion at the end of March 2003.

Second, the NPLs at commercial, local, and special banks decreased from 61.0 trillion won in 1999 to 15.1 trillion won in 2002. The NPL ratio also dropped from 12.9% in 1999 to 2.3% in 2002. In addition, the BIS capital adequacy ratio surged from 7.0% in 1997 to 10.6% in 2002.

<Table 6> Macroeconomic Variables[1)]

(Unit: %, US$ Bil., won)

	1996	1997	1998	1999	2000	2001	2002
GDP Growth	6.8	5.0	-6.7	10.9	8.8	3.1	6.2
CPI Inflation[2)]	4.9	4.4	7.5	0.8	2.3	4.1	2.7
M2 Growth[2)]	20.9	18.0	23.6	13.5	2.2	6.9	11.5
Call Rate[2)]	12.5	13.3	14.9	4.9	5.1	4.7	4.2
Corporate Bond Yield[2)]	11.9	13.4	15.0	8.9	9.3	7.1	6.6
Government Bond Yield	11.9	12.3	12.9	7.7	8.3	5.7	5.8
Won/Dollar Rate[2)]	805	951	1,398	1,190	1,131	1,291	1,250
Current Account	-23.0	-8.2	40.4	24.5	12.2	8.2	6.1
Capital Account	23.3	1.3	-3.2	2.0	12.1	-3.3	1.5
FDI	2.3	2.8	5.4	9.3	9.3	3.5	2.0
Portfolio Investment	15.2	14.3	-1.9	8.7	12.0	6.6	0.2
Total External Liabilities	164.3	159.2	148.7	137.1	131.7	118.8	131.0
Long-term Debt	71.3	95.6	118.0	97.9	83.8	77.8	81.2
Short-term Debt	93.0	63.6	30.7	39.2	47.9	41.0	49.8
International Reserves	33.2	20.4	52.0	74.1	96.2	102.8	121.4

Notes: 1) Year-on-year percentage changes. 2) Period average.

Source: The Bank of Korea.

<Table 7> Total NPLs and BIS Ratio at Banks

(Unit: Trillion won, %)

Period[1)]	June 1999	1999	2000	2001	2002
Total NPLs	56.5	61.0	42.1	18.8	15.1
NPL Ratio	11.3	12.9	8.0	3.4	2.3
BIS Capital Ratio	9.8	11.7	10.6	11.7	11.3

Notes: 1) At the end of the given period.

2) Non-performing Loans (NPLs) = substandard + doubtful + estimated loss.

3) **Substandard**: Amount expected to be collected from customers who have credit arrears of at least 3 months.

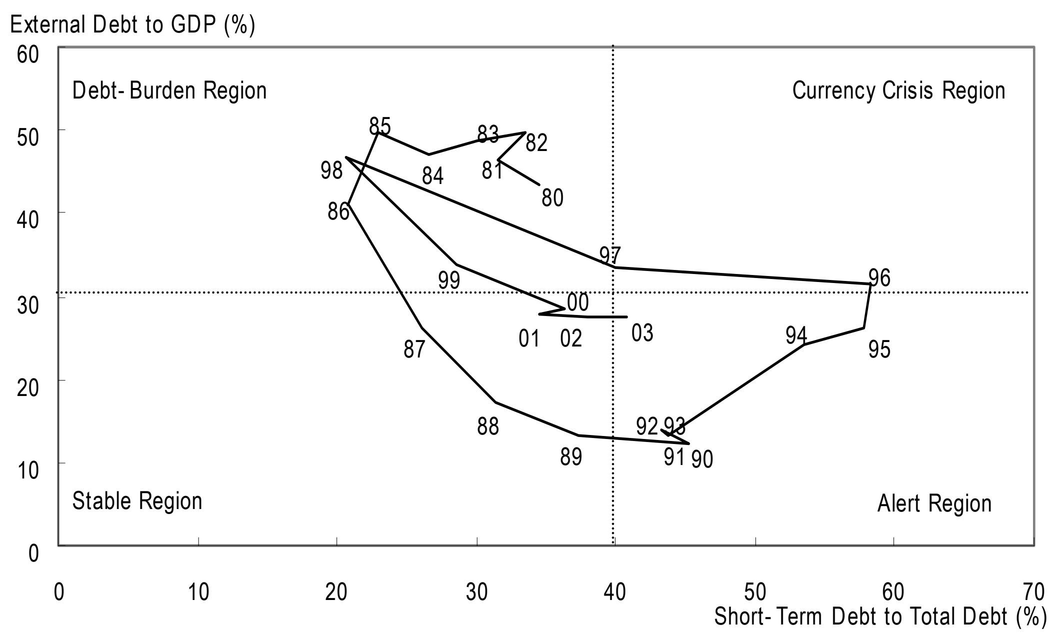
Doubtful: Portion of assets in excess of the amount expected to be collected from customers who have credit arrears of at least 3 months but less than 12 months.

Estimated Loss: Portion of assets in excess of the amount expected to be collected from customers who have credit arrears in excess of 12 months

Third, Korea’s external debt service indicators have stabilized greatly. Korea’s external debt structure remained at a stable region between 2000 and 2002. Entering this year, however, it moved to an alert region. As of March 2003, the total amount of external liabilities and the total amount of foreign assets recorded US$137.0 billion and US$188.0 billion, respectively. Therefore, the total amount of external liabilities to the GDP ratio declined to 27.5%, which is lower than the World Bank’s 30% threshold; and Korea is now classified as a less indebted country. The short-term to total external liabilities ratio dropped significantly from 57.5% in 1997 to 40.7% in March 2003, slightly higher than the 40% threshold. The drop in the liabilities ratio indicates that the Korean economy will not have difficulty rolling over its short-term debt and will successfully avoid maturity misalinement in liquidity.

Finally, the financial sector reform mentioned above should be given credit for helping Korea's sovereign credit rating recover. International credit rating agencies have acknowledged Korea's financial reform efforts, upgrading Korea's sovereign rating since 1999 even in the presence of the increasing credit risk of emerging economies. The S&P, an international credit rating agency, upgraded Korea’s sovereign credit rating from B+ in November 1997 to A- in July 2002. Coupled with this upgraded sovereign credit rating, the financial sector reform helped the portfolio investment from abroad increase substantially in recent years. At the same time, the spread on the foreign exchange stabilization bond has dropped dramatically.

<Figure 1> **Quadrant Regions of External Debt**



V. An Outlook of Institution Building

1. The Future of Financial Industries

As of today, banks, securities companies, and insurance companies are three pillars in Korea's financial industries. These three institutions are trying to keep their own core business but are allowed to partially involve in the other sectors' business. It is expected that a rise in cross border business under the WTO system and multi-sector capabilities (universal) will expedite financial institutions to expand their business to the other sector without limitation. With this movement, the financial industry will increase in size, develop multi-sector capabilities, and become specialized, in the age of global and regional finance, general and "tailored" finance, while product distribution structure will see itself diversify in the future.

First, along with the development of information and telecommunication technology, global financial markets will become more and more homogenous, increasing the market size, thereby increasing the size of financial institutions as well. Given the global trend of deregulation, the financial institutions are likely to grow even more with various sub-sectors coming together.

The growing financial sector will turn more specialized thanks to fast developing financial technology. Plus, through the consolidation of various other sectors, financial production will be ever more developed. This new consolidation is the new one-stop financial service that will satisfy the different needs of clientele and open up a new financial market.

Top quality financial giants that provide comprehensive financial services through a vast global network will dominate the international market, while, regionally, financial firms that have control of the national markets will thus dominate the local markets. The unique yet volatile competition between national and global firms will depend on the national market and its openness to global competition. Financial giants have a concentrated clientele of international companies and high-asset firms while smaller financial firms will seek general public in local markets as their main clientele. If the financial industry develops in the right direction, the Korean financial market will most likely consist of a handful of institutions with global influence, special firms that provide comprehensive service, and hundreds of small, regional firms including local banks and credit unions. "The handful of financial institutions" mentioned above consists of banks, securities, insurance companies that have national market coverage and are able to compete in the global market.

Thanks to a wide range of new and tailored products based on financial engineering, the financial industry is likely to see the rise of both common service and tailored service as the two broad available services. The common financial service may have been rendered generic, but, unlike the services in the past, it is a new, all-purpose service that caters to the different needs of the consumer. Meanwhile, the "tailored" financial service that meets the consumer's specific needs will flourish even more with the development of electronic finance and derivative markets.

The supply of financial services in general will develop into two basic avenues of supply: branch office-based "on-site" channel and the electronic finance-based "off-site" channel. It is more likely that the off-site approach will be in wide use. Where electronic settlement is possible, the consumer will depend on the off-site method to do business; where it is not, the other method will be taken. In the future, due to the development of the off-site method, in the actual business process, the financial industry will see two trends of disintermediation and mass customization.

Finally, in order to meet the banking, securities, insurance, and asset management needs of the consumer simultaneously, future financial firms will need to evolve its structure to a new level of human resources and consumer satisfaction. Once the basic infrastructure for multi-sector service is in place, grounded on solid distribution, construction, and management, it is essential to employ the necessary experts in the sub-sectors in order to successfully manage the institution. Therefore, in this business structure, the marketing manager who can successfully carry out the demands of consumers through efficient planning and management becomes ever more important. Because of the need for a small number of efficient managers, despite the increased size in general, the financial institutions and their human resources will take the form of pyramid with a slim but strong management. Such trend will first appear in wholesale financial sector, and, once electronic finance takes off, such will also appear in retail services as well.

2. The Desirable Financial Policies

First, the government needs to reform its laws and regulations relevant to financial holding companies, bancasurance[1], and asset management. In order to improve the competitiveness of financial holding companies, the business scope of financial holding companies should be expanded so that they can supply clientele the diversified financial services. Under the financial holding companies, the consolidation of various other sectors is more competitive rather than the mergers among commercial banks themselves. In addition, dynamic fit and proper tests should be strengthened in order to resolve interest conflicts between financial holding companies and subordinates or among subordinates themselves. Therefore, laws for financial holding companies should be revised reflecting the major points aforementioned.

The introduction of bancasurance in August 2003 is expected to be a benchmark that Korea's financial industry might transform into multi-sector capabilities from single sector capability. This will swiftly reform the financial market during the next three to four years. Regarding bancasurance, the government should consider the improvement of efficiency of financial industries, a gradual reform, and the protection of financial consumers rather than the protection of domestic insurance companies.

The law on asset management should be enacted as soon as possible, in which regulations and supervisions are implemented not by each business but by function. This will speed up equity-dominated financial system, improving asset management business as a whole.

Second, the government will simplify the approval procedure of new financial products and will spend more efforts in developing software and financial infrastructure that can activate the development of long-term financial products and asset-backed securities. Along with the removal of asymmetric regulations of different sectors, the financial sector should be realigned to multi-sector capabilities while enhancing the related institutions. The industry must provide the appropriate avenues of satisfying the various consumer demands through top-quality service based on the development of information technology and the flourishing secondary market.

Third, regarding electronic transactions, legal uncertainties should be minimized by enacting laws that reflect international standards. Consumers should be protected by regulating the duties and responsibilities of financial institutions which cause damage to consumers. For a rise in financial crime through internet, a monitoring system needs to be strengthened and the break of crime should be investigated easily by establishing relevant rules. In particular, Financial Supervisory Service should present the basic

[1] There are many definitions about the term 'bancassurance'. The trend towards bancassurance refers primarily to banks entering the insurance industry by offering insurance products through their own distribution channels to their customers.

principle for the risk management of internet finance and strengthen supervision on the risk management of internet finance. In addition, international cooperation among financial authorities are necessary in terms of acquiring information and strengthening supervision.

Lastly, in order to cultivate financial experts, the government should provide many programs such as general education and expertise education and should strengthen a way to exchange human resources among financial institutions. In order to induce the advanced financial technique held by foreign institutions, domestic financial service industries need to be opened widely, and the state-run commercial banks should consider the introduction of strategic investment from foreign financial institutions. In addition, the government should give financial institutions strong incentive to perform better and more autonomously by improving personnel management, performance evaluation, and compensation at financial institutions.

VI. Conclusion

Korea' capital liberalization started from the mid-1980s and accelerated in 1992 when the stock market partially opened to foreign investors. In Korea's experience, globalization and liberalization have been main factors to reconstruct institutions in the financial sector. If institution building in the financial sector had progressed swiftly in the early 1990s, we could have avoided the currency crisis in 1997. As a silverlining, the 1997 currency crisis acted to trigger strong reform of the financial sector in Korea, as financial markets fully opened to foreigners.

Since the 1997 currency crisis, financial restructuring in the Korean economy has been successful in terms of many structural changes in the banking and non-banking sectors. These sweeping restructuring stabilized the financial system. With successful financial restructuring, the Korean economy recovered fast and is being more attuned to market forces. But there are still many problems to be resolved; low recovery rate of the public funds, underdeveloped capital market, widespread moral hazard among market participants, delayed restructuring at non-banking sector, etc.

As liberalization, globalization, and deregulation have developed, international capital is moving freely across countries in a bid to seek high returns, raising instability in financial markets. What is more, a sustainable economic growth is not easily attained in an open market, and there is a concern over a global recession coupled with deflation. A rise in uncertainties has dwindled investment sentiments worldwide.

Efficient institution building in financial market is very important to attain a sustainable economic growth in the long run. Under the above unstable situation, however, it is not easy to develop the bank-oriented financial system into global capital market-dominated one. It is obvious that the best way is to push through more restructuring. If market-based restructuring continues without delay, the Korean economy will not face another round of economic crisis, because Korea is still one of the fastest growing economies and has an important share in the financial services throughout the world.

In the future, the financial industries in Korea will increase in size, develop multi-sector capabilities, and become specialized, in the age of global and regional finance, general and tailored finance, while product distribution structure will see itself diversify. To reach this goal, the government should keep the following polices in mind. First, the government must change the regulatory and supervisory mechanism into incentive-oriented one so that financial institutions can pursue profit-oriented management. For this, the financial supervisory body should be performance and risk based, while direct intervention from the government, including implicit regulations, needs to be discontinued.

Second, the government needs to reform its laws and regulations, paving the way for improvement of the financial service sector and for promotion of competition in the financial market. Lastly, the government should improve human resources at financial institutions and supervisory body.