



Banking Sector Liberalisation in South Korea Experiences and Lessons

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December 2010

A case-study about banking liberalisation policies in South Korea examines its impact from a historical perspective. The study provides new insights into the role of financial deregulation and globalisation policies adopted by the South Korean authorities leading to increased financial instability and large bailouts of banks and financial institutions. The study has a special focus on the role of foreign banks and financial investors.

In this case study, the strong linkages between financial liberalisation and financial crises in South Korea as well as the important role played by external actors (particularly the IMF and the OECD) in pushing unbridled financial liberalisation are documented. Key developments in the Korean banking sector before and after the 1997 financial crisis are analysed. It also provides a critical understanding of the interplay between state, big business and foreign financial investors (including foreign banks) in shaping the landscape of Korean financial system.

The study unravels the flawed regulatory regime changes which led to asymmetric and unbalanced financial liberalization. "It was no surprise that the government reform policies were ambivalent and inconsistent. Government stance on financial liberalization was characterized by asymmetry and unbalance between the external and domestic sector, between the banking and non-banking sector, and between long-term and short-term markets. Korea's financial liberalization process is a classic case of regulatory capture by vested interests, resulting in a banking and currency crisis in 1997.

The study provides a critical analysis of post-crisis banking reforms in South Korea under the influence of the IMF. The IMF-directed reforms led to a sharp increase in ownership of Korean banking industry by foreign banks, private equity funds and foreign institutional investors. The South Korean government removed foreign ownership limits and other regulatory obstacles to enhance the entry of foreign banks in the domestic banking sector. It was expected that a large presence of foreign banks would enhance the efficiency and stability of the banking system. Not only foreign banks bought majority stakes in state-owned banks under the privatization process, they also expanded their presence through subsidiaries and branches in the Korean banking markets.

In the competitive environment with foreign banks, bank lending went through characteristic "boom and bust" cycles. Excessive credit extension to households fuelled a credit card bubble and household debt in South Korea, which imploded in 2003. Subsequently banks turned to real-estate lending largely financed by wholesale funding and foreign sources which abruptly came to halt in 2008 in the aftermath of global financial crisis.

Unlike domestic banks, foreign banks have been focusing their activities more on capital market-related businesses than credit business and have been generating substantial profits from risky foreign exchange and derivative trading. Foreign-owned banks charge higher interest rates and shun lending to SMEs.

The study shed lights on the emergence of new financial risks and vulnerabilities in the Korean banking sector. In particular, the eminent role of foreign bank branches in the building of short-term foreign borrowings is highlighted. With strong foreign presence, the Korean banking sector's vulnerability to pure external shocks has been increased.

The study questions the hypothesis that foreign banks are a source of financial stability. "During the recent financial crisis, foreign banks in Korea played a significant role in transmitting global shocks and served as source of instability," points out the author. The authorities have recently tightened regulations to stabilize won's fluctuations which were caused by foreign banks' currency derivative trading.

Of late, foreign-owned banks have come under public criticism for their alleged mis-selling of currency derivative contracts (KIKOs) to South Korea's small and mid-sized exporters. The exporters suffered heavy losses from such currency derivative contracts. These trades have resulted in hundreds of cases filed by exporters against foreign-owned banks for not properly explaining the potential risks associated with such derivative contracts.

The Korean experience offers several important policy lessons pertaining to domestic financial liberalisation, capital account liberalisation and foreign ownership of banking system. It is hoped that this study will further stimulate policy debates and discussions on the costs and benefits of financial reforms.

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This study is a part of research and policy studies initiated by SOMO (Netherlands), in cooperation with Madhyam (India), to examine the experiences of banking sector liberalization in developing countries, starting with Asia and Africa. It was financially supported by the Dutch Ministry of Foreign Affairs. The content of the study is the sole responsibility of SOMO and Madhyam and can under no circumstances be regarded as reflecting the position of the Dutch Ministry of Foreign Affairs.

The full version of the study can be requested at the SOMO address and is available for download at http://somo.nl/publications-en/Publication_3647/view