KCMI-CASS Joint Conference

Korea's experience and its implications for China

- privatization of commercial banks and legalization of private financing -

May 10, 2012

Bo Sung Shin
(Korea Capital Market Institute)

Privatization of Korean Banks (1)

- 1950s (after the Korean War)
  - Sold government owned bank stocks to a few conglomerates (chaebols)
  - Banks were managed to fund their own large shareholders, the chaebols
- 1960s
  - 'Five-Year Economic Plan'
    - Needed to mobilize the financial sector to fund designated industries
    - Nationalized commercial banks; established specialized banks to boost economic development
  - Set up a government-driven resource allocation system

Privatization of Korean Banks (2)

- 1980s
  - Structural problems emerged amid rapid economic growth
    - Chronic inflation, underdevelopment of financial sectors
  - Switched policy focus from growth to stability and accommodated market force
    - Privatized commercial banks as part of financial liberalization

- ~1997 bank crises
  - Government continued to intervene in banks' decisions even after privatization
  - Massive resource misallocation resulted in over-investment in inefficient sectors and bank crises

- 1998~present
  - Government stopped involvement in resource allocation of commercial banks
  - Privatization of nationalized banks and some specialized banks is needed

Privatization of Chinese banks (1)

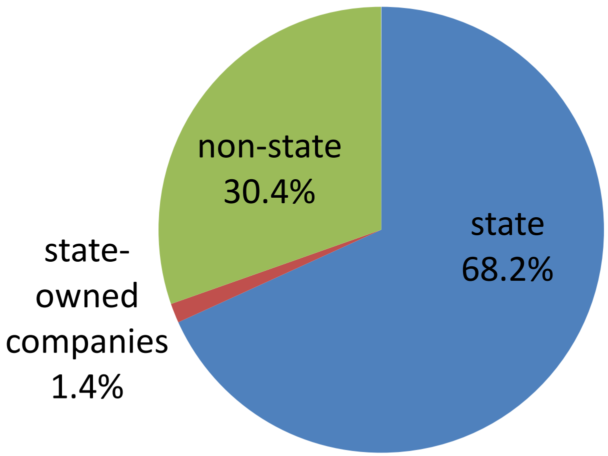
- 1979~1984
  - Established state-owned commercial banks
    - Agricultural Bank of China, Bank of China, China Construction Bank, Industrial and Commercial Bank of China
  - A government-driven resource allocation system
    - State-owned banks supplied loans to state-owned companies
- 1994
  - Set up state-owned three policy banks
    - China Development Bank, Agricultural Development Bank of China, China Exim Bank
  - Eased the burden of four state-owned commercial banks regarding policy loan supply
- 2000s
  - IPOs of state-owned commercial banks

Privatization of Chinese banks (2)

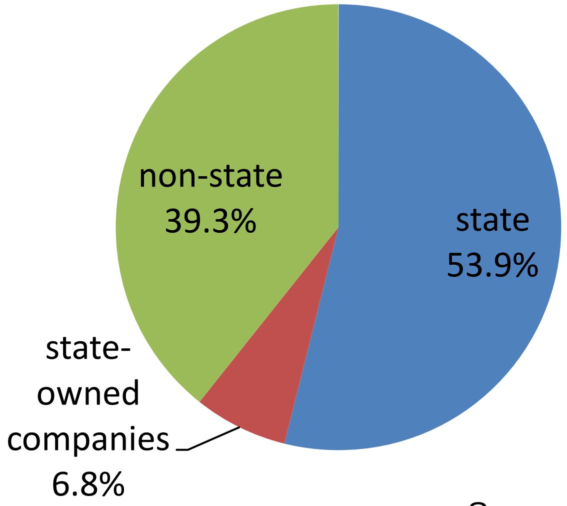
- Government is the largest shareholder of commercial banks
  - Chinese government owns the most number of bank shares even after the IPOs of state-owned commercial banks
  - Government policy is still considered when lending decision is made

Composition of bank shareholders

Five largest commercial banks



All banks



Source: CASS

Implication from Korea's experience

- Korea's experience
  - In the early stage of economic growth, government-driven resource allocation can be efficient
  - However, when the high growth phase ends…
    - Resource misallocation, massive NPL→ bank crises
    - intensive supply of low interest rate loans to a few chaebols→ over-investment
    - Increased concentration of economic power→ the growth of SMEs has been suppressed

- Implications
  - China seems to have passed the high growth phase and needs to decrease government involvement in resource allocation
    - More than 70% of bank loans are channeled to government-owned companies while these companies' contribution to industrial production is less than 30%
  - Need to speed up the privatization of commercial banks to improve bank soundness and to secure continued economic growth

Legalization of private financing in Korea

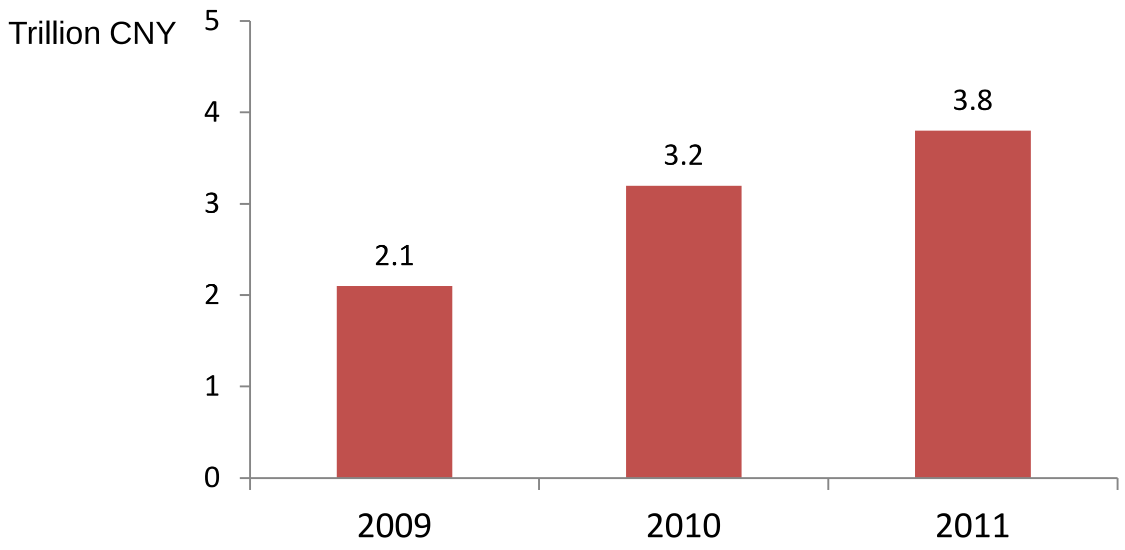
- Freezing private debt (1972)
  - Korean companies suffered from lack of funds and many of them went bankrupt in the wake of economic recession in the early 1970s
    - GDP growth rate: 13.8% (1969)→ 5.7% (1972)
  - In 1972, corporate debt to private financiers was frozen
    - Companies could pay private debt in five years with a three-year grace period
    - Reduced monthly interest rate: 3.84%→ 1.35%

- Legalization of private financing (1972)
  - Private financing markets ceased to operate due to the freeze of private debt
    - The size of private financing markets was 80% of money supply
  - Three new financial intermediaries were set up
    - Short-term investment finance company→ large companies
    - Savings bank, credit union→ SMEs, households

Private financing markets in China

- Rapid growth of private financing
  - Banks tend to fund state-owned large companies
  - Reducing bank lending→ SMEs are highly dependent on private financing
  - Control on bank interest rates

The estimated size of private financing in China



Source: CICC

Implication from Korea's experience

- Korea's experience
  - Loan supply was increased by legalizing private financing
  - The role of private financing tends to be reduced when interest rate control is lifted and commercial banks are completely privatized
    - Most of the short-term investment finance companies disappeared in the wake of bank crises in 1997
    - Savings banks and credit unions have difficulty in securing their markets

- Implications
  - Need to regulate and supervise any type of financial intermediary by legalizing private financing markets
  - Problems of private financing markets may damage the banking sectors
    - Some companies borrow money from banks and then lend the money in private markets
  - Privatization of commercial banks and complete liberalization of interest rates should be considered along with legalization of private financing

The end