Foreign Banks and Monetary Policy in Korea*

In Kie Kim**

I. Introduction

The Korean economy, 1980, experienced the worst recession of its kind since the Korean War, as evidenced by the -5.7% GNP growth. These difficulties are attributed to the second oil crisis and the recent downturn in the world economy as well as the political unrest experienced during the latter half of the year.

Thus, one of the major economic challanges facing Korea today is to ensure a smooth inflow of foreign capital of finance its deteriorating trade deficit. In order to meet this challange effectively Korea must evdeavor to strengthen its relationship with world's leading banking institutions.

Ever since, the Korean government in 1967 allowed foreign banks to open their branches in Korea, there has been steady influx of foreign banks into Korea. Currently, the foreign banking presence — comprising 32 branches and 19 representative offices — constitutes a substantial component in the nation's financial market.

One indication of their contribution to the Korean economy may be found from the fact that, since 1974, the foreign banks

* This work was financed by Korea Scholarship Foundation and also co-worked with Professor Bong Sik Suhl, Department of Agricultural Economics, Chung-Ang University.

** Professor, Department of Economics, Chung-Ang University.

Table 1

FOREIGN BANKS' SHARE IN 1979

(unit: million won)

	Deposit	Loans	Assets	Profit
Deposit Money Banks * (A)	10,765,299	9,190,539	23,570,545	156,149
Foreign Banks (B)	107,626	969,513	1,532,168	21,055
Share (B/A)%	1.0	10.5	5.2	13.5

Source: The Bank of Korea, Monthly Economic Statistics.
Note: * Includes the commercial banks (which comprise five nation-wide commercial banks, ten local banks, and thirty two foreign banks operating in Korea) and the special banks (which comprise Korean Exchange Bank, the Medium Industry Bank, Citizens National Bank, Korea Housing Bank, the Credit and Banking Sector of the Agricultural and Fisheries Cooperatives).

have raised more than US$6 billion in syndicated loans and, have outstanding guarantees and acceptances to Korean construction firms of US$900 million. Table 1 shows some important indicators regarding foreign banks' activities and their growing influences. For example their asset increased from 32 billion won[1] at the end of 1972 to 1532 billion won at the end of 1979, which corresponds to nearly 30 fold increase. And the share of foreign banks' loan in the Korean banking market was a meager 1.7% of the total at the end of 1972, but it increased to nearly 11% at the end of 1979, reflecting their expanding influences in the Korean economy.

However, there are few theoretical and empirical researches on this subject in Korea. Accordingly, this paper represents an attempt briefly to analyze foreign banks activities and related problems in Korea. In following section, the regulations governing foreign banks operating will be explained and the present status and performance of foreign banks will be discussed in section III. Finally some problems and future policy proposals regarding foreign banks operations will be examined.

1 US$1 is currently equivalent to about 726 Korean won.

II. Regulation Governing the Foreign Banks

1. Entry Regulation

Basically, General Banking Act which governs the domestic banks is applied to the establishment of foreign banks branches in Korea. Any foreign bank which intends to open a branch in Korea should receive the prior and implicit approval of the Minister of Finance through preliminary contact with appropriate monetary authorities in Korea. The Monetary Board of Korea officially approves applications made by foreign banks with the recommendation of the Superintendent of Banks at the Bank of Korea. The same procedure is applied when a foreign bank which is already established in Korea plans to change the location of its branch or the scope of its business activities. In addition, foreign bank branches must also obtain necessary permission from the Minister of Finance in order to conduct foreign exchange business in Korea.

2. Regulations on Operating Funds

Foreign banks' operating funds are classified into Fund A, the paid-in capital, and Fund B, which is the amount of funds obtained through swap transactions. Currently, a foreign bank must have a Fund A of more than 1 billion won in order to obtain an approval to open a branch in Korea. This amount can increased with a special permission of the Superintendent of Banks, depending on the purpose of the request. In this case the Minister of Finance may specify the eligible use of this additional fund. In the case of Fund B, the Minister of Finance can impose the limit, the profit margins and the use of the fund. The present limit is 400% of the aggregate of Fund A plus the retained profits of each foreign bank concerned.

The main purpose of imposing swap limit is twofold: first, the unristicted inflow of new funds into the country could be a disturbing factor in controlling domestic money supply. Secondly, the wide interest rate differentials between Korea and the banks' nation of origin place the domestic banks under undue competition with foreign banks.

Before 1974, restrictions were imposed upon the use of the proceeds of such swap transactions. But, in December of the same year, these restrictions were lifted to overcome foreign exchange shortages caused by the first oil shock. However, a 3% margin limit was imposed on the differential in interest between the low cost of overseas borrowing and high return on lending in Korea.

Subsequently, once Korea began to overcome its foreign exchange difficulties, a new threat appeared in the form of excessive liquidity in the foreign sector and the indiscreet lending activities of the foreign banks which gave rise to substantial inflationary pressure. Thus the government once again set a new limit of swaps permissible in addition to controlling margin.

In early 1980, facing balance of payment difficulties again, the Korean government eased the swap limit for banks which have entered Korea after 1978 raising their ceilings to US$10 million. Also a new swap formula has been adopted for banks which have more than 1 billion won in operating funds. At the same time, the Bank of Korea decided to ease the restrictions governing the foreign banks' swap transactions by expending the range of industrial customers eligible to receive loans with funds derived from this source to include joint venture with a lower ratio of foreign investment. And the Bank of Korea limits the banks' profit margin to 1% on swap transactions.[2]

3. Regulations on Book Closing and Profit Remittances

Within 30 days of their book closing, all foreign bank branches must submit a report on the settlement of accounts for the business period, together with its financial statements, duly audited by a firm of certified public accounts, to the Superintendent of Banks. If a bank incurred a loss during its accounting period or when its assets held in Korea fall short of its operating funds, it must make good the loss, either by receiving foreign currency funds from its head office or by applying a portion of its reserves or surpluses to cover the loss, narmally within 60 days from its book-closing date.

All foreign banks must obtain permission from the Bank of Korea regarding their appropriation of profits, remittances to head office, payments of tax or for any purpose other than the

2 To do so, the following formula is applied: Swapcost $\frac{\text{(prime rate + general loan rate)}}{2}$

(Credit guaranty fund rate + funding cost + swap margin) depositing of legal reserves. In addition, the government may refuse permission for any profits acquired from sources other than normal banking activity to be remitted to head office and may take the necessary steps to appropriate such profit.

4. *Regulation on Foreign Currency Lending*

Foreign currency lending by foreign banks is subject to official control. In 1978, the Minister of Finance decreed that foreign bank branches could extend a combined total of up to US$200 million in foreign currency loans during the year. Also these foreign banks which intend to extend credit to domestic firms without guarantees from the borrower's principal bankers are permitted to include an additional US$100 million. In 1979, the authorities increased the limit to US$240 million. Foreign banks must make individual application to the Bank of Korea which determines each banks' foreign currency loan limits for every six month period.

III. Present Position and Performance

1. *Entry Status*

Since the Chase Manhattan Bank was provisionally allowed to open its Seoul Branch in April 1967, the number of foreign bank branches has risen rapidly to a total of 32 branches and 19 foreign bank representative offices at the end of 1979. At the same period, no less than 23 banks representing 12 countries were applying for permission to set up branches.

Table 2 classifies the number of foreign banks into the banks' nationality. The Table indicates American and Japanese banks account for more than 50 percent of total, reflecting growing external transactions with these countries. Most of these banks are among the world 100 largest banks and 8 out of 10 largest U.S. Banks are represented in the Korean financial market.

2. *Sources and Uses of Funds*

The classification of the sources of funds of foreign banks is shown in Table 3. The main sources of foreign banks' funds are

Table 2

FOREIGN BANKS IN KOREA
(including representative office)

unit: number

Year \ Nations	U.S.A.	Japan	France	U.K.	Others	Total
1967-76	6 (4)	6 (4)	2 (2)	1 (1)	1 (-)	16 (11)
77	4 (3)	1 (-)	1 (1)	2 (2)	2 (2)	10 (8)
78	8 (5)	3 (-)	1 (1)	1 (1)	5 (4)	18 (11)
79	2 (-)	3 (-)	1 (1)		1 (1)	7 (2)
Total	20 (12)	13 (4)	5 (5)	4 (4)	9 (7)	51 (32)

Note: Branches inside the parenthesis.
Source: The Bank of Korea, Monthly Research Bulletin, March 1980.

their paid in capital, won and foreign currency deposits, and inter-office borrowings which can be converted into local currency by means of swap transactions.

The foreign currency share reached 76.6% of their total funds at the end of 1979 indicating an annual growth of 140% since 1975. This compares with a growth in local currency funds of 56% each year, and can be explained by the profitability of swap transactions. The main source of foreign funds is borrowings from their head office or other international financial centers. This inter-office borrowings increased from 33.4% at the end of 1972 to 75.3% at the end of 1979. Although the amount of foreign exchange deposits increased steadly, the weight has been decreasing rapidly since 1978 because of the domestic banks' improved international financial capabilities.

In the case of local currency, the absolute amount of deposits has been increased gradually but their share of total funds has declined from 33.4% in 1967 to 8.2% in 1979. This reduction may be attributed to the fact that the foreign banks have been endeavoring to reduce their funding costs by cutting back on high interest time and savings deposits as explained by Table 4. Table 4 indicates a change in the composition of demand deposits from

Table 3

FOREIGN BANKS' SOURCES OF FUNDS

(unit: million won)

Sources / Year	1967 (%)	1972 (%)	1975 (%)	1976 (%)	1977 (%)	1978 (%)	1979 (%)
Local Currency							
Domestic Deposits	336	3,761	13,188	26,579	43,347	66,013	71,942
	(16.7)	(9.3)	(5.8)	(8.7)	(8.0)	(8.1)	(6.2)
Other Deposits[1]	254	8,190	17,045	19,678	15,569	27,047	23,816
	(16.7)	(21.2)	(7.4)	(2.9)	(2.9)	(3.3)	(2.0)
Paid in Capital	500	3,200	3,600	4,400	8,400	13,900	20,300
	(27.8)	(7.8)	(1.5)	(1.5)	(1.6)	(1.7)	(1.7)
Reserves			1,466	1,833	2,622	3,481	5,757
			(0.6)	(0.6)	(0.5)	(0.4)	(0.5)
Others[2]	583	9,300	62,920	60,266	58,139	106,742	151,394
	(33.3)	(22.7)	(27.5)	(19.8)	(10.7)	(13.0)	(13.0)
Foreign Currency							
Inter-Office Transfers		13,727	112,034	156,694	375,923	587,973	876,736
			(48.9)	(51.5)	(69.4)	(71.7)	(75.3)
Deposits in Foreign Currency	92	2,284	18,743	34,835	37,272	14,363	15,017
	(5.6)		(8.2)	(11.4)	(6.9)	(1.8)	(1.3)
Total	1765	40,462	228,996	204,285	541,272	819,519	1,164,952
	(100)	(100)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)

Source: Monthly Economic Statistics of the Bank of Korea.
Note: 1) Mostly Time and Saving Deposits.
2) Includes borrowings from the cooley Fund and Guarantees.

Table 4

COMPOSITION OF DEPOSITS IN LOCAL CURRENCY

(unit: %)

	1967	1972	1977	1978	1979
Foreign Banks					
Demand Deposits	56.9	31.5	74.0	72.0	77.5
Time & Savings Deposits	43.1	68.5	26.0	28.0	22.5
Deposit Money Banks*					
Demand Deposits	35.5	30.2	36.4	37.1	30.6
Time & Savings Deposits	64.5	69.8	63.6	63.9	69.4

Note: * Excluding foreign banks.
Source: The Bank of Korea, Economic Statistics Year Book.

31.5% of all deposit types in 1972 to 77.5% in 1979. Finally, paid-in capital has become much less important than in 1967. Its share had fallen to a mere 1.7% at the end of 1979.

The importance of foreign banks' share in total deposits has not been changed substantially since 1967. This is quite contrary to the case of loan share. (see Table 7) Its share in the Deposit Money Banks' total deposits was 2.0% in 1976, 1.2% in 1978 and 1.0% in 1979.

Table 6 shows the classification of the uses of foreign bank funds. There has been a rapid increase in lending activity, both in local and foreign currency over the years. At the end of 1979, the balance outstanding was 969.5 billion won, representing 83% of their total assets. The ratio between local and foreign currency lending was 31:69 in 1974, but after the first oil crisis, this was reversed to 60:40, widening in 1976 to 67:33 due to the relaxation in swap restriction. But in 1977, swap ceilings were imposed and foreign loan limits raised, and the government relaxed restriction on foreign currency loans for raw material imports and operating funds. As a result the ratio once again began to reverse. At the

Table 5

Foreign Banks' Share in Deposits

(unit: million won)

	1967	1972	1975	1976	1977	1978	1979
Deposits in Foreign Currency Foreign Banks (A)	590	11,951	29,882	43,173	58,538	91,696	92,609
All Deposit Money Banks (B)	179,092	1,323,879	2,749,357	3,644,909	5,277,799	7,862,687	9,919,890
Share (A/B)%	0.3	0.9	1.1	1.1	1.1	1.2	0.9
Deposits in Foreign Currency Foreign Banks (A)	92	2,284	18,743	34,835	37,272	14,363	15,017
All Deposit Money Banks (B)	72,217	225,363	313,783	308,160	733,752	732,237	845,409
Currency Share (A/B)%	0.1	1.0	6.0	11.3	5.1	2.0	1.8
Total Foreign Banks (A)	682	14,235	48,625	78,008	95,810	106,059	107,626
All Deposit Money Banks (B)	251,309	1,549,242	3,063,140	3,953,069	6,011,551	8,594,924	10,765,299
Share (A/B)%	0.2	0.9	1.6	2.0	1.6	1.2	1.0

Source: The Bank of Korea, Monthly Economic Statistics.

Table 6

EMPLOYMENT OF FUNDS

(unit: million won)

Types of Loan \ Year	1967 (%)	1972 (%)	1975 (%)	1976 (%)	1977 (%)	1978 (%)	1979 (%)
Local Currency							
Loans & Discounts	410 (22.2)	14,108 (34.4)	78,687 (34.4)	124,137 (40.8)	206,593 (38.2)	268,078 (32.1)	294,866 (25.3)
Due from B.O.K. & other Banks	131 (5.2)	3,672 (9.0)	61,387 (26.8)	60,226 (19.8)	48,403 (8.9)	57,895 (7.1)	63,136 (5.4)
All Loans	430 (22.2)	940 (2.2)	2,570 (1.1)	13,900 (4.6)	13,480 (2.5)	7,300 (0.9)	2,800 (0.3)
Others*	700 (38.9)	206,051 (50.2)	5,499 (2.4)	19,616 (6.3)	40,430 (7.5)	52,728 (6.4)	96,702 (8.3)
Foreign Currency							
Loans in Foreign Currency		14,798 (36.1)	52,993 (23.2)	60,143 (19.8)	202,375 (37.4)	422,106 (51.5)	674,647 (57.9)
Due from Banks in Foreign Currency	196 (11.1)	3,248 (7.8)	4,865 (2.1)	40 (0.0)	10,273 (1.9)	2,073 (0.3)	2,364 (0.2)
Foreign Exchange Bought		2,622 (6.3)	23,004 (10.0)	26,223 (8.6)	19,705 (3.6)	14,339 (1.7)	30,437 (2.6)
Total	1,765 (100.0)	410,000 (100.0)	228,996 (100.0)	304,285 (100.0)	541,272 (100.0)	819,519 (100.0)	1,164,952 (100.0)

Note: * Include currency, checks, personal loan and real estate.
Source: The Bank of Korea, Monthly Economic Statistics.

Table 7

FOREIGN BANKS' SHARE OF LOANS

(unit: million won)

Year	1967	1972	1975	1976	1977	1978	1979
Local Currency							
Foreign Banks (A) All Deposits[1]	410	14,108	78,687	124,137	206,593	263,073	294,866
Money Banks (B)*	151,981	1,198,061	2,635,085	3,448,117	4,084,105	6,019,161	8,267,660
Share (A/B)%	0.1	1.3	3.0	3.6	5.1	2.7	3.6
Foreign Currency							
Foreign Banks (A) All Deposits (A)		14,798	52,993	60,143	202,375	422,106	674,647
Money Banks (B)*	30,042	102,785	290,635	286,006	304,904	1,098,948	1,722,879
Share (A/B)%		14.5	18.2	20.9	66.3	38.4	39.1

Source: The Bank of Korea, Monthly Economic Statistics.
Note: * See footnote to Table 4
1) Loans from government funds an excluded.

end of 1979, the ratio was 30:70. In case of local currency lending almost 100% of their funds were employed in short-term operating funds.

The amount of foreign currency lending registered a phenomonal increase from 14.8 billion won at the end of 1972 to 674.6 billion won at th end of 1979, which is nearly 52 fold increase. At the same time, the share of foreign currency lending in total increased 36.1% in 1972 to 57.9% in 1979. Of course, the government's relaxation of restrictions on foreign currency loans for raw material imports and operating funds has contributed to the rapid increase which has taken place in the foreign banks' overall foreign currency lending activities in these years.

Finally Table 7 shows foreign banks' share of total banking institutions loan. At the end of 1979, the shares of foreign banks' loan in Korean banking market were 3.6% for local currency and 39.1% for foreign currency, reflecting their growing importance in Korea's banking industry. This figure also indicates that doemstic banks experienced greater difficulty than the foreign banks in raising low cost funds in international markets.

3. Foreign Bank Performance

In 1979, the 25 banks had a combined revenue of 123,400 million won and 108,400 million won in expenses with the net profit of 15,000 million won. Their main source of income was loan interest, which made up 78.7 of the total revenue. And their component of expenditure was interest on inter-office borrowings which formed 54.3 of the total (Table 8).

In general, the foreign banks have outperformed domestic banks in securing profits. Table 9 shows the ratio of their net profit to capital of both foreign banks and domestic banks. As the Table indicates, the average profit-capital ratio since 1972 for foreign banks is about 75-80% while that of domestic banks is 15-20%.[3]

One important fact is that the combined net earnings of the

3 However, the capital base of the foreign branches is not directly comparable with that of the Korean banks. A true picture would be obtained by including the foreign banks' Fund B in the calculation of their capital, since this is used in determining their acceptance and guarantees ceilings.

Table 8

REVENUE & EXPENSES OF FOREIGN BANKS* IN KOREA IN 1979

(unit: million won)

Revenue	Interest on loans in won currency	44,600 (36.7)
	Interest on loans foreign currency	51,000 (42.0)
	Interest on securities	5,300 (4.3)
	Other Interest	2,300 (1.9)
	Revenue from foreign exchange business	14,800 (12.1)
	Others	5,400 (4.4)
Total		123,400 (100.0)
Expenditure	Interest on won currency deposits	3,600 (2.9)
	Interest on foreign currency deposits	400 (0.3)
	Interest on inter-office borrowings	66,800 (54.3)
	Other interests**	9,000 (7.3)
	General Expenditure	11,000 (9.0)
	(personnel expenditure)	4,900 (3.9)
	Others	8,700 (7.0)
	Corporation Tax	8,900 (7.2)
	Net Profit	15,000 (12.1)
Total		123,400 (100.0)

Note: * includes the 25 banks which close their books on 31, December.
** includes swap cost.

Source: The Bank of Korea, Monthly Economic Statistics.

Table 9

THE RATIO OF PROFIT TO CAPITAL

unit: percent (per annum)

	Foreign Banks	Domestic Commercial Banks
1972	42.7	6.3
1973	64.3	8.5
1974	73.9	29.2
1975	84.6	16.9
1976	90.0	20.7
1977	96.0	16.8
1978	80.0	16.2
1979	84.79	17.2

Source: The Bank of Korea, Statistical Year Book.

foreign banks in 1979 totaled 13.5% of the total for all deposit money banks (after tax), while their shares of total deposits and loans were just 1.1% and 10.4% respectively. For this reason, there have been many complaints of excessive profits of foreign banks.

IV. Problems and Proposals

The Korean government's basic attitude with regard to the foreign banks operating in the domestic financial market is to allow them as much freedom as possible to conduct general banking and foreign exchange business within the scope of existing laws and international banking custom. Thus, in principle, they are treated on equal terms as domestic banks and face no discrimination, legal or otherwise. To the contrary, foreign banks in Korea are granted a number of special privileges thanks to the government's effort to attract an increased flow of foreign funds. The followings are some of the privileges accorded to them:

1). Foreign banks are exempted from many of the official directives which impair the profitability of the domestic banks.

2). They can avoid default risk and save the lending costs by securing guarantees from the borrowers' principal Korean banks as a prior condition of their loans.

3). Guaranteed foreign currency lending margins.

4). The high interest rate in Korea and officially guaranteed swap margins.

5). Foreign banks are not obliged to accept government undertakings, such as the public bonds or stabilization bonds which are issued periodically by the Bank of Korea. Nor are they required to deposit won currency in the Bank of Korea's stabilization account.

6). They are not required to extend low margin policy priority loans, such as those which the domestic banks are required to provide for exporters.

7). Various tax privileges are given to foreign banks.

These privileges, some people argue, provide foreign banks, an undue competitive edge over domestic counterparts. Some in the monetary circle advocate more stringent regulations over foreign banks' operations in Korea. In this respect, the Research Department of the Bank of Korea indicates the following points.[4]

First, foreign banks are harvesting rather excessive profits by utilizing interest differential, and ever-present excess demand of funds and underdeveloped domestic banking industry. These excessive profits in turn lead to an undesirable inflow of foreign banks.

Second, foreign banks' exemption from low margin policy priority loans are in direct contradiction with the government's development policy.

Third, the avoidance of long-term savings deposits by foreign banks places domestic banks under undue competition with foreign banks and impair the profitability of domestic banks.

Fourth, the swap operation and non requirement of foreign banks to deposit won currency in the central bank's stabilization account could become a destabilizing factor in domestic stabilization policy.

Because of these reasons, the Bank of Korea memorandum sug-

4 For details, see *The Direction of Regulatory Policies on Foreign Banks Operations in Korea* (Memorandum), First Department of the Bank of Korea, July 1978.

gests:[5]

1). The Monetary authorities in Korea should not allow additional foreign banks to establish branches in Korea until domestic banks become fully competitive with foreign banks.

2). Regarding foreign currency borrowing, foreign banks must receive a permit from the Minister of Finance as in the case of domestic banks.

3). In the case of inter-office foreign currency borrowing foreign banks must use the funds in foreign currency lending only.

4). The monetary authorities in Korea should restrict the margin between lending rate and low cost borrowing rate and only allow a limited margin only.

A thorough analysis of the domestic banking institution would indicate, however, that the proposed measures are shortsighted and doomed to failure. The source of inequities lies not so much in some of the privileges accorded to foreign banks, as in the excessive government control imposed upon domestic banking industry.

The Korean government has traditionally maintained a paternalistic attitude toward all aspects of the banking system to see to it that the institutions serve the broader interests of the national development program. The government has been actively involved in managing the bank system, using it to mobilize financial resources from home and abroad, and to allocate these resources in ways that supported its high growth policies.

Government control of the organized financial institutions has been a major vehicle for guiding and regulating private enterprise. Businesses of all sizes have been continuously and heavily indebted to one or more of the government owned banks. With a few exceptions bank loans were short-term based and their renewal was subject to government discretion rather than banks' decision. Even in the field of loan guarantee operation, commercial banks played a very limited role in the decision-making process. Arrangements were worked out directly between the borrower and lender and then approved by the government. The banks basically issued the guarantees upon instruction from the government and took little

5 *Ibid*, pp. 10-14. Also see *The Present Situation and Regulatory Policies of Foreign Banks in Korea*, December 1976.

responsibility for the project.[6] Therefore the commercial banks neglected to develop skills in terms of lending. Eventually when some of the projects proved unsound, the government had little basis for holding the banks accountable and therefore had to take extraodinary measures to relieve the banks of the bad debts.

Furthermore, interest rates on loans and deposits have been instruments of government policy that should be evaluated in terms of their relative efficiency when compared with other instruments for achieving particular objective. For example, the Korean government attempted to increase exports by means of low interest rate preference loans on exports. In 1979, these export loans and other preference loans accounted for more that 50% of total commercial bank loans. Needless to say, the chronic excess demand for such loans created room for corruption and led to inefficient resource allocation.[7]

Institutional controls and rationing have inevitabely resulted in an increasingly rigid financial system and artifically segmented financial markets which have simply not been amendable to monetary control for short-run stability of the economy. More importantly, this tightly controlled financial system often tended to interfere with a successful implementation of Korea's long run development strategy. Despite a rapid growth in number and variety, Korean financial institutions, have had little incentive to expand their intermediation capacity or improved financial technology, and have been unresponsive to changing financial market conditions and need of the economy. They have been alienated from international financial community to continue the outdated financial practice, that are suitable only to a closed economy. The result has been a lack of ability to competite internationally. On the other hand, private business, in particular export-oriented ones, have aggressively penetrated into the world market. They have continuously modernized their management skills and adopted sophisticated marketing strategies. Domestic financial institution has always lagged behind, unable to provide

6 For detail, see David C. Cole and Y. C. Park, *Financial Development in Korea, 1945-78*, Korea Development Institute Working Paper 7904, Korea Development Institute, 1979.

7 See I. K. Kim, "Recent Monetary Situation and Some Measures to Increase Financial Savings In Korea," *Korea Banking Review*, April 1978, Korea Bankers Association. Also see B. K. Shim and et al., *A Study of Preferential Interest Rate Structure-The Korean Experience*, October, 1972, pp. 95-97.

adequate and efficient international services to these world market-oriented businesses. Nor have they effective or taken an active role in channelling much needed foreign credit with favorable terms and conditions to them.

In considering all these elements, the previously indicated problems regarding foreign banks' activities in Korea must be solved not by tightening the regulations on foreign banks as suggested by the Bank of Korea's memorandum, but by allowing greater freedom for the free functioning of domestic banking industry and capital market. To this end, a drastic reduction of low interest rate policy loans and deregulation of interest rate to reach an equilibrium level are strongly recommended.

However, a few criticisms are warranted for foreign banks activities in Korea. First, as indicated previously, one important reason for allowing foreign banks into Korean market is that they can enrich the local banking scene by setting a fine example for the Korean institutions to follow and thus help to raise the standard of banking practice by introducing advanced technique into the market. However, the foreign banks have not fully lived up to the expectation. For example, in the lending practice, foreign banks in Korea have continuously maintained to avoid risk and save the lending costs by securing guarantees from the borrowers' principal Korean banks as a prior condition of their loans rather than extending loans on pure credit bases.

Accordingly, domestic banks have not been able to acquire an advanced lending technique based on sound project evaluation. Therefore, in the future, it is advisable for the Korean government to instruct domestic banks to reduce loan guarantees for foreign banks substantially and to encourage foreign banks to extend loans on pure credit bases. A joint venture between local and overseas interests is a strong possibility. This joint venture mechanism is viable proposition because the foreign bank branches have ready access both to the technical skill and experience provided by the foreign partners and to over-seas funding sources which would not otherwise be available. These advantages are will complemented by the intimate local market knowledge of the domestic bank. What the local commercial banks need is to acquire more sophisticated financial services as the economy expands and becomes more complex.

Secondly, it was mentioned that Korean government imposes certain restrictions on swap transactions mainly because of excessive liquidity consideration. But in order to ensure a smooth inflow of foreign funds into the country, further relaxations on swap operations are recommended. It is, particularly, advisable that the government lift completely the present limits on swap funds and only set limits on loans using swap funds. The excess swap funds must be allowed in investing various kinds of securities including private securities. In doing so, inflationary pressure arising from foreign sector may be controlled.

V. Conclusion

Foreign banks have been authorized to conduct banking business by opening branch offices in Korea to fulfil two main objectives; first, maintaining a closer relationship between the domestic economy and international financial markets and second, improving international financial techniques of the domestic banks through competition with foreign bank branches.

A total of 32 foreign bank branches and 19 representative offices as of the end of 1979 were in full operation to meet the challanges. As for the sources of their funds, as of the end of 1979 deposits in won currency constituted only 8.2% of their total resources compared with more than 60% for deomestic commercial banks. By far their most important source of funds is borrowing from their head offices which represents about 75% of their total resources. As of the end of 1979 loans in foreign currency accounted for 58% of their total assets while loans and discounts in won currency represented 25%. Their loans in foreign currency represented more than half of all commercial bank foreign currency loans outstanding, reflecting their growing influences in Korean economy.

Korea has been an exceptionally rewarding market for foreign banks. As we have seen, the foreign banks have been able to secure exceptionally large profits in relation to their capital. The excess profiteering by foreign banks has prompted still others in the Korean monetary circle to advocate a tighter control on foreign banks' operations in Korea. Some people argue that there are too many privileges given to foreign banks, and hence place domestic banks under undue discrimination. Many find no fault with special privileges accorded to foreign banks because of their vital contribution to inducing the much needed foreign currency and thus redressing Korea's deteriorating balance of payment position.

It is the author's belief, however, the problem of unfair competition if it exists between foreign and domestic banks must be solved by means of deregulating domestic banking industry by the government.

In the course of future foreign banks operations, one suggestion is to take the form of joint ventures between local and foreign interests. At the same time, it is desirable that the Korean government continue to provide an encouragement to the foreign banks by extending their eligible areas of business, simplifying capital inducement procedures and raising swap limits.

References

Cole, D. C. and Y. C. Park, *Financial Development in Korea, 1945-75* KDI Working Paper 7904, Korea Development Institute, 1979.

Gurley, J. G., H. T. Patrick, and E. S. Shaw, *The Financial Structure of Korea*, United States Operation Mission to Korea, July 1965.

Kim, I. K., "Recent Monetary Situation and Some Measures to Increase Financial Savings in Korea," *Korean Banking Review*, April 1978.

Korea Exchange Bank, *Monthly Review*, January 1980-June 1980.

Research Institute for Economics and Business, *Study of Money Market and Industrial Investment*, Sogan University, November 1970, pp. 46-52.

Shim, B. K. and et al., *A Study of Preferential Interest Rate Structure — The Korean Experience, 1963-1971*, October, 1972, pp. 95-97.

The Bank of Korea, *Financial System in Korea*, 1974-1978.

______(First Research Department), *The Regulatory Policies on Foreign Banks Operations in Korea* (Memorandum), 1978.

______, (First Research Department), *The Present Situation and Regulatory Policies of Foreign Banks in Korea*, December 1976.

______(The Office of Bank Super vision and Examination), *Suggestions for the Improvement of Commerical Bank Management*, 1970.

______, *The Statistical Year Book*, 1967 through 1979.

______, Monthly Economic Statistics, January 1967 through April 1980.