FINANCIAL LIBERALIZATION AND REFORMS IN PAKISTAN AND KOREA

By

Mirza Khalid Amin

THESIS

Submitted to
KDI School of Public Policy and Management
In partial fulfillment of the requirements
For the degree of

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2007

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ABSTRACT

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Financial liberalization has been the cornerstone of financial and economic reforms. This study starts with introduction to financial liberalization, its impact, preconditions and procedure in light of literature, which emphasizes that it should be carried out keeping in view the socio-economic and political structure of the country. Then it discusses the partial financial and economic policy reforms towards financial liberalization adopted in Pakistan particularly during the period 1999-2006 after brief overview of economic development and impact of financial liberalization. The next chapter explains the evolution of financial system in Korea with focus on financial liberalization policies and their evaluation. The last chapter gives comparison of the economies of the two countries and the financial liberalization policies and brings out the salient differences between steps taken by these two countries towards financial liberalization. Finally, it concludes that Pakistan lacked in many social, economic and political factors such as literacy rate, skilled human resources, per capita income, incessant democratic governments and its image as a stable, safe country for investment as compared to Korea. The policy of market based system can bring economic uplift to the country provided the prerequisites for its implementation are fulfilled which take time. Pakistan is facing many difficult challenges and will continue to face new unforeseen challenges and has no room for complacency. The worldwide preoccupation with the large economies of China and India and the ever-increasing quest to enter these markets is also working to the disadvantage of countries such as Pakistan. But the lesson we have learned is that there is no point in complaining and whining about this but to get on with the job, to work even harder, to overcome these deficiencies and constraints and to hope for the best.

Dedicated to my son Hamayun Abdullah Amin

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1 A SURVEY OF LITERATURE ON FINANCIAL LIBERALIZATION

1.1 INTRODUCTION

The essence of financial liberalization hypothesis is that domestic financial markets should determine a country's interest rates. Positive real interest rates discourage capital flight and increase savings. Financial liberalization is aimed at establishing market based free economy to achieve consistent and stable economic growth through efficient and optimal use of resources.

In 1973, McKinnon and Shaw wrote their seminal work on the impact of financial liberalization. They argued that an economy that holds the interest rate below the market clearing value will generate less than optimal savings, thereby detracting from the pool available for investment. A smaller proportion of savings will be channeled through the formal financial system, presumably resulting in a less efficient allocation of investment. In addition, the low interest rate will make low yielding projects profitable and given a degree of randomness in banks lending decisions, there will be many low yielding investments that will serve to reduce the average rate of return on investment.

Sufficient experience has now been accumulated to permit a reasonably confident verdict about the consequence of financial liberalization which shows that the beneficial effects of liberalization i.e. better allocation of investment as anticipated by McKinnon and Shaw is typically realizable. In the simple model of credit being rationed by price to those who bid the highest is inappropriate in the case of the financial sector. Those who are prepared to bid the highest are typically those with the riskiest projects, and a prudent banker has to search for a borrower that offers the best risk-return combination rather than one who offers the highest interest rates. Therefore he is not given an incentive to lend to the safest borrowers almost regardless of the expected rate of return. This does lead to a better pattern of investment. The anticipated benefit that seems to be absent is the impact of financial liberalization on savings, at least once the real rate is positive.

1.2 FINANCIAL LIBERALIZATION AND VARIOUS MACROECONOMIC INDICATORS:

There are several differing views on what exactly has been the effect on various macroeconomic variables. Several studies conclude that financial development contributes positively to economic growth. Using cross-country analysis, Robert King and Ross Levine (1993) find a significant, robust and positive correlation between higher levels of financial development and faster growth, physical capital accumulation and economic efficiency. Alan Gelb (1989) finds a positive correlation between the real interest rate and growth for 34 countries for the period 1965-85. Jose De Gregorio and Pablo Guidotti (1992) find a positive relationship between credit to the private sector and growth for a sample of 98 countries, for 1960-85. However, their regressions for 12 Latin American countries for the period 1950-85 find that credit had a significantly negative correlation with growth. The correlation was not significant in the 1950s and 1960s but became strongly negative in the 1970s and 1980s.

1.2.1 FINANCIAL LIBERALIZATION AND INVESTMENT

Joshua Greene and Delano Vilenueva (1991) find a negative and significant effect of real interest rates on investment. Using 23 developing countries, for the period 1975-87 Alan Gelb (1989) finds a positive though weak relationship between aggregate investment and interest rates. Panicos Demetriades and Michael Devereux (1992) with a sample of 63 developing countries and a data spanning from 1961 to 1990, find that the effect of higher interest rates is stronger on the cost of capital than the effect on enhanced supply of investible funds. Thus higher interest rates went on to diminish investment.

In the literature, which argues a positive relationship between financial sector development and economic growth, majority agree to the fact that the growth stems from increased efficiency in allocation of investment rather than a larger volume of investment. Theoretical studies such as those by Jeremy Greenwood and Boyan Jovanovic (1989), Valerie Bencivenga and Giles Saint Paul (1992) estimate that some 75% of the positive correlation between financial intermediation and economic growth is due to increased investment efficiency rather than an increased volume of investment. Alan Gelb (1989) also finds that most of the positive association between real interest rates and growth stemmed from the efficiency effect rather than the level of investment.

Jacques Morisset (1993) finds that although the effect of financial liberalization on the quantity of investment was weak, but was consistently positive on its quality. Gregorio and Guidotti (1992) find that credit to the private sector was negatively related to growth in the 1970s and 1980s. They attribute this negative correlation to inefficient lending by banks in light of poor regulatory incentives.

1.2.2 FINANCIAL LIBERALIZATION & SAVINGS

Maxwell Fry (1978, 1980 and 1995) in his various articles finds that, across a sample of 14 Asian developing countries gross national saving rate is positively affected by increases in real interest rates. However, Giovannini (1983, 1985) points out that the findings of Maxwell Fry were not robust to the changes in time or region. Fry (1995) himself conceded that the effect is small and diminishes in the more recent years and is prevalent mostly in Asia. A large number of studies point out that the high level of saving in Japan and other East Asian countries was not because of high interest rates but expansion of banks into rural areas and the availability of low yielding but safe deposit instrument.

Thus most of the literature on interest elasticity of savings concludes that a low positive interest rate is ideal to maximize savings. The question that arises then is whether the financial liberalization has been able to produce such interest rates. Most of the countries have moved away from negative interest rates after liberalization but some moved quickly to interest rates that were not only positive but very high in real terms. Following deregulation, Australia, Chile, Malaysia, New Zealand, Taiwan, Thailand and US, all experienced sharp increases in interest rates. There were some countries where the interest rates have fallen like Israel, Italy and United Kingdom. In Hong Kong and Singapore, which have had liberalized financial sectors, real interest rates have in general been positive and moderate in real terms.

The impact of financial deregulation on financial deepening has also been looked into some depth by various economists. Dimitri Margaritis, Dean Hyslop, and David Rae (1994) present econometric evidence for New Zealand, showing that financial liberalization is positively related to the growth of M3 to GDP. The ratio of M2 to GDP showed an increase in several developing countries like Argentina, Brazil, Thailand, Indonesia, Mexico, Malaysia etc. However, it also showed a decline following liberalization in Colombia, Venezuela, Philippines and Turkey.

The literature on correlation between financial liberalization and savings is again ambiguous with contradictory evidence. Nureldin Hussain (1996) calculates that, in the three years following liberalization, financial savings in Egypt increased on average by 6% of GDP over the level that would have occurred in the absence of financial liberalization. On the other hand Tamim Bayomi (1993) estimates that financial deregulation in the United Kingdom resulted in a decline in the personal saving ratio of 2.3 percentage points over the 1980s. Simon Chapple (1991) finds that both household and corporate saving has fallen since liberalization in New Zealand. In the United States, the savings rate has fallen steadily since deregulation in the 1980s. There is also evidence of lower savings rate following liberalization in Argentina, Colombia and Philippines.

There have been several cases where financial liberalization has led to a consumption boom. Three separate studies by Lopez-Meija, (1991), Bayomi (1993) and Darby and Ireland (1994) show that financial liberalization resulted in consumption boom in the United Kingdom in the late 1980s. Similarly Mexico and Thailand experienced large increases in consumer lending after financial liberalization.

1.3 FINANCIAL LIBERALIZATION & FINACIAL CRISES

Finally a review of the literature on financial sector would be incomplete without looking at the vast literature devoted to deregulation and financial crises. The fear that financial liberalization was destined to breed crisis was first given wide currency by Carlos Diaz Alejandro's 1985 paper "Good Bye Financial Liberalization, Hello Financial Crash". Williamson and Mahar (1998) take up a panel of 34 countries, both developed and developing, and show that almost all the 34 economies experienced some form of systematic financial crisis between the beginning of 1980s and July 1997, and several suffered new and severe crisis later that year. It is probably true that not all crises were direct consequences of financial liberalization. In particular it seems likely that in a number of cases, banks had already a share of large number of non-performing loans at the time liberalization occurred as a result of previous directed lending, and that liberalization simply exposed portfolio weakness that had been previously hidden. Nevertheless financial liberalization was at least a contributory factor in many cases. Certainly, Argentina (1980), Chile, Mexico (1994), Philippines, Thailand, Turkey, United States, and Venezuela are cases in point. The costs of these crises have run into billions of dollars.

Carmen Reinhart and Graciela Kaminsky (1996) use cross country profit estimations to detect causality between banking crises, balance of payment crises, and financial liberalization. Their results indicate that, although banking crises tend to precipitate balance of payments crises, the reverse is not always true. Importantly, they find that financial sector liberalization is positively and significantly related to subsequent banking crisis. Asli Demirigüc-Kunt and Enrica Detragiache (1997), in a study that covers 65 countries from 1980 to 1994, use a number of macroeconomic and institutional variables to determine the probability of banking crisis. They use three separate variables, real interest rate, share of credit to private sector and growth in credit.

Although all three variables are positively and significantly related to the probability of a banking crisis occurring, the study neither lays out a macroeconomic model capturing the interaction of these and other macroeconomic variable, nor attempts to incorporate the extent of prudential regulation and supervision in the financial sector into the analysis. In addition, the interest rate, credit to private sector, and growth in credit are influenced by a host of other factors than financial liberalization.

Patrick Honohan (1997) alleges that the causes of banking crises span a wide spectrum. He divides banking crises into three syndromes, macroeconomic epidemics, microeconomic deficiencies and endemic crises in a government protected system. The latter two categories describe the underdeveloped and government managed financial system, typically found in a financially repressed economy. However, Honohan does not blame either repression or liberalization for the spate of banking crises. He blames the change of regime, which altered the nature, scale, frequency and correlation pattern of shocks to the economic and financial system, increasing the riskiness of traditional behavior, or introducing new and inexperienced players. Looking back on a number of developing country cases, Honohan defines the types of regime changes as financial repression, financial liberalization, structural transformation, political developments, privatization, and technological innovation and globalization in finance. **Of these, financial liberalization, structural transformation, privatization and technological innovation and globalization often result from the financial reform process.**

Michael Gavin and Ricardo Hausmann (1990) see the origin of banking crisis as residing in a credit boom that allows almost any borrower to service its debt by borrowing from another source. This deprives the lender from the information that would have helped him to differentiate between sound and risky borrowers. In a macroeconomic crisis, continued debt servicing becomes problematic, and many borrowers default on their loans. This has been seen following the financial liberalization in the Chile, Mexico, and Thailand. After liberalization, both Argentina and Turkey experienced widespread distress borrowing because of a vicious circle of unsustainably high interest rates at banks to cover growing numbers of nonperforming loans and a further distress borrowing by the corporate sector.

Gerard Caprio, Berry Wilson and Anthony Sanders (1997) present evidence that a rapid expansion of lending to consumers was a leading factor behind the collapse of banks in Mexico in 1994. Among many factors which contributed to this collapse were inadequate supervision, lack of proper incentives and existence of broad deposit insurance factors that limited the need for bankers to diversify risks in newly liberalized environment. These studies suggest that financial sector vulnerability frequently develops after liberalization, even though it can be argued that the root cause of the weak banks was the preceding financial repression.

1.3.1 ASIAN CRISIS EXPERIENCE

The Asian crisis was the result of “weak” domestic financial systems in volatile international capital movements owing to globalization of financial markets (Dean 1998, Goldstein 1998, Montes 1998, Radelet and Sachs 1998). The Asian economies (affected badly by the crisis of 1997–98) were victims of this naive notion about free capital movement without realizing that a sound and strong financial system was the pre-requisite. Adequate regulation, banking supervision, accounting standards, financial transparency, legal protection and accountability in corporate governance along with pervasive market perfections free from government interventions in business, and merit based credit allocation are essential for effective financial liberalization and absence of these all led to a high proportion of “bad loans” and “bad investments.”

According to Wade and Veneroso (1998) & Kumar and Debroy (1999), financial liberalization in Asia was an inappropriate policy that only weakened a relationship based system and government’s monitoring and supportive role (that had served the region’s economies well by mobilizing and allocating savings/resources efficiently to productive investments) in an effort to restructure it in the fashion of the Anglo-American system resulting in over-expansion of firms beyond their capacity which became the root cause of the crisis which essentially represents a case of market failure and not of government failure. Hellman, Murdock, and Stiglitz (1997) argue that the standard financial liberalization policy is based on a naive acceptance of neoclassical *laissez-faire* ideas and is, therefore, inappropriate for many developing countries rather the right financial regime for the developing countries is “financial restraint”.

According to Camdessus MD of the IMF (1998), Masuyama (1999) and Radelett and Sachs (1998), inappropriate or “disorderly, haphazard and partial” manner of financial liberalization under pressure without addressing the proper phasing and sequencing of capital account liberalization weakened the Asian financial system and exposed the vulnerable economies to a rapid reversal of international capital flows. Following Stiglitz’s analysis, we can infer financial liberalization in Asia might have failed to deliver the goods because of: firstly financial liberalization might have been misunderstood as a simple mirror image of financial repression (Kaul 1999) and regarded merely as deregulation of interest rates, privatization of state-owned financial institutions and promotion of competition in financial markets, elimination of directed credit, and removal of foreign exchange controls and secondly even if the blueprint for reform was a correct one, its implementation might have strayed from its true course because of the pressures of various interest groups. For instance, according to Park (1998), the Western governments pressured the developing countries to open their capital markets for foreign investment although they were aware that the accounting practices and disclosure requirements in the developing countries did not conform to the accepted standards and that the supervisory authorities in those countries did not enforce rules and regulations as tightly as they should.

1.4 HOW TO PURSUE FINANCIAL LIBERALIZATION?

The first real-life test of the McKinnon-Shaw (1973) thesis of interest rate deregulation was southern cone experiment when Argentina, Chile, and Uruguay implemented financial liberalization policies in the late 1970s which led to skyrocketing interest rate, bankruptcy of many solvent firms, and an eventual financial crisis in 1982. This failure of financial liberalization is attributed to unsuited macroeconomic environment by the researchers like McKinnon (1988: 387–88) who considers macroeconomic stability and sound regulatory framework as preconditions for successful financial liberalization which he thought, was difficult to create in the developing countries where human capital and knowledgeable auditors or supervisors were in short supply.

1.4.1 MACROECONOMIC PRECONDITIONS

According to McKinnon (1991), for successful financial liberalization, the following steps are essential:-

- The first step is the establishment of an appropriate macroeconomic policy, which includes fiscal control, balancing the government budget, privatizing state-owned enterprises, and ensures an adequate internal revenue service for the purpose of tax collection.
- The second step is the liberalization of domestic financial markets by allowing interest rates to be determined freely by the market, freeing up onerous reserve requirements, and privatizing the banks. This step also includes the establishment of commercial law and the liberalization of domestic trade.
- The third step is the liberalization of foreign exchange, which includes the liberalization of the exchange rate for current account transactions and that of tariffs, quotas, and other international trade restrictions.
- In the final step, international capital flows are to be liberalized.

According to Stiglitz (1989), market failure is an inherent characteristic of financial markets. Financial liberalization may lead to an inefficient allocation of financial resources (Cho 1986) in developing countries due to credit-rationing by banks and lack of well-functioning equity market. The use of the equity market for raising funds is more limited in developing than in developed countries because the former generally have a less developed equity market than the latter and are subject to greater uncertainty, particularly where the political system is unstable. Furthermore, the small firms have inefficient capital allocation among their sub-units and imply greater difficulty in collecting, evaluating, and disseminating information, which poses problems for financial intermediaries. Even when firms are large, the relative weakness of regulatory institutions impedes full disclosure and adequate provision of information to the market.

1.4.2 INSTITUTIONAL PRECONDITIONS

The institutions necessary for a market economy must be purposefully created prior to financial liberalization (Akyüz 1993, Villanueva and Mirakhor 1990, Caprio et al. 1994, Gertler and Rose 1996, Demirguc-Kunt and Detragiache 1998, Drees and Pazarbasioglu 1998, and Sikorski 1996). The developing countries do not have the institutions necessary for free-market policy and, furthermore, those institutions do not get established quickly and spontaneously, therefore adopting free market policy in short period is not possible.

Which strategy and sequencing a country adopts in reforming its financial system, moreover, depends on its initial conditions and the speed of institution building. As a matter of fact, another World Bank study on financial reform concludes that, "…recommendations for any country's financial system need to be 'tuned' to the institutions and culture of the country" (Caprio and Vittas 1997: 3).

According to Caprio (1994), the outcome of financial reform depends:-

- Firstly on the overall net worth of banks and the initial mix of their assets at the time of reform.

- Secondly on the initial stock of human capital as bankers need to have skills in risk assessment and the ability to gather information about new potential credit, if they are to make correct loan decisions.
- Thirdly on the initial stock of information capital, which in turn depends on the existence of audited financial statements, developed equity markets, and the level of acquisition of public and client-specific information.
- The fourth requirement for successful financial reform is the existence of a system of rules and procedures for the implementation of decisions within banks.

As pointed out by Caprio (1994: 61), these requirements cannot be implemented overnight as their development requires time and diligence. A developing country will have to develop its own financial system keeping in view its political, economic, sociological, legal and institutional conditions in the development of its financial system.

1.5 CONCLUSION

In conclusion one finds that financial sector liberalization has occurred in a wide range of countries since 1973. Almost all developing countries have now at least partially liberalized their financial sector. The process has varied greatly; both in terms of speed and sequencing. The evidence suggests that financial liberalization has yielded positive results in terms of greater financial depth and increased efficiency in the allocation of investment but it has not brought the boost in the savings as was predicted by McKinnon and Shaw. It also suggests that a positive, but modest, real interest rate would be most conducive to secure a high rate of saving. This rate of saving is also an optimum from the view point of avoiding financial crisis. The danger that liberalization will lead to such a crisis is the most important drawback in the entire process, the other drawback being a loss of monetary control.

Also the research on financial liberalization and the Asian crisis makes it clear that financial liberalization needs to have macroeconomic & institutional preconditions and be tuned, as argued by Caprio and Vittas (1997), to the institutions and culture of the country if it is to be successful in creating a well-functioning market-based financial system.

The purpose of any reform is to ensure economic stability and then sustainable economic growth. No doubt, market based financial system can do it most efficiently, but that is the case only when there are no market failures. Financial deregulation/ liberalization, does not by itself bring about a stable and efficient market-based financial system, when it is carried out without a coherent strategy, and without institutions and financial market infrastructure necessary to guard against the market failures (which replace the Governments' role against the market failures).

Thus, before any country decides to undertake financial liberalization, it must ensure if it is correct policy for it to adopt in lieu of its economic, social, cultural and institutional conditions and if so, it must be carried out prudently according to the policy blueprint and in proper sequenced manner.

Chapter 2

2 FINANCIAL LIBERALIZATION AND REFORMS IN PAKISTAN

Pakistan was on the verge of default in May 1998 and had been put in selective default category by S&P and Moody's (In short, primarily due to political instability, inconsistent economic policies, lack of common vision and leadership and national & international issues like two wars with India, Afghan War, Gulf War etc). So, it was the need of the time to formulate a strategy, not only to improve the situation but also to ensure stability and sustainable economic growth. In December 1999, the present Government formulated and started implementing policy to achieve macroeconomic stabilization through fundamental structural reforms and improved governance which they believed would lead to sustainable growth and poverty reduction. The purpose was not just the crisis management or pursuing simply stabilization (as these were short term objectives) but to ensure long term stability and a platform for economic take off. Before looking into the Financial Reforms & Policy measures, their outcome and evaluation let's have an overview of Pakistan's economic development and impact of financial liberalization in Pakistan.

2.1 PAKISTAN'S ECONOMIC DEVELOPMENT: AN OVERVIEW

Pakistan experienced persistent uneven development ever since the country was established in 1947. The first few years were the most difficult ones, given the violence and the refugee problems. Its economic performance was very poor in the first decade. The 1960s witnessed a sharp favorable as growth approached 6 percent and since then the country has experienced fair economic growth, though with cyclical downturns. Average annual real GDP growth rates were 6.8% in the Sixties, 4.8% in the Seventies, and 6.5% in the Eighties which fell to 4.6% in the Nineties, with significantly lower growth in the second half of that decade. Growth trend was maintained at 5-6 percent per annum until mid-1990s. The major reasons for cyclical growth (fluctuating) were endemic political instability and huge defense expenditure for strategic & security reasons (essentially to regain a disputed land over which India and Pakistan had fought seven small/big wars). War-mongering is part of the political culture that slowly evolved to justify the huge resource mobilization for these wars: all political parties had to subscribe to war, and that is a major handicap for this country. Another main obstacle to development is the high population of 160 million growing at 2.7 percent per annum, which is considered to be one of the highest in developing countries. Even Bangladesh has reduced birth rate below this level.

Pakistan has traditionally a mixed economy. Pakistan kept the traded sector quite open, though the domestic sector had pervasive price distortions. The traded sector was relatively liberalized. The financial sector had all forms of controls to support a system of subsidies for agriculture and industries. The outcome was a lack of fiscal discipline, and the public services fostered (thus diminishing economy’s ability to grow) endemic inefficiencies in the process of intervening in the market pricing process. Educational, social and health services were considered least important for budgetary allocation.

Although the trade sector was liberalized at an early stage but the capital and current accounts were closed along with stringent financial suppression that distorted domestic prices, made perverse by subsidies. The country had neither a capital nor an industrial base at the time of its birth in 1947. Obviously, the basic focus then was on agriculture and agro-based industries. The 1960's witnessed the Green Revolution, when resources were applied to increase per capita outputs. Shortage of natural resources, especially irrigation water, required spending huge amounts of domestic resources as well as foreign aid loans to introduce a canal irrigation system as a backbone for agricultural output required to feed a growing population. These efforts resulted in reduced dependence on food imports, especially wheat, and increased export earnings from cash crops such as cotton, rice, jute and sugar cane.

Only after this foundation in agriculture was laid in the 1960s, that private sector became interested in manufacturing industries such as textile, cement, fertilizer, etc. Meanwhile, investment was made in the services sector, to build infrastructure in banks and financial institutions, educational institutions and health facilities. The public sector, however, could not accelerate investment in these sectors as a large proportion of domestic resources were allocated for defense in a period of rule by generals. Despite that, some industrial sector development did occur in textile and agro-based industries. During the next four decades, Pakistan experienced complete political instability with military regime takeover five times. All efforts of any economic planning proved to be unsuccessful due to political instability and border issues with neighboring India, which included seven direct or indirect border clashes. The collapse of the Eastern wing of the country (now Bangladesh) in December 1971 was a further blow to economic prosperity. The nationalization drive in 1972-75 reversed the process of any private sector participation in economic development. Until 1980, distortions such as subsidized agriculture and industrial activities were the norm. By any stretch of imagination, this was not pro-growth, nor did it result in the market mechanism to work unhindered on the prices in the different sectors. During 1984-90, the authorities became desperate and could only do one thing, which is to reduce and eventually eliminate these subsidies. In these reforms, IMF structural stabilization program and the USAID economic aid package did what the political elites failed to do for quite a long while.[1] Later, the Russian occupation of Afghanistan which left Pakistan with no option but to become a direct partner to the US-led coalition war brought a culture of drugs, ammunition, and terrorist activities in the country diverting the resources from economic planning to internal security concerns during the regime of General Zia.

Besides political instability, many economic factors were responsible for this decline in growth in 1990s. These include financial resource limitation, persistent fiscal imbalances, inadequate infrastructure, declining export demand, declining foreign reserves and soaring international debt.

In 1990, a major package of economic reforms was introduced. It had a wider focus on many development issues; exchange rate and payment reforms, privatization, trade deregulation and financial sector reforms. This was supposedly a more serious attempt at reforms than the reform in the 1980s. However, a lack of political consensus built to implement these policies, high level of corruption and political instability could not help the economy to grow. The result was just a meager progress that did not solve the many problems of a young new country founded on a vision to give its people more

[1] During 1982-88, Pakistan was the second largest recipient of economic aid from the United States Agency for International Development (USAID).

prosperity.

Timely assistance from IMF helped the country to avoid the worst scenario. The revival of economic reforms was expected soon to take centre place and the government focused on these reforms as its main agenda. Some drastic measures were also announced including reforms in tax collection system, downsizing the government and incentives to attract foreign capital both from foreigners and nationals living abroad. To these were added a wide range of reforms in financial sector, which included capital markets, central bank and commercial banks. These measures, however, failed to produce any positive result as gross domestic savings and investment continue to remain extremely low. The government attempted on its own and on the behest of IMF and the World Bank to curtail public spending and improve revenue collection mechanism. Despite the assurances and securities provided, investor confidence did not improve given the continued political instability.

In the later half of 1990s, another insidious problem emerged: non-performing loans of the private sector worsened. The banking and financial sector suffered loan defaults of about 7 percent of GDP in 1997 (Asian Development Outlook, 1998; p. 135). On the external sector, the country was facing three basic problems. One, remittance from nationals working abroad was declining; two, a reduction in demand for exports; and three, a huge allocation of funds for debt servicing. Foreign debt in 1999 stood at US$29.0 billion, which was 44.5 percent of GDP. Although, efforts were made to accelerate exports, but this sector remains sluggish, just got worse with decline of 2.7 percent in 1997.

2.2 FINANCIAL LIBERALIZATION IN PAKISTAN

Financial liberalization is part of financial reform process and particularly refers to deregulation of interest rates. Financial deepening (M2/GDP ration), savings, investment and economic growth are indicators of its effectiveness.

2.2.1 FINANCIAL DEEPENING

Indicators of Financial and Capital Market Depth are listed in Table 2. M3/GDP which was more or less stable until 2001 has slightly increased to around 56 percent in 2002 and has been stagnant since then. It's very low as compared to some other Asian economies such as Singapore (163 percent) or Korea (108 percent).

The financial intermediation ratio shows that public sector is a major borrower in the credit market. The ratio of public and private sector claims are almost the same, which is very different to those of East Asian countries, where private sector seems to be much active and efficient. Gross capital formation was almost stagnant until 2000 when it started declining. The foreign direct investment improved significantly since 1993, though still very low as compared to some relatively developed countries in the region. The huge burden of fiscal deficits forces the government to involve in substantial borrowing activities. In periods, when foreign borrowing becomes difficult, the government has no option but to borrow domestically, thus leaving the total borrowing unchanged. The numbers provided in Table 2.1 do not attest to any significant impact from liberalization. This may be due to the fact that the liberalization process that was initiated in 1991 could not be continued until 1995 due to political instability.

Table 2.1: Indicators of Financial and Capital Market Depth in Pakistan

(Percentage Annual Averages)

Indicators	**1961-70**	**1971-80**	**1981-90**	**1991-95**	**1996-2000**	**2000**	**2001**	**2002**	**2005-06**
Money Depth (M3/GDP)	40.3	46.8	49.6	50.4	49.7	50.2	50.8	55.5	55.3
Intermediation Depth:									
FIR (total)/GDP (=DC/GDP)	38.4	45.5	51.2	52.7	50.6	49.6	45.5	42.3	
FIR (Private)/GDP	19.2	23.7	28.6	26.9	27.9	29.7	28.4	27.1	30.1
Capital Accumulation:									
GCFC/GDP	15.4	15.4	16.9	18.1	15.4	14.4	14.3	12.3	
FDI (Net)/GDP	-	-	0.39	0.81	1.03	0.54	0.75	-	-
FDI (Inflow)/GDP	-	-	0.38	0.81	1.01	0.53	0.69	-	-
Indebtedness:									
Domestic Borrowing/GDP	1.84	3.42	5.29	5.60	4.89	4.56	2.51	3.35	2.7
Foreign Borrowing/GDP	3.34	3.74	1.45	2.06	2.03	0.91	2.20	1.27	1.53

Source: Ahmed M. Khalid (2006), .Economic Survey of Pakistan

M2 = Currency + quasi money; M3 = M2 + Other Deposits; FIR = financial intermediation ratio; claims on public + private sector (total credit), on private sector (private); GFCF = Gross fixed capital formation; FDI=foreign direct investment (net); FDI (In): foreign direct investment (inflow).

Mickinnon-Shaw hypothesis suggests that financial liberalization, which advocates that the reasonably high and positive real interest rates in a liberal environment would induce large financial savings. This would in turn increase credit supply to the firms and allows the firms to carry out positive net present value projects, which were previously constrained by credit availability in a financially repressed economy with, for example deposit interest rate ceiling (India and China being two good examples in the pre–1990s). Increase in capital accumulation would lead to economic growth. There is also an opposing effect on the investment. The rise in real interest rate increases the cost of borrowing and decreases investment outlays. Thus, strictly, the effect on growth may be ambiguous depending on which effect is dominant. If economic growth is stimulated by financial liberalization due to the dominance of the credit effect, then a virtuous circle of higher savings, investment and growth would open up as savings out of current income rises when income increases.

2.2.2 SAVINGS, INVESTMENT & GROWTH

Ahmed M. Khalid (2006) uses the data which is split into five groups to see the impact of liberalization on savings, investment and growth. The five groups are, 1961-2002 (the complete period); 1961-1980 (pre-liberalization period); 1961-1988 (denationalization initiated); 1981-2002 (post-liberalization) and 1989-2002 (2nd phase of liberalization). The results of his findings are summarized as under:

- In the pre-liberalization period (until 1988), total saving is only influenced by the real GDP and its own lag and the same is true for the complete sample (1961-2002) as well. Financial saving is measured by the difference between M3 and M1. This basically includes relatively less liquid to highly illiquid assets. The results do not reflect any impact of liberalization policies on financial saving. It is mainly determined by real income. Any macroeconomic variable consistent with financial liberalization hypothesis, would have had some impact on financial saving is statistically insignificant.

- The results suggest that the investment demand in Pakistan is determined by lagged real income, domestic credit and financial saving. In the absence of a developed capital market for corporate bonds and equity, supply of domestic credit becomes dominant in fulfilling the demand for investment. Real interest rate show statistical insignificant negative relationship with investment.
- The results for the first sample (1961-2002) show that the growth is negatively related to government saving due to huge budget deficits (basically used to service debt) which erodes any resources available for real sector. Capital flight is negatively related to economic growth and is consistent with the theoretical expectations. The results are very much the same in all sample periods.

Financial liberalization was pursued slowly in 1980's, seriously in 1990's and aggressively after 1999 by the present Govt. as a part of its financial reforms & development strategy to secure sustainable economic development and social development. These reform policies were first initiated in early 1980s (with denationalization) and then major steps were taken in 1990 to revamp the whole financial system. It is unfortunate to note that these policies have not been successful and effective. In the light of literature (Chapter I), we can say that impact of financial liberalization is not significant in case of Pakistan as the prerequisites of macroeconomic stability, political stability and institutional preconditions are not met.

2.3 FINACIAL REFORMS & POLICY MEASURES BY THE PRESENT GOVERNMENT

In May 1998, the country's decision to retaliate to the Indian atomic explosion by their own nuclear explosion brought severe economic sanctions by the world. The result: by the end 1999, the country had exceptionally high level of debt with foreign exchange reserves enough for mere 3-months of imports. This economic mismanagement led to another military takeover in October 1999. In December 1999, the present Government formulated and started implementing policy to achieve macroeconomic stabilization through fundamental structural reforms and improved governance which they believed would lead to sustainable growth and poverty reduction. Following major measures were taken.

2.3.1 DEBT RESTRUCTURING

The first and foremost measure was to find a durable solution to the external debt problem as it was the major cause of stress to the economy. Major debt was owed to multilateral institutions and the bilateral official creditors with former unassailable and thus the focus was centered on the bilateral debt re-profiling. Pakistan was able to reach an agreement with the IMF on a three-year Poverty Reduction and Growth Facility (PRGF) of which the debt restructuring was an integral part. The success on the external debt front was absolutely essential for macroeconomic stability and prior to the approval of PRGF all the pre-requisites for obtaining debt re-profiling on a long term basis were fulfilled.

2.3.2 FISCAL AND TAX REFORMS

The fiscal policy reforms and consolidation by raising tax revenues, reducing expenditures, cutting down subsidies of all kinds and containing the losses of public enterprises were also carried on concurrently with the debt restructuring. Tax reforms were undertaken to widen tax base, remove direct contact between tax payers and tax collectors, introduce value-added tax as the major source of revenue, simplify tax administration and strengthen the capacity of the Central Board of Revenue.

2.3.3 PRIVATIZATION AND FINANCIAL SECTOR REFORMS

The next major thrust of the reform program was to accelerate the process of privatization of state-owned enterprises which was initiated in 1991 under the Nawaz Sharif Government, continued under the Benazir Government because of an underlying philosophy that the Government should not be in the business of running businesses but regulating the markets and laying down policies. The Central Bank was granted autonomy and the control of the Ministry of Finance (MOF) over banking institutions was diluted. Excess labor was shed off through voluntary golden hand shake schemes (under which employees who opted for retirement were paid handsome amounts in addition to their regular emolument) and unprofitable branches were closed down. The voluntary golden hand shake schemes were introduced by the government whereby the employees were offered lump sum amount much greater than the normal pension if they voluntarily resign from their jobs.

2.3.4 TRADE LIBERLIZATION AND FOREIGN INVESTMENT

Trade liberalization has been undertaken in Pakistan for the last 15 years and the maximum tariff rate which was as high as 250-300 percent has been brought down to 25 percent while the average tariff rate is about 9 percent. Uniform rules and regulations have been implemented for both domestic and foreign industry to improve efficiency and compete in the world. The foreign investors can transfer their profits freely, raise funds from domestic sources, without any restrictions and are treated equally with national firms. Oil and gas, telecommunication and civil aviation sectors have also been deregulated.

2.3.5 GOVERNANCE AND INSTITUTIONAL REFORMS

The cornerstone of the governance agenda is the devolution plan which was put into effect in 2001 to transfer powers and responsibilities to elected local representatives, as opposed to bureaucrats sitting in provincial and federal capitals. Devolution of power will thus strengthen governance by increasing decentralization, transparency, accountability of administrative operations, and people's participation in their local affairs. Other essential ingredients for improving economic governance are the separation of policy and regulatory functions, which were earlier combined within the ministry. Civil service reforms aimed at improving recruitment, training, performance management, career progression, right sizing of ministries and attached departments, and improving compensation for government employees are part of the second generation reforms of the government for building strong institutions in the country. The reforms in some of the most important federal institutions - the Central Board of Revenue (CBR), Securities and Exchange Commission of Pakistan (SECP), the State Bank of Pakistan (SBP) and Pakistan Railways–were initiated by the government. Reforms in access to justice will deal with delays in the provision of justice, case management, automation, and court formation systems.

2.4 FINANCIAL REFORMS & POLICY OUTCOMES

The financial and economic reforms initiated by the Government have brought about economic turn around if compared with the situation as was prevailing in 1998. Today Pakistan's international credit rating is Ba2 – only three notches below investment

Table 2.2 GDP & Sector Growth Rates

INDICATORS	1960's	1970's	1980's	1990's	2001-03	2004-06
	Average Annual					
Growth Rate (%) (CONST fc)						
GDP	6.8	4.8	6.5	4.6	3.3	7.6
Agriculture	5.1	2.4	5.4	4.4	0.7	3.8
Manufacturing	9.9	5.5	8.2	4.8	6.9	11.7
Commodity Producing Sector	6.8	3.9	6.5	4.6	2.2	7.6
Services Sector	6.7	6.3	6.7	4.6	4.4	7.6

Source: Economic Survey of Pakistan 2006

grade. Pakistan's GDP growth rate has consistently averaged 7.6 percent during period 2004-06 (Table 2.2), per capita incomes have shot up to almost US$850, the incidence of poverty has declined from 34 percent to 25 percent, unemployment rate has gone down to 6.2 percent and the size of the economy has doubled to $130 billion.

2.4.1 DEBT RESTRUCTURING

External debt and liabilities as ratio of GDP has declined from almost 52 percent to 28 percent and as a percentage of foreign exchange earnings down to 125 percent from almost 300 percent six years ago. The myth that Pakistan is highly dependent upon official foreign assistance and particularly that from U.S. can be gauged from the fact that less than 9 percent of country's foreign exchange income is derived from official aid. Official Development Aid (ODA) per capita is only $8 or 1% of Gross National income. Forex reserves have risen from $1 billion in 1999-2000 to $13 billion in May 2006 representing about 6 months of imports.

2.4.2 FISCAL AND TAX REFORMS

Although these reforms are still underway, the adoption of universal self assessment followed by random audit of selected tax returns, automation and reorganization of the tax machinery has begun to help improve tax collection although tax-GDP ratio has not yet improved to any significant extent. The total revenue came down to 14.1% during the period 2001-2006 from 17% in the 1990's but total expenditure has also been brought down to 18.2% during the period 2001-03 and further reduced to 17.5% during 2004-06. This has resulted in reduction of overall deficit to 3.3% during 2004-06 from around 7 % of GDP in the 1990s (Table2.3).

2.4.3 PRIVATIZATION AND FINANCIAL SECTOR REFORMS

Pakistan's record on privatization has been impressive and this has helped in stopping the hemorrhaging of public finances and easing the pressures on fiscal deficit. Pakistan's proceeds from privatization of banks, telecom, steel and other public enterprises were about $3 billion in the last few years.

Table 2.3 Fiscal Policy Indicators

INDICATORS	1960's	1970's	1980's	1990's	2001-03	2004-06
	Average Annual					
GROWTH RATE (%)						
FISCAL POLICY						
As % of GDP(Current MP)						
Total Revenue	13.1	16.8	17.3	17.1	14.1	14.1
Tax Revenue	-	-	13.8	13.4	11.0	10.5
Non-Tax Revenue	-	-	3.5	3.7	3.1	3.3
Total Expenditure	11.6	21.5	24.9	24.1	18.2	17.5
Current Expenditure	-	-	17.6	19.4	15.9	13.4
Defense	-	-	6.5	5.6	3.3	3.2
Interest Payment	-	-	3.8	6.8	5.5	3.3
General Admn.	-	-	1.3	1.9	2.2	2.1
Development Expenditure	-	-	7.3	4.7	2.4	3.6
Overall Deficit	2.1	5.3	7.1	6.9	4.1	3.3

Source: Economic Survey of Pakistan 2006

As a result of these reforms, the share of the private sector ownership of the banking assets has risen to 80 percent. The banks are highly profitable and the average lending rates had declined to as low as 5 percent as automation, on-line banking and multiple channels of delivery improved the efficiency of services and a healthy competitive environment set in. Agriculture credit, Small Medium Enterprises (SME) financing, consumer loans and micro credit have become mainstream products of the banking industry and the borrower base of the banking system has multiplied from 1 million to 4 million households. Large scale manufacturing has grown in double digits and the cumulative private sector credit by banking system in last three years was more than $15 billion compared to less than $10 billion in the previous ten years. Market capitalization of the stock exchange has grown steadily and averaged 30% of GDP during 2001-03 and 63.3% during 2004-06 as compared to 13.4 % during the 1990’s (Table2.4).

Financial assets have grown by 70% over the past five years and by end-CY05 reached Rs 5.1 trillion, equivalent to 80% of GDP. Banking sector grew at a faster pace relative to non-bank sectors and currently accounts for 71% of the financial industry assets. There has been exceptional growth in the profitability and efficiency of the financial services industry.

Table 2.4 Money & Credit and Stock Market

INDICATORS	1960's	1970's	1980's	1990's	2001-03	2004-06
	Average Annual					
GROWTH RATE (% of GDP)						
Monetary Assets(M2)	16.3	21	13.2	16.8	14.1	16.3
Domestic Assets	15	20.5	15.4	12.2	2.1	19.0
STOCK MARKET (Growth Rates)						
General Index for Share Prices	-	-	0.1	4.1	21.9	36.6
Aggregate Market Capitalization	-	-	2.5	13.4	30.0	63.3

Source: Economic Survey of Pakistan 2006

2.4.4 TRADE LIBERLIZATION AND FOREIGN INVESTMENT

Trade – GDP ratio has reached 38 percent – one of the highest in South Asia region. Exports have doubled in U.S. dollar terms in last four years attaining a level of $18 billion. Foreign Direct Investment (FDI) flows have been rising every year and amounted to more than $3 billion or 2.3 percent of GDP – the highest in South Asia. Private capital flows in form of workers' remittances and other current transfers are touching $9 billion annually. On the external front, Pakistan successfully entered international capital markets in early 2004 and has received enthusiastic response every year since then. Every single sovereign bond issue was oversubscribed several times and the pricing was better than that of investment grade countries. In 2006, Pakistan was able to raise more than $1 billion in 30 year and 10 year sovereign bonds in the U.S. market at fine pricing and these bonds were heavily oversubscribed. At the same time, outlays on public sector development expenditure tripled in this period, accelerating investment in infrastructure and human development.

Table 2.5 Balance of Payments (Growth Rates %)

INDICATORS	1960's	1970's	1980's	1990's	2001-03	2004-06
	Average Annual					
Private Transfers(net)			2.3	5.9	23.8	7.9
Workers Remittances			1.9	-5.3	69.2	0.5
As% of GDP(MP)						
Exports (FOB)			9.8	13	12.8	11.8
Imports (FOB)			18.7	17.4	13.7	15.7
Trade Deficit			8.9	4.4	0.9	3.9
Current Account Deficit			3.9	4.5	2.1	1.2

Source: Economic Survey of Pakistan 2006

After a consistent reduction in macroeconomic imbalances over FY00-04, the fiscal and external current account deficits have been above the targeted levels for FY06 and are likely to remain in that range in FY07. Most notable is the concern regarding trade deficit which is around $8.2 billion in FY06. Around 45% of the increase in trade deficit for July-May FY06 over the comparable period in the preceding year is on account of the rise in import bill for crude oil and petroleum products, 39% due to higher imports of machinery, 11% because of iron and steel and 14.3% for food and fertilizers.

2.4.5 GOVERNANCE AND INSTITUTIONAL REFORMS

The role of effective accountability through regulatory agencies is very important and pivotal in improving the quality of governance and quality of working in institutions. The National Accountability Bureau (NAB) has been functioning quite effectively for the last five years as the main anti-corruption agency. A large number of high government officials, politicians and businessmen have been sentenced to prison, subjected to heavy fines and disqualified from holding public office for twenty-one years on charges of corruption after conviction in the courts of law. Major loan and tax defaulters were also investigated, prosecuted and forced to repay their overdue loans and taxes. However, it will take some time so that the informal institutions take their place and start working efficiently along with the formal institutions.

2.5 FINANCIAL REFORMS & POLICY EVALUATION

Pakistan's economy had, until a few years ago, been characterized as unstable and highly vulnerable to external and internal shocks. However, the economy proved to be unexpectedly resilient in the face of multiple adverse events concentrated into a 2000-06 period —

- economic sanctions — according to Colin Powell, Pakistan was "sanctioned to the eyeballs";
- global recession;
- severe rioting in the port city of Karachi;
- a severe drought — the worst in Pakistan's history, lasting four years;
- heightened perceptions of risk as a result of military tensions with India — with as many as a million troops on the border, and predictions of impending (potentially nuclear) war;

- the post-9/11 military action in neighboring Afghanistan, with a massive influx of refugees from that country;

Despite these adverse events, Pakistan's economy kept growing, and economic growth accelerated towards the end of this period. This resilience has led to a change in perceptions of the economy, with leading international institutions such as the IMF, World Bank, and the ADB praising Pakistan's performance in the face of adversity. Pakistan's economic outlook has brightened in recent years in conjunction with rapid economic growth and a dramatic improvement in its foreign exchange position as a result of its current account surplus and a consequent rapid growth in hard currency reserves. In the last decade of the twentieth century, Pakistan had experienced severe fiscal imbalances — its debt had grown rapidly during the 1990s. Nuclear tests in May 1998 triggered the imposition of economic sanctions by the G-7, and in early 1999 Pakistan narrowly averted defaulting on its debt. Although the country had been receiving IMF assistance, the government had difficulty meeting the conditionality of the IMF program, which was suspended in July 1999 and resumed later during the administration of General Pervez Musharraf. Having improved its finances, Pakistan's government announced in 2004 that it would no longer require IMF assistance, and the assistance program ended in that year. Economic agenda of the Government continues to include measures to widen the tax net, privatize public sector assets, and improve its balance of trade. Pakistan has made governance reforms, privatization, and deregulation the cornerstones of its economic revival. In the first four years of the twenty-first century, Pakistan's KSE 100 Index was the best-performing stock market index in the world as declared by the international magazine “Business Week”.

Table2.6a Social Development Indicators

INDICATORS	1960's	1970's	1980's	1990's	2001-03	2004-06
	Average Annual					
Education						
Expenditure as % of GNP			0.8	2.3	1.7	2.1
Literacy Rate Percent			29.5	40.7	50.4	53.0
Male			39	51.6		65.0
Female			18.7	28.6		40.0
Health						
Registered Doctors (000 Nos.)	2	6.3	28.1	68.9	96.6	113.2
Hospitals(Numbers)	380	521	651	823	896.3	913.7
Exp on Health as % of GNP		0.6	0.8	0.7	0.7	0.6

Source: Economic Survey of Pakistan 2006

Table 2.6b Human Resource Indicators

INDICATORS	1980's	1990's	2001-03	2004-06
Population	Average Annual			
Population(Million)	96.3	124.6	144.4	152.5
Labor Force(Million)	11.6	35.1	42.1	45.5
Employed Labor Force(Million)	11.2	33.1	39.1	42.0
Un-employed Labor Force(Million)	0.4	2	4.5	3.6
Un-employment Rate(% per annum)	1.4	5.7	7.2	7.5
Crude Birth Rate Per 1000			18.7	27.1
Crude Death Rate Per 1000			5.4	8.1
Infant Mortality Rate Per 1000			56.0	80.7

Source: Economic Survey of Pakistan 006

Although the Govt. has received appreciation from International Financial Institutions for its financial and reforms and improved the economic situation significantly as compared what it was in 1999, yet there are number of concerns. The country has yet not strong industrial base & infrastructure and lacks far behind than other countries on the technology frontiers. The World Bank considers Pakistan a low-income country, although it is recorded as a "Medium Development Country" on the Human Development Index 2005 and its rank on UN Human Development Index is 134^{th} in 2006. The level of corruption is quite high as indicated by the corruption perception index rank i.e., 142^{nd} in 2006. The expenditure on education and health has been around 2% and 0.7 % (Table2.6a) respectively through 1990's till now.

Resultantly still the social development and human development indicators are very low. Low allocation of resources to socio-economic development or infrastructure projects has resulted in inadequate provision of social services and very high birth rates in the past have contributed to a persistence of poverty which is still around 25% reduced from 32.1 % in 2000-01. The rural poverty has declined from 39 percent to 31.8 percent and urban poverty from 22.7 percent to 17.1 percent. Pakistan has a family-income Gini index of 41, close to the world average of 39.On measures of income inequality, the country ranks slightly better than the median.

2.6 CONCLUSION

Pakistan has political and economic history of 60 years characterized by political and economic instability. Five times military has taken over and ruled for 32 years, the remaining 28 years, government has been in hand of politicians with almost 20 prime ministers. Apart from this Pakistan's economy has been hit by two wars with India, Afghan War, Gulf War and Involvement in War against terror.

Financial and economic reforms have been pursued by various governments but due to political inconsistency they have not been implemented in letter and spirit. Financial liberalization does not show any significant impact on economy due to absence of political and macroeconomic stability preconditions and most importantly the institutional preconditions.

Present Govt. (backed by military general) has also initiated various financial & economic reforms and continued financial liberalization under the guidance from IMF and World Bank. It has been able to bring about some macroeconomic stability duly appreciated by international financial institutions. Although the present govt. has also introduced institutional and regulatory reforms in order to strengthen the institutions but firstly the Military President and secondly the recent Judiciary Crises (whereby the President ousted the Chief Justice of Supreme Court) clearly show institutional weakness both formal and informal.

Pakistan is a developing country with weak industrial base, underdeveloped infrastructure and not very promising social and human development indicators. The Govt. may continue to pursue financial liberalization and reforms under guidance/ pressure from international institutions but it has to play dynamic and proactive role in order to join the developed nations.

Chapter 3

3 EVOLUTION OF KOREAN FINANCIAL SYSTEM

The economy of South Korea is one of the largest economies in the world. It ranks 10th in the world and is Asia's 3rd largest economy according to GDP measured by nominal, as of 2006. Just after the Korean War, South Korea was one of the poorest countries in the world—yet, today South Korea is one of the richest nation in the world: Per capita gross national product, only $89 in 1962, exceeded $16,000 in 2005(Table 3.1). Korea has been cited as one of successful countries with relatively low income inequality and rapid growth. Gini index 0.35 & per capita growth rate 7.25 from 1965-1990. Absolute poverty declined steeply from 48% in 1961 to less than 10% entering 1980s. South Korea had the fastest growing economy in the world's history during mid and late 20th century, advancing at double-digit figures; this unbelievable economic development is often referred to as the "Miracle of the Han River".

The core of the South Korean economy has changed substantially over the country's six-decade existence. In the 1940s, the country was predominantly agricultural, with little industry. The emphasis shifted to light industry and consumer products in the following decades and then to heavy industry in the 1970s and 1980s. In the first three decades after the Park Chung Hee government launched the First Five-Year Economic Development Plan in 1962, the South Korean economy grew enormously and the economic structure was radically transformed.

Table 3.1 Bird's Eye View of Korean Economy (1962-2005)

Economic Development	**1962**	**1992**	**1997**	**2005**
Per Capita GDP	**$89** **(101st)**	**$7,527**	**$11,176**	**$16,291** **(29th)**
Investment (% of GDP)	**13.8**	**37.3**	**36.0**	**30.1**

Exports (% of GDP)	**5.1**	**26.6**	**32.4**	**42.5**
Imports (% of GDP)	**16.8**	**27.7**	**33.0**	**40.0**
Social Development				
Life expectancy at birth	**55**	**72**	**74**	**77**
Infant mortality rate(per 1000 births)	**90**	**8**	**5.8**	**-**
Water Service Rate (%)	**18.2**	**79.0**	**85.1**	**-**
	1970	**1980**	**1990**	**2000**
Years School	**5.7**	**7.6**	**9.5**	**10.6**
High school enrollment ratio (%)	**28.1**	**63.5**	**88.0**	**96.4**
Tertiary school enrollment ratio (%)	**8.4**	**15.9**	**37.7**	**80.5**

Source: Lecture Slides (Evolution of Korean Financial System)

The rapid economic growth of the late 1980s was boosted by the 1988's Olympics in Seoul. The economy rapidly became mature during the 1990s and the exponential growth rate finally started to slow down to a still-robust approximate 6.5 percent as wages of Korean workers increased at the same rate. Much of the labor intensive industries moved away to neighboring countries such as China, Vietnam and Indonesia. As in other developed countries, the service sector has become increasingly dominant since the 1990s; it now comprises about two-thirds of the GDP. South Korea became a member of the OECD in 1996, joining the 'League of the Richest Nations in the World'. The economy was further boosted later in the 2002 World Cup, hosted by South Korea and Japan.

At the start of the 21st century, South Korea aimed to become the world's leading IT nation. In just 5 years Korean IT products & services captured leading market shares in the world and today, companies like Samsung leave all competition behind, including the Japanese Sony and American Microsoft, controlling key sectors of the IT industry such as semiconductors and still advancing at a very fast rate to-date.

South Korea has a very promising, futuristic economy and is one of the 'Next Eleven' economies and also one of the fastest developing mature economies: At its current speed, South Korea's economy is going to be in the same class as the United Kingdom and France by 2025. Many other sectors of the economy is planned to be created or extended, including the Financial, Biotechnology, Aerospace and Entertainment Industries.

3.1 HISTORICAL OVERVIEW

Following the Japanese occupation and the Korean War, the Syngman Rhee administration of the newly formed South Korean state used foreign aid from the United States during the 1950s to build an infrastructure that included a nationwide network of primary & secondary schools, modern roads, and a modern communications network. The result was that by 1961, South Korea had a well-educated young work force and a modern infrastructure that provided a solid foundation for economic growth.

3.1.1 BEGINNING IN THE 1960s

South Korea's real gross national product expanded by an average of more than 8 percent per year, from US$3.3 billion in 1962 to US$204 billion in 1989. Per capita annual income grew from US$87 in 1962 to US$4,830 in 1989. The manufacturing sector grew from 14.3 percent of the GNP in 1962 to 30.3 percent in 1987. Commodity trade volume rose from US$480 million in 1962 to a projected US$127.9 billion in 1990. The ratio of domestic savings to GNP grew from 3.3 percent in 1962 to 35.8 percent in 1989.The most significant factor in rapid industrialization was the adoption of an outward-looking strategy in the early 1960s because of South Korea's poor natural resource endowment, low savings rate, and tiny domestic market. This strategy promoted economic growth through labor-intensive manufactured exports, in which South Korea could develop a competitive advantage. Government initiatives played an important role in this process. The inflow of foreign capital was greatly encouraged to supplement the shortage of domestic savings. These efforts enabled South Korea to achieve rapid growth in exports and subsequent increases in income. By emphasizing the industrial sector, Seoul's export-oriented development strategy left the rural sector relatively underdeveloped. Increasing income disparity between the industrial and agricultural sectors became a serious problem by the 1970s and remained a problem, despite government efforts to raise farm income and improve living standards in rural areas.

3.1.2 SHIFT TO CAPITAL-INTENSIVE INDUSTRIES

Up to early 1970s the industrial structure had been based on low value-added and labor-intensive products, which faced increasing competition and protectionism from other developing countries. The government responded to this problem in the mid-1970s by emphasizing the development of heavy and chemical industries and by promoting investment in high value-added, capital-intensive industries which included iron and steel, transport machinery, household electronics, shipbuilding, and petrochemicals. The developers of heavy and chemical industries sought to supply new industries with raw materials and capital goods and to reduce or even eliminate dependence on foreign capital. New (and critical) industries were to be constructed in the southern part of the peninsula, far from the border with North Korea, thus encouraging economic development and industrialization outside the Seoul area and providing new employment opportunities for residents of the less developed areas. As a result, heavy and chemical industries grew by an impressive 51.8 percent in 1981; their exports increased to 45.3

percent of total output. These developments can be ascribed to a favorable turn in the export performance of iron, steel, and shipbuilding, which occurred because high-quality, low-cost products could be produced in South Korea. By contrast, the heavy and chemical industries of advanced countries slumped during the late 1970s. In the machinery industries, investments were doubled in electric power generation, integrated machinery, diesel engines, and heavy construction equipment; the increase clearly showed that the industries benefited from the government's generous financial assistance program. The structural transition to high value-added, capital intensive industries was difficult. Moreover, it occurred at the end of the 1970s, a time when the industrial world was experiencing a prolonged recession following the second oil price shock of the decade and protectionism was resulting in a reduction of South Korean exports. By 1980 the South Korean economy had entered a period of temporary decline: negative growth was recorded for the first time since 1962, inflation had soared, and the balance-of-payments position had deteriorated significantly.

3.1.3 STABILITY TO CRISES

In the early 1980s, Seoul instituted wide-ranging structural reforms. In order to control inflation, a conservative monetary policy and tight fiscal measures were adopted. Growth of the money supply was reduced from the 30 percent level of the 1970s to 15 percent. Seoul even froze its budget for a short while. Government intervention in the economy was greatly reduced and policies on imports and foreign investment were liberalized to promote competition. To reduce the imbalance between rural and urban sectors, Seoul expanded investments in public projects, such as roads and communications facilities, while further promoting farm mechanization. The Fifth Five-

Year Economic and Social Development Plan (1982-86) sought to shift the emphasis away from heavy and chemical industries, to technology-intensive industries, such as precision machinery, electronics (televisions, videocassette recorders, and semiconductor-related products), and information. More attention was to be devoted to building high-technology products in greater demand on the world market. The Sixth Five-Year Economic and Social Development Plan (1987-91) to a large extent continued to emphasize the goals of the previous plan. The government intended to accelerate import liberalization and to remove various types of restrictions and non-tariff barriers on imports. These moves were designed to mitigate adverse effects, such as monetary expansion and delays in industrial structural adjustment, which can arise because of a large surplus of funds. Seoul pledged to continue phasing out direct assistance to specific industries and instead to expand manpower training and research and development in all industries, especially the small and medium-sized firms that had not received much government attention previously. Seoul hoped to accelerate the development of science and technology by raising the ratio of research and development investment from 2.4 percent of the GNP to over 3 percent by 1991.These measures, coupled with significant improvements in the world economy, helped the South Korean economy regain its lost momentum in the late 1980s. South Korea achieved an average of 9.2 percent real growth between 1982 and 1987 and 12.5 percent between 1986 and 1988. The double digit inflation of the 1970s was brought under control. Wholesale price inflation averaged 2.1 percent per year from 1980 through 1988; consumer prices increased by an average of 4.7 percent annually. Seoul achieved its first significant surplus in its balance of payments in 1986 and recorded a US$7.7 billion and a US$11.4 billion surplus in 1987 and 1988 respectively. This development permitted South Korea to begin reducing its level of foreign debt. The trade surplus for 1989, however, was only US$4.6 billion dollars, and a small negative balance was projected for 1990.In the late 1980s, the domestic market became an increasing source of economic growth. Domestic demand for automobiles and other indigenously manufactured goods soared because South Korean consumers, whose savings had been buoyed by double-digit wage increases each year since 1987 and whose average wages in 1990 were about 50 percent above what they had been at the end of 1986, had the wherewithal to purchase luxury items for the first time. The result was a gradual reorientation of the economy from a heavy reliance on exports toward greater emphasis on meeting the needs of the country's nearly 43 million people. The shifts in demand and supply indicated that economic restructuring was underway, that is, domestic consumption was rising as net foreign demand was falling. On the supply side, the greater growth in services mirrored what the people wanted--more goods, especially imports, and many more services.

By 1990 there was evidence that the high growth rates of the late 1980s would slow during the early 1990s. In 1989 real growth was only 6.5 percent. One reason for this development was the economic restructuring that began in the late 1980s--including the slower growth of major export industries that were no longer competitive on the world market (for example, footwear) and the expansion of those industries that were competitive, such as electronics.

From the 1960’s to 1980’s Korea had a relationship based Institutional arrangement among the govt., banks, and the *chaebols:* i.e. Quasi-Internal Organization, which according to Chung H. Lee (1992) can be more effective than policy implementation through the market due to the sharing of information and economies in transaction costs. However, process of financial liberalization was initiated in slowly in early 1980 and accelerated in early 1990 as step towards the market based economy but it lead to corporate sector failures and ultimately 1997-98 financial crises.

3.2 FINANCIAL LIBERALIZATION, CRISIS AND REVIVAL IN KOREA

The financial liberalization in the early 1980s was undertaken as one of the menu for comprehensive stabilization program prepared by the Chun Doo-Hwan government. The comprehensive stabilization program included reduction in govt.'s deficit, tight monetary policy, wages control, trade liberalization, relaxing control over foreign investment, privatization of banks, and phasing out the subsidies to HCIs. These programs were designed by the newly empowered liberal economists in Korea, notably Kim Jae Ik, a Stanford Ph.D.

3.2.1 FINANCIAL LIBERALIZATION

In 1981, MOF selected Hanil Bank for privatization among the 5 banks which was completed in June 1981. Two major *chaebols* including Samsung acquired the controlling shares, raising questions on imposing an upper limit on the share a single company or individual could own. Little progress had been made until May 1982, when Chang Yong-Ja scandal involving four commercial banks broke out which coupled with mounting NPLs due to increases in insolvent debt-ridden firms in some industries amid world-wide recession after the 2nd Oil shock created a dead lock. Minister of Finance, Kang Kyung-Sik, came to occupy the upper echelons of the MOF, and resumed the privatization of three commercial banks, Korea First Bank and the Bank of Seoul and Trust Company in 1982 and the Chohung Bank in 1983. In Dec. 1982, the National Assembly passed an amendment to the General Banking Act. A ceiling of 8% was imposed on individual ownership of nationwide commercial banks. This restriction was further strengthened as the ceiling was lowered to 4% in 1994 in line with the progress in financial liberalization. As of the end of 1996, the combined shares of those who own more than 1% of the total voting stocks of nationwide banks accounted for 39.3% on average. Also, among large shareholders top 30 *chaebols* were predominant. Despite the bank ownership structure comparable to that of advanced countries, large shareholders of most banks had remained passive in exercising their voting rights and monitoring bank management. Government intervention in the appointment of CEOs of banks had prevented bank management from pursuing shareholders' interests. Indeed, the board of directors of banks had not been in a position to check the management in an independent manner.

Some barriers to entry into the financial industry were lowered and financial services provided by different intermediaries (both of banking and NBFIs) were diversified and streamlined. The curb market incident (Chang's scandal) in 1982 had made MOF to lower entry barriers to the NBFIs. As a result, number of NBFIs such as investment and finance companies and mutual savings and finance companies, increased conspicuously. Within a year, 12 new short-term finance companies and 57 mutual savings and finance companies were chartered. Unlike bank, NBFIs were free of ownership restrictions except life insurance companies and investment trust companies.

As the role of NBFIs continued to increase, the influence of *chaebol* on them did as well. In order to free interest rates and discontinue policy loans, the interest rate gap between policy loans and ordinary bank loans was almost completely eliminated in 1982. Despite the fact that the freeing interest rates constitute an integral part of financial liberalization, little progress had been made. The fundamental reason for this delay was that Korea's business, particularly *chaebols*, was highly leveraged, with high interest costs. Interest rate surge after deregulation was policymaker's major concern. It was only 1991 that a more extensive interest rate deregulation began to be undertaken on a step by step basis. All lending rates except the SME loans and most deposit rates except demand deposits were deregulated.

There were two more major constraints on Financial Liberalization. Financial liberalization was set back in the course of industrial rationalization and the bail-out period in the 1980s. The govt. involved in a large-scale restructuring of firms facing financial difficulties, because of overexpansion of the HCI in the 1970s and the collapse of foreign markets in overseas construction and shipping in the early 1980s. The Govt.-led bail-out policy forced banks to assume large NPLs as creditor banks were directed to reschedule or write-off debts incurred by troubled firms, and to provide additional financial resources as "seed" money. At the end of 1988, bank loans to firms designated for rationalization amounted to 7.3 trillion won, 12.6% of total bank loans. To mitigate the financial burden of the banks involved, the Bank of Korea delivered 1.7 trillion won of special credit, carrying a low interest rate of 3% per annum. Another major constraint to financial liberalization was the expansion of credit support to formerly unfavored sectors, such as SMEs. The govt. tightened the required ratio of SME loans out of banks' total loans (SME required ratio: 45%). In particular, political democratization since 1987 spurred social demand for social equity, which forced the govt. to further assist the SME sector. At the same time, credit control system for *chaebols* was intensified to ease the concentration of bank loans. In 1987, the basket control of credit system (credit ceilings) was introduced to limit the shares of bank loans to the 30 largest *chaebols* SMEs received an increasing share of commercial banks while *chaebols* received decreasing shares. As for NBFIs, chaebols' share of lending increased from 32.4% in 1988 to 38.4% in 1995. Given that the aggregate market share of NBFIs was increasing rapidly, the increasing share of *chaebols* in NBFI loans implied a substantial volume of credit was intermediated to *chaebols* through this alternative source.

Capital market opening to international flows had also been gradually implemented. The opening of the security markets allowed indirect investment ahead of direct investment in Korean securities by foreigners. In 1981 domestic investment trust companies (ITCs) began to issue matching funds to foreign investors. In 1984, the Korea Fund, designed for transactions of domestic securities by foreign investment companies, was established at New York. The Korea Euro Fund was created to serve the European market in 1987. Korea Asia Fund was established in 1990. Beginning in 1985, domestic firms were permitted to issue convertible bond (CB) in international financial market. When the current account surplus stimulated an increase in the domestic money supply during 1986-89, the govt. relaxed controls on capital outflows. Deregulation of capital outflows enabled domestic financial institutions to invest in foreign securities. The govt. even allowed such transactions as overseas real estate investments, which had hitherto been regarded as proscribed practice. On the other hand, the fear of massive capital inflows, attracted by anticipated won appreciation, prompted the authorities to tighten its control on capital inflows. For instance, foreign bank loans were substantially curtailed, while foreign commercial loans to the private sector were prohibited. When current account swung back into deficit in early 1990s, the govt. restarted the deregulation of capital inflows. In 1992, foreigners were allowed to directly purchase the Korean stocks, with the maximum foreign ownership of a company set at 10%. Along with the opening of the securities markets, foreign direct investment (FDI) was also deregulated. Until early 1980s, Korea had relied mainly on foreign borrowing rather than on FDI as its financing strategy. In 1984, restrictions on FDI were relaxed in recognition of the FDI's role in promoting competition and transferring advanced foreign technologies. A negative-list system for FDI was introduced with abolition of restrictions on the foreign ownership ratio and the repatriation of capital. By the late 1980s, the manufacturing sector was almost completely open to FDI. At the end of 1989, all but 10 of 522 categories of manufacturing activity were open to FDI. Nevertheless, FDI's share in Korea's total fixed investment registered a mere 0.3%, on average, in 1981-91, much smaller than 1.9% in the 1960s and 2.0% in the 1970s. Financial liberalization since early 1980s had reduced the differentials in access to credit between the export and domestic firms, the HCI and light industries, the large firms and SMEs, and the producers and consumers. In late 1980s, NBFI's share in total deposits began to surpass that of banks, and peaked at the onset of the financial crisis, accounting for more than 70% of total deposits. This rapid growth of NBFIs was due to fewer regulations with respect to interest rates and policy loans than the commercial banks. Ownership restrictions on NBFIs have been lifted in the process of financial liberalization since the late 1980s. As a result, many NBFIs have been owned or actually controlled by chaebols. Although many NBFIs are owned by *chaebols*, government's financial supervision has been almost absent until the onset of the crisis.

3.2.2 FINANCIAL CRISIS 1997-98 & ITS CAUSES

Corporate sector insolvency was the key factor behind 1997-98 financial crises. Decreasing trend in profitability combined with increasing trend in debt exposure since the late 1980s resulted in weak debt servicing capacity. Korean firm's financial vulnerability was not a temporary but structural phenomenon in nature. Since the late 1980s, profit performance of firms deteriorated except for the semiconductor companies affiliated with the top 5 *chaebols.* Debt leverage rose for all firms and the ratio for the *chaebols* were systemically higher than that for non-*chaebol* firms. IPCR for the Korean corporate sector was on a downward trend for almost a decade prior to the crisis. There were already signs of financial trouble in both corporate and financial sectors: large potential NPL held by the financial institutions. However, according to the official NPL data, not only NPL ratio recorded at low level but it had also been decreasing until 1996.

These findings imply that there existed substantial "false demand for credits". Financial institutions simply rolled over of what were essentially bad loans, "Evergreen" accounting problem. The marginal productivity of capital declined from 35% in the 1960s to 25% in the early 1970s and less than 10% on the eve of the crisis. Rising labor costs, combined with the emergence of low-cost exporters such as China weakened Korea's international competitiveness, especially labor-intensive, low technology industries and lead to declining profitability in Korean firms. Korea has not been able to compensate for this loss in competitiveness with a sufficiently rapid gain in competitiveness in technology-intensive sectors due to its weak capability to innovate and adopt advanced technologies. Labor costs had persistently risen in excess of productivity gains since the mid-1980s. China increased its export share in the U.S. from 1.2% in 1985 to 7.3% in 1997, while Korea's share dropped from 4.6% in 1988 to 2.6% in 1997. Korean manufacturing (except high-tech) sector experienced a decreasing trend in profitability since the late 1980s.

In short declining marginal productivity of capital, further expansion of *Chaebols'* investment, heavy corporate debt leverage, decreasing trend in profitability, labor market rigidity and increasing competition from China resulted in increased Corporate Failures which coupled with deteriorated financial soundness due to reckless Financial Liberalization & Lax Financial Supervision lead to massive capital outflow and denied rollover of Short-term external debt and hence a crises situation.

3.2.3 FINANCIAL LIBERALIZATION – AN ANALYSIS

In Korea, financial liberalization began in the early 1980s in a piecemeal manner and without a coherent strategy. However, its pace was accelerated during the Kim Young Sam administration (1993–98). The government relaxed or abolished many of the financial market restrictions and foreign exchange transactions to internationalize the Korean economy (& join OECD). Despite widespread interest based support by various groups there was, however, no clear consensus on the understanding and implementation process of financial liberalization. Consequent upon this opaque situation and disagreement among various domestic and foreign interest groups, it was not a prudent strategy for a new financial system. By 1997, the practice of direct intervention in credit allocation and government management of commercial banks had been completely eliminated but it also weakened the “government-*chaebol*-bank co-insurance” scheme that had worked well in bringing about rapid economic development in Korea. At the same time, typical corporate firms in Korea were highly indebted, and in the case of some *chaebol* firms the leverage ratio even reached close to 500. It was not possible for any single financial institution to impose the necessary debt discipline on the large chaebols, and there was misconception that they would not be allowed to go bankrupt by the government which was not in any way conducive to creating a sound banking or credit culture in Korea.

Yoon Je Cho argues that structural problems should have been tackled before Korea began its financial liberalization and he highlights that before the crisis many influential observers in Korea believed financial liberalization to be an automatic solution to many of the structural problems and establishing an efficient financial system.

Korea’s financial crisis of 1997–98 was, in Cho’s own words, a “natural consequence of the financial liberalization that had been carried out in an economy with a highly leveraged corporate sector, poorly developed financial market infrastructure, inadequate corporate governance, and a poor credit culture.” He argues that since reforming the real sector is a difficult, time-consuming process Korea should have undertaken financial liberalization in a gradual manner in pace with reforms in the corporate sector and the regulatory regime. It is, however, doubtful that this strategy would have been any easier to implement. According to Rajan & Zingales, the two systems (i.e. relationship based system and arm’s length market based system) that are essentially incompatible with each other came into contact, arm’s length capital to relationship based system without protection to financer and no price signals to deploy massive inflow of capital that resulted in crisis situation.

3.2.4 REVIVAL AND POST CRISES REFORMS

Korea made quickest recovery from the crises among the affected countries. It was aided by a rescue package of 40 billion US$ from the IMF and restructuring under its guidance. During the restructuring process following the crisis, a number of insolvent financial institutions failed or merged with other institutions. The government-led restructuring effort reduced the amount of NPLs held by financial institutions. The financial soundness and profitability of the industry, particularly banking sector, have improved dramatically. After the crisis, the share of banking sector in total assets expanded, thanks to financial security offered by deposit insurance scheme. Firms focused on strengthening their financial soundness through the reduction of borrowing Korean firms' debt-equity ratio is even lower than those of advanced countries. Consumer loans by financial institutions expanded rapidly after the financial crisis. Financial institutions have focused on expanding in home financing market.

In the aftermath of 1997 crisis, Korea undertook a number of reforms in financial supervision. It created the Financial Supervisory Commission (FSC) and the Financial Supervisory Service (FSS). FSC (state agency) was created to function as an integrated supervisory agency for all types of financial institutions and markets, while FSS was established to act as an executive arm of FSC and FSS is a private corporation in the form of a special legal entity operating in the public domain. Although FSC and FSS are formally separate, the two agencies are supposed and expected to operate as a single supervisory authority. Under this new system of integrated financial supervision, FSC/FSS is the sole supervisory agency for banks and NBFIs, formerly the charges of

BOK and the MOFE, respectively. However, the chronology of events show that under lax supervision, credit card companies extended credits without assessing credit information such as income which they could not have if they had been properly supervised by the appropriate supervisory agencies, i.e. public agencies such as MOFE, FSC/FSS and BOK failed in their role as supervisory agencies, during the period 1999-2003. World Bank (Financial Sector Assessment Korea, June 2003 pp. 6-7) reports:

> "*Despite notable progress in prudential supervision, concerns remain about the regulator's ability to supervise certain risks in an integrated, coherent manner and to respond to new challenges*"

IMF (Republic of Korea: Financial system Stability –Assessment, March 2003, p. 24)

> *"Prudential regulators lack the unfettered right to issue new regulations when they perceive a need to do so."*

The prudential problems relating to credit card companies and household debt were a failure of an institutional structure, due to interdependency of formal institutions (laws & statutes) and informal institutions (conventions and social norms), in which MOFE dominated other public agencies, making it difficult for them to carry out their statutory responsibilities when their doing so went against MOFE's achieving its own policy objectives. The post-crisis reform in financial supervision in Korea was largely limited to changing formal institutions for financial supervision and that further reforms will have to be undertaken in other related institutions if Korea is to improve its financial supervision.

3.3 CONCLUSION

Korea has become widely known for achieving rapid economic growth. Major contributing factors for shared growth were: Growth with job-creation, initially led by labor intensive export promotion, broad access to education and raising technical know-how, leadership – vision sharing between government and private sector, political stability and promoting spirit of self-help (*Saemaul movement* and workfare). However, reckless financial liberalization and wide scale corporate failures led to economic crisis during 1997-1998. Although financial liberalization was correct policy as it was initiated in slowly through 1980's as Korea had strong base for economic takeoff but a coherent strategy for institutional and regulatory measures for corporate restructuring and to replace the government's role and support in a relationship based system were missing while heading towards the market based system. In response to the crisis, Korea implemented one of the most comprehensively designed liberalization and market-oriented reform measures to strengthen the economic fundamentals. Korea has made major progress in financial and corporate sector reform: the supervisory and regulatory regime for the financial sector has been substantially strengthened, and recent reforms have helped achieve a high degree of observance of international standards and codes. Korea's macroeconomic performance since the crisis has been impressive, with strong real growth, low inflation, and rapidly growing official foreign reserves. But these circumstances also permitted a delay in some important reform measures—including, for example, addressing issues in the area of insurance and securities, the adoption of the insolvency framework, and the completion of corporate restructuring—as the fast recovery made these steps appear less urgent and left the reform agenda unfinished. The completion of such reforms is crucial, since otherwise an economic downturn could unveil important weakness.

Although, Korea has recovered quickly from the Asian Crisis through assistance of IMF and its own economic policies but the case of credit card companies shows the failure of the institutional structure and structural holes in the system and we can say that institutional pre conditions are yet not fulfilled and expose the vulnerability of the financial system. The interdependency of the financial institutions, both formal (laws and statutes) and informal (social norms and culture), is the main reason for institutional failure. There is need for prudent, proactive and dynamic approach on behalf of the Korean Government to be successful and avoid and future crisis.

Chapter 4

4 COMPARISON AND CONCLUSIONS

The history of freedom of the two countries dates back to the mid 1940's. Korea got liberated from the Japanese rule in 1945 while Pakistan came into being as result of partition of the subcontinent in 1947. At the time of creation both the countries had dismal conditions; however their progress has been altogether different. Korea has joined the group of developed countries through its economic will and planning whereas Pakistan is still a developing country struggling for political and economic stability and prosperity.

4.1 COMPARISON OF ECONOMY

South Korea's economy is one of the developed economies in the world and ranked 10th by volume at nominal 2006 whereas Pakistan is a developing country and it economy is much smaller in comparison as the GDP (PPP) of the two countries is $439 billion (2006) and $1.18 trillion (2006 est.) respectively. Brief comparison of the economies of two countries is given in Table 4.1. At the time of their independence the economies of both the countries were dominated by agriculture but today Korea’s economy is a developed one dominated by industry and services sector contributing 40.3% and 56.3% in the GDP while Pakistan economy is under developed with industrial and services sectors contributing 25.1% and 53.3% respectively. The Korean industrial sector dominated by the high-tech industry while it’s negligible in case of Pakistan. The export and import volume of the two countries clearly depicts that Korea has trade surplus while Pakistan has trade deficit which resultantly affects current account positively in case of Korea and negatively in case of Pakistan.

The foreign reserves of Pakistan are US$13 billion much better than what they were in 1999 but are almost 1/16th of Korean foreign exchange reserves. This difference is because of the strength in the Korean high-tech export industries/companies like Samsung, LG, Hyundai, etc., which compete at the international level and are among the best in the world.

Although the two countries have same income distribution levels and relatively low income inequality with Korea having record of Gini index 0.35 & per capita growth rate 7.25 from 1965-1990 and Pakistan having a family-income Gini index of 41, close to the world average of 39. But Korea is rich nation with per capita income of $16291 (2005) and estimated absolute poverty of 2% (2006) whereas Pakistan is a low income and poor nation with per capita income of $847 (2005) and absolute poverty of 23 % (2006). Inflation and the unemployment rate in Pakistan (6% & 6.6% respectively) is almost double than Korea (2.8% & 3.4% respectively).

Korea has skilled labor force of 23 million (50% of the population) with 93% belonging to industrial and services sector where Pakistan has mostly unskilled labor force of 48 million (30 % of population) with 44.8 % belonging to agricultural & allied sectors and the remaining 55.2% to the industrial and services sectors.

Table 4.1 Comparison of Economy of Pakistan & Korea

	PAKISTAN	KOREA
GDP RANKING		10th by volume (at nominal) (2006)
GDP (PPP)	$439 billion (2006)	$1.18 trillion (2006 est.)
GDP growth	6.9% (2006 est.)	5.1% (2006 est.)
GDP per capita	$847 (2005)	$16291 (2005)
GDP by sector	Agriculture: 21.6% industry: 25.1% services: 53.3% (2006 est.)	Agriculture (3.3%), industry (40.3%), services (56.3%) (2005 est.)
Inflation	6%(2005 est.)	2.8% (2005 est.)
Labor force	48.29 million	23.53 million (2005 est.)
Labor force by	Agriculture, forestry,	Agriculture (6%), industry

occupation	hunting & fishing (44.8%), Manufacturing (13.6%), Construction, Transport, storage & telecom (11.7%), Wholesale & Retail trade (14.1%),Community, social & personal services& others (15.8%) (2005-6 est.)	(26%), services (67%) (2004 est.)
Unemployment Rate	6.6% (estimated 2006)	3.4%(estimated 2006)
Population below poverty line	23 %(estimated 2006)	2%(estimated 2006)
Main industries	Automotive ,textiles, chemicals, food processing, steel, transport equipment, machinery, beverages, construction, materials, clothing, paper products.	electronics, automobile production, chemicals, shipbuilding, steel, textiles, clothing, footwear, food processing
Exports	$19.24 billion (2006 est.)	$288.2 billion (2005)
Main Export Partners	United States 22.4%, UAE 8.3%, UK 6%, China 5.4%, Germany 4.7% (2006 est.)	China 21.8%, U.S. 14.6%, Japan 7.8%, Hong Kong 4.2% (2005)
Imports	$28.58 billion	$256 billion (2005)
Reserves of foreign exchange	$ 13 billion (2006)	$210.4 billion (2005)

Source: Internet www.answers.com , Economic Survey of Pakistan (2006), Lecture Slides Evolution Korean Financial System

These differences are reflected in the overall position of the economies of the two countries. Korea is today a developed economy competing world level and holding a leading position among Asia's developed economies. It is also expected to lead the world in penetrating Japan's trade barriers. On the contrary Pakistan is a developing country with a small and under developed economy and highly vulnerable to political instability.

4.2 COMPARISON-FINANCIAL

LIBERALIZATION

There are many things that can be learnt from the analysis of financial liberalization policies as implemented in these two countries. When the process of financial liberalization as it took place in Korea and Pakistan is analyzed although it is clear that the basic objective in both cases was the same, i.e. the economic uplift of the country, yet the intensity of problems and existing circumstances in two countries varied to a large extent. Before the introduction of financial liberalization, economic condition of Pakistan was very bad and Pakistan was at the verge of default (chapter 2, section 2.3) where as Korea had strong economic platform (chapter 3, section 3.2.1) and in a much better condition than Pakistan.

In Korea at the beginning of introduction of market based system in 1980s the per capita income was approximately 2000 US $ whereas in Pakistan still the per capita income is only around 850 US $. Further in Korea only 10% people were below the poverty line as compared to Pakistan where 34% of the population was below the poverty line which according to the latest official figures given by government of Pakistan has been brought down to a value of 25%.

When the policies of financial liberalization were in the offering in Pakistan, it lacked many essential infrastructure such as developed industrial sector in all essential fields of engineering and technology and has not even now developed to a satisfactory level but Korea had strong infrastructure and industrial base and had all the essential industrial sectors well developed in 1980s.

There is acute lack of skilled human resources in Pakistan, according to a survey of the year 2003/04 by an unofficial body, out of total labor force of 30.41%, only 4.88% is working in technology/engineering assisted jobs and 50.8% of labor force works in agricultural, fishery and other manual labor industries in contrary to Korea where these short comings were not there. Therefore for successful implementation of the policies Pakistan needs to pay urgent attention towards skilled labor, education, research and development, and establishing framework where local and foreign investors can launch joint projects. Just to cite one example where financial liberalization is successfully being implemented at proper pace is that of China where 500,000 foreign companies and approximately 5000 research and development cells are working.

In case of Korea, it was a correct policy but the pace of liberalization was not in step with the establishment of regulatory institutions and the policies were not implemented in whole and therefore it had to face the financial crisis at the end of 90s. This crisis therefore was not the result of wrong policies but was the result of partial implementation due to local and foreign pressures and faster than suitable pace because at that time Korea wanted to join OECD. As far the case Pakistan is concerned, it implemented economic and financial reforms under conditional help from IMF and continued financial liberalization despite the fact that it lacks prerequisites of political stability, macroeconomic stability and strong formal & informal institutions. Although the reforms have given positive results and macro economic growth indicators are improving and the there is more need to focus on strengthening the weak technology base, basic infrastructure, health, education and institutional reforms. That requires common vision and collaboration among various key players.

There are other significant differences or similarities between Korea and Pakistan which played an important role directly or indirectly in the process of financial liberalization. Some of these are as follows:-

- Political Stability: - In 60 years of independence of Pakistan, for 30 years, it has been ruled by Military and the civilian rule too saw much turmoil because of intervention by the Military. This did not let the basic condition to prevail necessary for investment and implementation of economic process whereas South Korea did not go through such long spells of political instability.
- Pakistan had not been very sovereign and independent in forming many political and economic policies because of its strategic location and a path to access rich oil resources along the Caspian Sea. South Korea on the other hand had partially similar conditions because of North Korea threat.
- Lack of Land Reforms: - Pakistan was not successful in implementing land reforms whereby land could be distributed to those who cultivate. Because of influential land lords who possessed huge lands, it was not possible to cultivate the land in an optimum manner. This led to not an impressive performance in agriculture centre, moreover these land lords also interfered in other affairs of the state through their political positions.
- High level of corruption and inaccessibility to the opportunities by the public without discrimination is also one of the major causes which did not let the financial liberalization policies to produce the effect, it aimed. South Korea had a much better position in this regard.
- English as an official language: - In Pakistan English is official language of the state, so all the correspondence and state affairs are carried out in

English. With a very low literacy rate there are not more than 10% people who can communicate well in English. Therefore in all major economic reform programs especially those implemented by UN, World Bank and IMF, the public participation is negligibly small. In universities also, the medium of instruction is English. On the contrary, South Korea has strong programs in their own language.

4.3 CONCLUSIONS

Financial sector liberalization has been followed widely since 1973 and almost all developing countries have now at least partially liberalized their financial sector. The process has varied greatly; both in terms of speed and sequencing, yielding positive results in terms of greater financial depth and increased investment efficiency but it has not bought the boost in the savings. It also suggests that a modest positive real interest rate would be not only most conducive to secure a high rate of saving but also an optimum from the view point of avoiding financial crisis. Financial liberalization needs to have macroeconomic & institutional preconditions and needs to be adjusted according to the institutions and culture of the country for its success. Ultimate goal of any reform is to ensure economic stability and then sustainable economic growth. Although market based financial system can do it most efficiently, but that is the case only when there are no market failures which is inherent characteristic of markets so financial liberalization needs to be carried out with a coherent strategy to guard against the market failures which replace the Governments' role against the market failures.

Thus, before any country decides to undertake financial liberalization, it must ensure if it is correct policy for it to adopt in lieu of its economic, social, cultural and institutional conditions and if so, it must be carried out prudently according to the policy blueprint and in proper sequenced manner.

Pakistan has history is characterized with political and economic instability along with that Pakistan's economy has been hit by two wars with India, Afghan War, Gulf War and Involvement in War against terror. Financial and economic reforms have been pursued by various governments but due to political inconsistency they have not been implemented in letter and spirit and studies show that financial liberalization does not have any significant impact on economy due to absence of political and macroeconomic stability preconditions and most importantly the institutional preconditions. The Present Govt. of General Pervaiz through its various financial, economic reforms and liberalization policies has brought about some macroeconomic stability duly appreciated by international financial institutions. Although the present govt. has also introduced institutional and regulatory reforms in order to strengthen the institutions but firstly the Military President and secondly the recent Judiciary Crises (whereby the President ousted the Chief Justice of Supreme Court) clearly show institutional weakness both formal and informal. Pakistan is a developing country and weak industrial base, underdeveloped infrastructure and not very promising social and human development indicators. The Govt. may continue to pursue financial liberalization and reforms under guidance/ pressure from international institutions but it has to play dynamic and proactive role in order to join the developed nations.

Korea achieved rapid economic growth through job-creation, initially led by labor intensive export promotion, broad access to education and raising technical know-how, leadership – vision sharing between government and private sector, political stability and promoting spirit of self-help. Although financial liberalization was correct policy but was carried out recklessly without coherent strategy for institutional and regulatory measures for corporate restructuring and to replace the government's role and support in a relationship based system were missing while heading towards the market based system resulting in corporate failures and 1997-98 financial crises. Korea implemented one of the most comprehensively designed liberalization and market-oriented reform measures to strengthen the economic fundamentals after the crises and has made major progress in financial and corporate sector reform: the supervisory and regulatory regime for the financial sector has been substantially strengthened, and recent reforms have helped achieve a high degree of observance of international standards and codes impressively improving macroeconomic performance, with strong real growth, low inflation, and rapidly growing official foreign reserves. But these circumstances also permitted a delay in some important reform measures as the fast recovery made these steps appear less urgent and left the reform agenda unfinished. The completion of such reforms is crucial, since otherwise an economic downturn could unveil important weakness. Despite having recovered quickly from the Asian Crisis through assistance of IMF and its own economic policies still there are but there institutional weaknesses and structural holes as evident from the case of credit card companies. We can say that institutional pre conditions are yet not fulfilled and expose the vulnerability of the financial system. The interdependency of the financial institutions, both formal (laws and statutes) and informal (social norms and culture), is the main reason for institutional failure. There is need for prudent, proactive and dynamic approach on behalf of the Korean Government to be successful and avoid and future crisis.

Financial liberalization for implementation of market based system has been critically analyzed and it has been discussed in the context of Pakistan and Korea. It has been concluded that financial liberalization should be implemented keeping in view the social, economical and political structure of the country and before its launch, the placement of institutions, regulatory framework and infrastructural development must be ensured. The policy must be implemented in whole and governments should not budge to local or foreign pressures. A comparison of its enforcement in Pakistan and Korea showed that Pakistan lacked in many social, economic and political factors such as literacy rate, skilled human resources, per capita income, incessant democratic governments and its image as a stable, safe country for investment as compared to Korea. The policy of market based system can bring economic uplift to the country provided the prerequisites for its implementation are fulfilled which take time. Pakistan is facing many difficult challenges and will continue to face new unforeseen challenges. There is no room for complacency. One fourth of the population still lives below the poverty line. Human Development Indicators remain low as almost half of the population is illiterate, infant and maternal mortality rates are high, access to quality education and health care particularly by the poor is limited, income and regional inequalities are widespread, infrastructure shortages and deficiencies persist, skill shortages are taking a toll in the economy’s productivity while at the same time, there is high unemployment and underemployment. The worldwide preoccupation with the large economies of China and

India and the ever-increasing quest to enter these markets is also working to the disadvantage of countries such as Pakistan. But the lesson we have learned is that there is no point in complaining and whining about this but to get on with the job, to work even harder, to overcome these deficiencies and constraints and to hope for the best.

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