Alice Amsden and Yoon-Dae Euh. 1990. Republic of Korea's financial reform: what are the lessons? UNCTAD discussion paper 30 (April).

Stylised facts

With the exception of officials (civil servants) of the Ministry of Finance, everybody else wants the liberalisation of the financial system. This dilemma also results from the organization of the Korean economy.

The dominant form of economic organization in Korea is the *chabeol.* The chaebols are pressing for liberalization of the financial system because they wish to exert more control upon capital markets, but they also wish to maintain the access to cheap and stable capital. Thus, they press for formal liberalisation but are willing to accept limited liberalisation and informal rules that govern the allocation of strategic finance.

The financial system in Korea has been built as an integral, organic part of the government's industrial policy. The financial policies and institutions are responsible for providing cheap and stable finance and stable macroeconomic environment.

The provision of cheap finance for working and fixed capital, conditional to rigorous performance targets, has been at the centre of the institution of industrial policy in Korea. The provision of cheap finance in the case of Korea, which lacked the competitive advantage of technological leaders associated with higher productivity and product differentiation, made the difference that allowed business to enter new industries with large scope for improvement, and to develop new competitive advantages in a very short period of time. The goal of cheap finance was not to increase private profits.

Lessons from financial reforms

The overriding principles guiding the Ministry of Finance are:

- rapid industrialisation is of primary importance;
- low interest rates are necessary to stimulate investment whereas high interest rates are not necessary to encourage savings;
- private companies' productive virtues should be balanced against their de-stabilising, speculative instinct;
- support to firms and industries is conditional to rigorous performance criteria and can be withdrawn.

The liberalisation of the financial system, conditional to the objectives of industrial policy, makes sense to the extent that the market mechanism can be given more scope in decision-making because the decision process has become simpler. As the economy industrialises and grows more complex, industrial policy has to deal with a smaller and smaller number of firms relative to the stock of existing firms because a smaller number of firms in at the frontier of national capabilities.

For economies that have left infancy and are enjoying a healthy adolescence, the role of industrial policy is four fold:

- nourishing sunrise industries;
- aiding existent industries at critical turning points;
- lowering the level of financial costs for a wider number and range of firms; and

- adjudicating the demise or restructuring of sunset industries.

Common mistaken “lessons” from Korean financial liberalisation:

- speed of reform:
    - developing countries are advised to “follow” Korea:
        - by liberalising fast
        - or liberalising gradually given strong economic imbalances;
    - this conflict of opinions reflect a critical misunderstanding of the Korean experience, as Korea:
        - liberalised slowly
        - and did not have critical economic problems to solve
    - but gradual liberalisation of different financial institutional frameworks and dynamics, in countries under severe economic strain and imbalance may not be possible;
    - thus, the Korean experience has value per se, but may or may not be transferable to other countries.

- it is commonly argued that Korea has abandoned strategic allocation of credit, because the variance of the spread of interest rates across industries and firms has been significantly reduced. However, this is more likely to result from the success of industrialisation rather than from financial liberalisation, because as the number of firms that qualify for cheap credit increases; and as the number of firms at the frontier reduces at the margin relative to the stock of firms, the spread of interest rates is bound to fall, with or without liberalisation;

- furthermore, if social and private marginal products differ, there is a case for selectivity and nourishing which, given underdeveloped industrial structures, may well result in a larger spread of the interest rate;

- finally, it is argued that liberalisation of the financial system is likely to increase competition and end the era of the chaebol. The argument is simply that if chaebols were created by subsidised credit, the liberalisation of the financial system will return the economy to a competitive structure. This is very unlikely and actually does not make much sense, as liberalisation per se is more likely to offer the control of the financial system to existing economic powers. Thus, if the chaebol controls the financial system, the pattern of economic organization and power is likely to be reinforced, rather than changed.