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**BANK LOANS TO MICROENTERPRISES, SMEs
AND POOR HOUSEHOLDS IN KOREA:
COUNTRY STUDY OF THE REPUBLIC OF KOREA**

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This paper was prepared by Dr Moon-Soo Kang, Senior Fellow, Korea Development Institute, Seoul, Republic of Korea. The views expressed in the paper are those of the author and do not necessarily reflected the views of the United Nations.

I. Introduction

The Korean economy has achieved unprecedented growth in the last three decades. Between 1965 and 1995 Korea's per capita GNP increased from US\$105 to over US\$10,000 while the share of agriculture in GDP decreased from 38% to less than 7% during this period. Exports recorded a substantial increase from US\$0.2 billion to US\$125 billion.

Small- and medium-sized enterprises (SMEs), and particularly new firms, have a distinct role in economic growth and in the development of innovation. Recent studies show that small- and medium-sized enterprises are at least as important as large firms in the creation of gross and net new jobs in the OECD area¹. In terms of innovation, small- and medium-sized enterprises have a greater tolerance for higher-risk initiatives and the capacity to reap substantial market rewards in niche markets². SME access to the formal financial sector, however, is constrained by the high risks and transaction costs associated with commercial lending to that segment of the market. The Korean government has provided a wide variety of programs to assist small- and medium-sized enterprises.

Korea's international competitiveness began to deteriorate in the early 1990s due to amassed structural deficiencies within the Korean economy. A major shock to the Korean economy occurred with the bankruptcy of the Hanbo Group in January 1997. Four more of the thirty largest chaebols also went bankrupt in 1997. The failure of these chaebols revealed problems with low profitability and excessive leverage ratios in the

¹ OECD, Technology, Productivity and Job Creation, 1996.

² OECD, Regulatory Reform, Industrial Competitiveness and Innovation, 1996.

corporate sector and faulty corporate governance in Korea.

In November 1997, less than a year after its accession to the OECD, Korea experienced a severe economic and financial crisis. The Korean government formally requested assistance from the International Monetary Fund to mitigate the external liquidity shortage and regain the confidence of international investors.

Since December 1997, the nation has embarked on a comprehensive program for economic reform and recovery, which has produced fruitful results in terms of rectifying the causes of the crisis.

SMEs were more likely than larger firms to be denied new loans during the financial crisis. Since December 1997, the government has implemented policies to strengthen support for small- and medium-sized enterprises and overcome economic crisis. The government has given greater attention to the "finance gaps" in small- and medium-sized enterprises and made efforts to help SMEs overcome the credit crunch during the financial crisis.

The economic crisis has been followed by social repercussions in many dimensions: rapidly augmenting unemployment, decreasing wage and income, and growing absolute poverty. In the wake of the financial crisis and subsequent economic recession in Korea, the unemployment rate has shown a steep rise, from an annual average of 2.6 percent in 1997 to a record high 8.6 percent in February 1999. Because of income reduction, unemployment increased the size and depth of poverty. In response to the record high rates of unemployment, the government put forth a comprehensive package to resolve unemployment, which includes job preservation, general job creation, vocational training, and social care.

In this paper, I discuss bank loans to small- and medium-sized enterprises, micro-enterprises, and poor households in Korea.

II. Economic Development and SMEs

1. Definition of a Small-and Medium-sized Enterprises

In general, a firm is classified as a small- and medium-sized enterprise (SME) if the number of employees in a firm does not exceed 300. More specific standard on the classification of small-and medium-sized enterprises is stipulated in Article 2 of the Framework Act on Small- and Medium-sized Enterprises as follows.

<Table II-1> Classification of a SME

Industry	Small- and Medium-sized Enterprise		Small Enterprise
	Employees	Assets	
Manufacturing	300 or fewer employees	Less than 80 billion won	50 or fewer employees
Transportation	300 or fewer employees	no standard	50 or fewer employees
Construction	300 or fewer employees	"	30 or fewer employees
Commerce & other services	20 or fewer employees	"	10 or fewer employees

Source: Framework Act on Small and Medium Enterprises.

There are certain types of businesses that are classified as small- and medium-sized enterprises even though the number of employees exceeds the above standard. Some labor-intensive businesses such as leather or fabric footwear, household or sanitary ceramic products, and parts and accessories for motor vehicles and engines belong to the exceptional category.

2. Small-and Medium-sized Enterprises in Korea

More than 99 percent of all businesses in Korea are small- and medium-sized enterprises (generally, firms having fewer than 300 employees in the manufacturing sector and fewer than 20 in the service sector) at the end of 1999. Korea in 1999 had more than 2.7 million small businesses with fewer than 300 employees, providing employment for 82 percent of all Koreans working in the private sector at the end of 1999.

<Table -2> Status of SMEs (1999)

(unit : unit, person, %)

	Total (A)		SMEs (B)		Ratio (B/A)	
	No. of establishments	No. of employees	No. of establishments	No. of employees	No. of establishments	No. of employees
Total	2,777,986	10,829,961	2,769,012	8,866,001	99.7	81.9
Agriculture	2,164	23,208	2,113	19,043	97.6	82.1
Fishery	865	37,674	856	35,604	99.0	94.5
Mining	2,115	21,971	2,108	17,061	99.7	77.7
Manufacturing	297,416	3,170,029	296,548	2,356,265	99.7	74.3
Gas	320	11,809	308	6,431	96.3	54.5
Construction	64,777	652,372	64,593	472,257	99.7	72.4
Wholesale and retail trade	909,205	2,345,671	907,217	2,113,979	99.8	90.1
Hotels and restaurants	601,117	1,453,198	600,415	1,398,217	99.9	96.2
Transport, storage	238,486	728,766	238,204	617,763	99.9	84.8
Communications	3,162	37,871	3,134	25,055	99.1	66.2
Finance	3,280	31,849	3,095	14,367	94.4	45.1
Real estate, renting	97,206	315,224	96,058	248,946	98.8	79.0
Education	78,598	296,584	77,409	233,344	98.5	78.7
Health and social work	52,265	379,762	51,736	245,744	99.0	64.7
Other community, social and personal service activities	249,979	502,060	249,534	472,449	99.8	94.1

Notes: 1) In this table, the standard number of employees of SME is between 1 and 299 employees.

Source: Small and Medium Business Administration, SME statistics, 2000.

<Table II-3> The Korean Economy

	1965		1975		1985		1995		2000
GDP(\$, billion)	3		21.1		93.4		489.4		457.4
Per Capita GNI(\$)	105		592		2,229		10,823		9,628
GDP Growth(real, %)		8.5		6.7		7.7		4	
Employment Growth(%)		3.7		2.5		3.1		0.6	
Industrial(Employment) Structure(%)									
Agri., Forestry & Fishery	38.0 (59.0)		27.5 (45.9)		14.1 (25.2)		6.8 (12.4)		5.1 (10.9)
Manufacturing	18.0 (9.5)		28.4 (18.7)		32.6 (23.7)		32.2 (23.5)		34.9 (20.2)
Construction & Services	41.9 (31.5)		44.1 (35.4)		53.4 (51.2)		61.0 (64.1)		59.9 (69.0)
Commodity Exports(\$, billion)									
Commodity Exports(\$, billion)	0.2		5		26.6		124.6		175.8
Total Exports/GDP(%)	9.5		28.5		35.5		31		45.0
National Savings Rate(%)									
National Savings Rate(%)	13.2		19.5		31.1		35.5		32.3
Foreign Savings Rate(%)									
Foreign Savings Rate(%)	0.2		9.6		-0.6		1.8		-3.5
Tax Burden/GDP(%)									
Tax Burden/GDP(%)	8.6		15.3		17.1		19.1		18.7
Consumer Price Inflation(%)									
Consumer Price Inflation(%)		14		12		5.8		2	
Won/US\$(year-end)									
Won/US\$(year-end)	273		484		890		775		1,265

2. Economic Development and Importance of SMEs

2.1. Development of SMEs in the Manufacturing Industry

In the 1960s, Korean small- and medium-sized manufacturing enterprises accounted for 94.0% of the increase in manufacturing establishments. However, they accounted for only 25-40% of the growth in employment, gross output, value of

shipments, and value added.

In the 1970s, due to the heavy and chemical industry (HCI) development policy which resulted in favoring large enterprises, the share contributed by manufacturing SMEs to the growth in employment, gross output, value of shipments, and value added remained at only 30- 45 % level.

From early 1980s, the government started to strengthen support for small-and medium-sized enterprises in order to rectify the worsening economic distortion, which had resulted from the concentration of economic power by large business groups. Manufacturing SMEs accounted for 89.2% of the increase in the number of employees in the 1980s. In addition, the share contributed by manufacturing SMEs to the growth of gross output, value of shipments, and value added increased significantly.

In the 1990s, the share contributed by the manufacturing SMEs to the growth in gross output, value of shipments, and value added continued to increase. Small- and medium-sized enterprises made a great contribution to economic growth. Small- and medium-sized enterprises (1 – 299 employees) accounted for 99.1% and 74.4% in the number of establishments and the number of employees in all industries, respectively. In 1997, the manufacturing SMEs accounted for 99.7% and 71.6% in the number of establishments and employees in the manufacturing industry, respectively.

2.2. Importance of SMEs in the Korean Economy

Growth rates of manufacturing SMEs in the 1960s were only half of those of large manufacturing enterprises in number of establishments, number of employees,

gross output, value of shipments, and value added.

Manufacturing SMEs did not grow as fast as large manufacturing enterprises in the 1970s due to heavy and chemical industry (HCI) promotion policies, which resulted in favoring large enterprises. However, from the end of the 1970s, the manufacturing SMEs started to outperform large manufacturing enterprises in their growth rates following the increasing participation of small-and medium-sized enterprises in parts and basic materials industries.

From the 1980s, manufacturing SMEs outperformed the large manufacturing enterprises in all growth indicators as a result of the government's active SME promotion policy to rectify the structural imbalance stemming from the HCI promotion policy.

<Table II-4> Growth Rates: Breakdown by Firm Size

(unit : %)

Items	Growth rate ¹⁾	1960s		1970s		1980s		1990s	
		('63	'69)	('70	'79)	('80	'89)	('90	'97)
Number of Establishments	SMEs ²⁾	3.4		3.1		9.0		4.4	
	Large firms	11.8		5.1		1.9		-5.3	
Number of employees	SMEs	5.4		10.2		7.3		0.0	
	Large firms	12.8		10.8		2.0		-4.7	
Gross output	SMEs	14.5		40.4		20.7		15.0	
	Large firms	29.7		39.1		14.8		12.6	
Value of shipments	SMEs	14.7		40.1		20.8		15.1	
	Large firms	29.7		38.9		15.0		12.6	
Value added	SMEs	16.3		40.0		21.9		15.1	
	Large firms	29.6		35.3		16.4		13.7	

Notes: 1) Annual average rate.

2) 5 299 employees.

Source: Korea Federation of Small Business (KFSB), Economic Development and Contribution of SMEs, 1998.

From the 1990s, manufacturing SMEs continuously showed growth rates higher than large manufacturing enterprises while large manufacturing enterprises showed negative growth rates in the number of establishments and employees.

<Table II-5> Contribution Ratios to Economic Growth: Breakdown by Firm Size

(unit : %)

Items		Contribution ratio ¹⁾		1960s	1970s	1980s	1990s
				('63 '69)	('70 '79)	('80 '89)	('90 '97)
Number of Establishments	SMEs ²⁾			94.0	93.1	99.6	101.6
	Large firms			6.0	6.9	0.4	-1.6
Number of Employees	SMEs			38.1	45.3	89.2	-3.4
	Large firms			61.9	54.7	10.8	-96.6
Gross output	SMEs			26.5	32.1	44.6	48.4
	Large firms			73.5	67.9	55.4	51.6
Value of shipments	SMEs			26.7	32.2	44.5	48.4
	Large firms			73.3	67.8	55.5	51.6
Value added	SMEs			25.7	35.5	46.9	47.1
	Large firms			73.3	64.5	53.1	52.9

Note: 1) The contribution ratio is the percentage share of each group of enterprises to

total increase.

2) 5 299 employees.

Source: Korea Federation of Small Business (KFSB), Economic Development and Contribution of SMEs, 1998.

<Table II-6> Number of Establishments in Manufacturing Industry: Breakdown by Firm Size and Number of Employees

(unit : unit, %)

Size \ Year	1993	1994	1995	1996	1997	1998	1999
Total	88,864 (100.0)	91,372 (100.0)	96,202 (100.0)	97,144 (100.0)	92,138 (100.0)	79,544 (100.0)	91,156 (100.0)
SMEs	87,913 (98.9)	90,447 (99.0)	95,285 (99.0)	96,241 (99.1)	91,324 (99.1)	78,869 (99.2)	90,449 (99.2)
5~9	36,144 (40.7)	37,777 (41.3)	42,576 (44.3)	44,029 (45.3)	43,965 (47.7)	36,525 (45.9)	42,796 (46.9)
10~19	25,205 (28.4)	25,784 (28.2)	26,447 (27.5)	26,300 (27.1)	23,536 (25.5)	21,065 (26.5)	23,970 (26.3)
20 49	18,169 (20.4)	18,349 (20.1)	17,894 (18.6)	17,802 (18.3)	16,197 (17.6)	14,612 (18.4)	16,335 (17.5)
50 99	5,438 (6.1)	5,519 (6.0)	5,335 (5.5)	5,208 (5.4)	4,856 (5.3)	4,288 (5.4)	4,774 (5.2)
100 199	2,244 (2.5)	2,283 (2.5)	2,298 (2.4)	2,192 (2.3)	2,110 (2.3)	1,861 (2.3)	2,011 (2.2)
200 299	713 (0.8)	735 (0.8)	735 (0.8)	710 (0.7)	660 (0.7)	518 (0.7)	563 (0.6)
Large enterprises	951 (1.1)	925 (1.0)	917 (1.0)	903 (0.9)	814 (0.9)	675 (0.8)	707 (0.8)
300~499	422 (0.5)	411 (0.4)	420 (0.4)	432 (0.4)	377 (0.4)	309 (0.4)	356 (0.4)

500 or more	529 (0.6)	514 (0.6)	497 (0.5)	471 (0.5)	437 (0.5)	366 (0.5)	351 (0.4)
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Note: () is composition ratio.

Source: Small and Medium Business Administration, SME statistics.

III. Financing Small-and Medium-sized Enterprises

1. Financial Supporting System for Small-and Medium-sized Enterprises

A financial system can influence the allocation of real resources by financial resources between surplus and deficit units. In addition, a financial inter-mediating system can be used to channel financial resources to certain favored deficit units that are expected to use the resources for specific purposes, or the terms on which the financial resources are provided can be manipulated to influence the decisions of potential users.

Access to financing can be a critical issue for small-and medium-sized enterprises, particularly in their early years. The current financial support system for small-and medium-sized enterprises aims to facilitate SME access to banks and non-bank financial institutions (NBFIs), and to lower the cost of borrowing from banks and NBFIs. Financing for small- and medium-sized enterprises in Korea is extended in various forms through diversified financial institutions and can be summarized in four major categories.

First, commercial banks provide loans and discount commercial bills to small- and medium-sized enterprises.

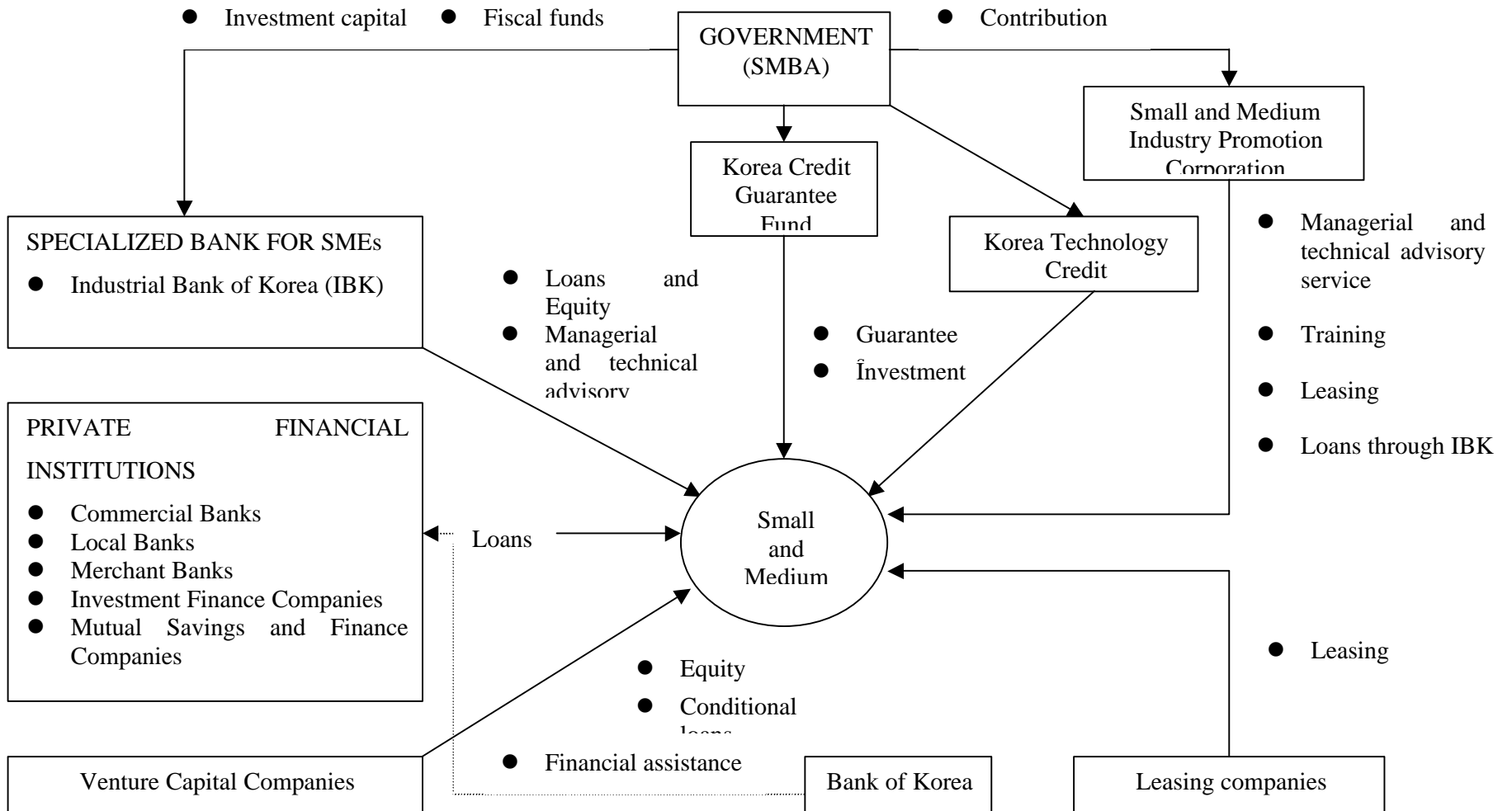
Second, the Industrial Bank of Korea, a special bank founded by the government specifically for small- and medium-sized enterprises, finances SMEs exclusively.

Third, special loans are provided to small- and medium-sized enterprises under various schemes. These include government-sponsored program loans, which are extended through the Industrial Bank of Korea to encourage small-and medium-sized enterprises in facility investment and to strengthen R&D activities. Others include Energy Consumption Rationalization Fund loans and Start-up Company Promotion Fund loans.

Finally, a credit guarantee system was established to facilitate bank lending to small- and medium-sized enterprises. The Korea Credit Guarantee Fund (KCGF) and the Korea Technology Credit Guarantee Fund (KTCGF) have undertaken guarantee businesses with special emphasis on guarantees for small- and medium-sized enterprises that have difficulties in qualifying for bank loans.

The basic financial supporting system for small- and medium-sized enterprises in Korea is shown in Figure 1.

<Figure 1> Financial Assistance System for Small-and Medium-sized Enterprises



2. External Financing of Small- and Medium-sized Enterprises

Most small- and medium-sized enterprises turn to debt financing at an early stage. Banks are the main lenders. Bank loans accounted for 79.7 percent of total external financing at the end of 1999.

Borrowings from non-bank financial institutions and corporate bonds recorded 7.5% and 3.9%, respectively, at the end of 1999. Borrowings from the private curb market declined to 0.6%.

<Table III-1> SME Borrowings: Breakdown by Source of Funds (based on balances)

(unit: billion won, %)

	End-1998		End-1999		Change()	
	Amount	Ratio	Amount	Ratio	Amount	Rate
Banks	39,914	89.2	48,971	79.7	9,057	22.7
Non-bank financial institutions	1,219	2.7	4,636	7.5	3,417	280.2
Corporate bonds	1,547	3.4	2,350	3.9	803	51.9
Curb loans	968	2.2	375	0.6	592	61.2
Others	1,117	2.5	5,093	8.3	3,976	355.8
Total	44,765	100.0	61,426	100.0	16,661	37.2

Source: The Kookmin Bank, Survey of Small and Medium Enterprise Financing, Annual Report 2000.

3. Bank Loans to Small- and Medium-sized Enterprises

Deposit money bank loans extended to small- and medium-sized enterprises at the end of June 2001 are shown in Table III-2. Deposit money banks provided 41.9 percent of total loans to small- and medium-sized enterprises at the end of June 2001. Banks have significantly expanded loans to households and tried to reduce their risk exposure to small- and medium-sized enterprises as well as large firms since the financial crisis in 1997.

<Table III-2> Deposit Money Bank Loans to SMEs ¹⁾

(unit : 100 million won)

	Dec. 1997	Dec. 1998	Dec. 1999	Dec. 2000	June 2001
Total loans (A) (%)	1,964,112 ()	1,963,503 (-0.03)	2,453,312 (24.9)	3,046,918 (24.2)	3,209,860 (5.3)
Loans to SMEs (B) (%)	922,547 ()	891,736 (-3.3)	1,094,936 (22.8)	1,275,979 (16.5)	1,344,321 (5.4)
B/A (%)	47.0	45.4	44.6	41.9	41.9

Note: 1) Based on banking account loan to SMEs.

2) Numbers in parentheses denote increase rates over precious year.

Source: The Bank of Korea.

4. Mandatory Minimum Ratio of Bank Loans to SMEs

The government used credit allocation through the banking system as its most powerful means of supporting small- and medium-sized enterprises. Banks were directed to make loans to small- and medium-sized enterprises.

According to the Credit Operation Guideline of the Financial Supervisory Service (FSS), all commercial banks are required to provide more than a specified proportion of their loans to small- and medium-sized enterprises. For example, nation-wide commercial banks are required to supply more than 45 percent of the increase in loans to small- and medium-sized enterprises. The mandatory credit extension system for small- and medium-sized enterprises has contributed considerably to expanding bank loans to small- and medium-sized enterprises since 1965. The mandatory credit extension system, however, has intervened in the credit allocation of banks; the financial health of borrowers was often neglected in making loan decisions.

<Table III-3> Mandatory Minimum Ratio of Bank Loans to SMEs

(unit : %)

	Apr. 1965	Dec. 1976	Oct. 1980	Mar. 1985	Apr. 1986	Aug. 1986	Feb. 1992	May 1994	July 1997	Feb. 1999
Nationwide Commercial Banks	30	30	35	35	35	35	45	45	45	45
Local Banks	60	40	55	55	80	80	80	70	60	60
Foreign Bank Branches	-	-	-	25	25	35	35	35	35	35
IBK	90	90	90	90	90	90	90	90	80	80

Note: Based on loans in domestic currency

Source: The Bank of Korea.

5. Aggregate Credit Ceiling System of the Bank of Korea

The Bank of Korea encourages deposit money banks to extend more funds to small- and medium-sized enterprises with its Aggregate Credit Ceiling system. In 2000, the Bank of Korea revised the Aggregate Credit Ceiling method of operation in order to assist business firms in the process of corporate and financial restructuring facing difficulties in obtaining funds, and particularly, to encourage bank lending to small- and medium-sized enterprises.

In September 2000, the Bank of Korea changed its method of appraising bank performance on lending to small- and medium-sized enterprises, which is used for calculating the quota for an individual bank under the Aggregate Credit Ceiling. It did so in such a way as to assist banks, which are expanding lending to small- and medium-sized enterprises, to receive a larger allocation than other banks focusing on retail credit.

To encourage an expansion of bank lending to regionally-based small- and medium-sized enterprises suffering from difficulties in the process of corporate restructuring, the Bank of Korea increased the Aggregate Credit Ceiling for its regional branches by a total of 500 billion won (from 2.2 trillion won to 2.7 trillion won) in December 2000. The total Aggregate Credit Ceiling stood at 7.6 trillion won at the end of August 2000.

The value of SME commercial bills discounted accounted for 84.7 percent of total commercial bills discounted in the first half of 2000. The Bank of Korea made available refinancing under the Aggregate Credit Ceiling to banks for up to 98.3 percent of SME commercial bills discounted.

<Table III-4> Trend of SME Commercial Bills Discounted

(unit: billion won)

	1993	1994	1995	1996	1997	1998	1999	June 2000
Total value of bills discounted (A)	14,887	18,420	21,783	24,498	23,629	16,098	22,158	21,485
SME bills discounted (B)	13,080	16,577	19,410	21,961	20,981	14,674	19,001	18,184
B/A (%)	87.9	90.0	89.1	89.6	88.8	91.2	85.8	84.7
BOK rediscount (C)	11,853	13,388	15,117	18,143	17,640	13,022	17,616	17,879
C/B (%)	90.6	80.7	77.9	82.6	84.1	88.7	92.7	98.3

Source: Small and Medium Business Administration.

6. Introduction of Corporate Procurement Loans Scheme

In Korea, business firms had for long made use of commercial bills for the settlement of commercial transactions. This practice, however, caused problems because small- and medium-sized enterprises, which had received commercial bills, had to wait for a considerable time before they could obtain cash settlement in full, aggravating their financial burden. Default of a company that had issued commercial bills ran the risk of causing a chain of defaults by those companies having received or accepted them.

The Bank of Korea introduced the Corporate Procurement Loans scheme in May 2000 to gradually reduce the use of commercial bills and encourage expansion of cash settlement. The Corporate Procurement Loans scheme represents a new procedure for the settlement of commercial transaction, under which corporations purchasing goods borrow settlement funds from banks, paying the suppliers in cash rather than commercial bills.

In order to secure the widespread adoption of the Corporate Procurement Loans scheme, under the Aggregate Credit Ceiling, the Bank of Korea made up to half of a bank's total Corporate Procurement Loans available for refinancing.

Thanks to the Bank of Korea's supportive provision of incentives and the favorable response of enterprises and banks, the scheme was swiftly established. The outstanding balance of loans extended under the new scheme surged from 65 billion won at the end of June 2000 to 3.3 trillion won at the end of December 2000. The number of corporate beneficiaries of the scheme also soared from 135 to 5,458 during the corresponding period.

In contrast to rapid rise in utilization of the scheme, the value of commercial bills discounted continued to decrease. At the end of December 2000, the Corporate Procurement Loans were equivalent to 17.2 percent of total discounts of commercial bills.

<Table III-5> Trends of Outstanding Amounts of Corporate Procurement Loans and Commercial Bills Discounted

(unit: billion won)

	2000		
	June	Oct.	Dec.
Corporate Procurement Loans (A)	65.1	1,989.7	3,361.7
Commercial Bills Discounted (B) ¹⁾	18,453.7	18,336.2	19,566.6
A/B (%)	0.4	10.9	17.2

Note: 1) Based on small and medium enterprises.

Source: The Bank of Korea.

7. Credit Guarantee Schemes

The Korea Credit Guarantee Fund (KCGF) and the Korea Technology Credit Guarantee Fund (KTCGF) were established in 1976 and in 1989, respectively, to increase the availability of loans for the purpose of establishments, expansion, and improvement of small- and medium-sized enterprises. KCGF and KTCGF provide lenders with a guarantee against losses incurred on loans. This support to lenders helps small- and medium-sized enterprises that do not have the tangible collateral to obtain debt financing. They provide guarantees for bank loans, bonds, commercial bills, and leasing.

The government substantially augmented its contribution to KCGF and KTCGF after the financial crisis in 1997. The government contributed US\$2 billion consisting of loans from the Asian Development Bank and the World Bank to KCGF and KTCGF in order to enlarge loan guarantees to small- and medium-sized enterprises and venture businesses. Thanks to a sharp increase in government contribution, outstanding balance of credit guarantees extended by the Korea Credit Guarantee Fund and the Korea Technology Credit Guarantee Fund surged from 4,105.5 billion won at the end of 1989 to 31,496.7 billion won at the end of June 2000.

The sharp increase in credit guarantees helped small- and medium-sized enterprises overcome the financial difficulties during the financial crisis.

On the other hand, the credit guarantee scheme has not been without cost to the state. Claims paid to lenders by KCGF and KTCGF on defaulted loans have sharply increased, recording more than 3 trillion won in 1998. The ratio of claims paid to the

outstanding balance of guarantees also soared from 4.8 percent in 1993 to 8.1 percent in 1995, and then to 9.2 percent in 1998. The high cost of the Credit Guarantee program has stopped fund properties of both KCGF and KTCGF from growing over time.

The financial losses associated with defaulting businesses should be reduced. Losses can be reduced by lowering the percentage guaranteed or by raising the interest premium. The KCGF, the KTCGF and banks should strengthen their capacity to evaluate creditworthiness of small- and medium-sized enterprises in a cost-effective manner, for example, through the use of credit scoring techniques³.

The Credit Guarantee program has been successful in helping start-ups and other small- and medium-sized enterprises in Korea gain access to needed capital for expansion and growth. The program has succeeded as an economic development tool and is a good example of public sector/private sector co-operation. The program's success has spawned similar guarantee programs in Korea. However, controlling the high cost of the Credit Guarantee program and keeping the program responsive to users will remain a challenge in coming years.

³ ³ Kristin Hallberg, A Market-Oriented Strategy for Small- and Medium Scale Enterprises, Discussion Paper 40, International Finance Corporation, 2000., pp.11-13.

<Table III-6> Credit Guarantee Activities of KCGF and KTCGF

(unit : 100 million won, %)

	1993	1994	1995	1996	1997	1998	1999	June 2000
Fund properties	7,545	8,626	8,596	11,002	10,318	33,069	38,352	38,390
Gov't Contribution ¹⁾	1,500	3,300	4,100	5,000	6,000	43,837	14,269	7,800
Outstanding balance of guarantees	107,208	104,496	116,977	138,074	170,521	328,035	309,264	314,967
Claims paid	5,183	6,435	9,466	7,882	11,707	30,191	18,588	5,115
B/A (%)	4.83	6.16	8.09	5.71	6.87	9.20	6.01	1.62

Note : 1) Loans from in the ADB and the World Bank (US\$ 2 billion) are included 1998 and 1999.

Source: Special Commission on Small- and Medium-sized Enterprises, White Paper on Small- and Medium-sized Enterprises, 2000

8. Policy Funds for SMEs

Policy-related loans for small- and medium-sized enterprises are supplied from government policy funds, primarily through the specialized bank. Total policy funds to small- and medium-sized enterprises financed by the government budget amounted to 5,152 billion won in 2000. In addition, the government contributed 1,036 billion won to credit guarantee funds in 2000. Facility funds and technology development funds accounted for 57.2 percent and 18.1 percent, respectively, in 2000. Equity investment in venture businesses increased from 20 billion won to 315 billion won in 2000.

Maturity of facility funds and technology development funds is eight years.

Provided long-term loans helped small- and medium-sized enterprises to modernize production facilities and develop a new product or process.

The government budget appropriations for supporting small- and medium-sized enterprises have increased in the 1990s and accounted for 4.6 percent of total government budget in 1999.

Small- and medium-sized enterprises complain about complicated loan assessment and decision-making procedures of lenders. Banks place high priority on creditworthiness of borrowers and their ability to repay loans. Streamlining the loan assessment and decision-making procedures will remain a challenge in coming years.

<Table III-7> Trend of Policy Funds to SMEs

(unit : billion won, %)

	1998	1999	2000 (budget estimate)
Facility fund	3,780 (78.3)	3,366 (62.4)	2,957 (57.2)
Operation fund	317 (6.6)	1,262 (23.4)	957 (18.6)
Technology development fund	713 (14.8)	648 (12.0)	933 (18.1)
Equity investment in venture businesses	20 (0.4)	118 (2.2)	315 (6.1)
Subtotal	4,830 (100.0)	5,394 (100.0)	5,152 (100.0)
Loan guarantees & others	4,620	1,661	1,036
Total	9,450	7,055	6,188

Source : Special commission on SMEs.

<Table III-8> Trend of Budget Appropriations for SME Support

(unit : 100 million won, %)

	Total government budget (A)	Appropriations for SME support (B)	B/A (%)
1993	463,922	10,990	2.37
1994	543,366	14,537	2.68
1995	633,665	20,014	3.16
1996	711,269	20,088	2.82
1997	730,309	28,466	3.90
1998	853,618	38,088	4.58
1999	934,769	43,139	4.61

Source: Ministry of Planning and Budget.

IV. Financial Crisis and SMEs

1. Financial Crisis

1.1 Weak Banking System

There was evidence of deterioration in the balance sheets of Korea's commercial banks up to four years before the crisis. In 1997, however, this trend took a turn for the worse, as can be seen in Table IV-1.

<Table IV-1> Non-performing Loans of Commercial Banks

(Ratio to Total Loans, %)

	1994	1995	1996	1997	1998	Sept. 1999
NPL Ratio	5.6	5.2	3.9	5.8	7.4	6.2

Note: 1) Figures from end-1996 include the Housing and Commercial Bank, whereas figures from end-1997 include the Long-term Credit Bank and not the five closed banks. and include.

2) Non-Performing loans (NPL) = Substandard + Estimated Loss + Doubtful.

Source: Financial Supervision Information, Vol. 99, No. 4, Financial Supervisory Service, March, 1999.

Fifteen merchant banking corporations were suspended in December 1997, and thirteen of these were closed in early 1998. Five non-viable banks were ordered to close down and transfer their assets and liabilities to relatively sound banks. Two of these five non-viable banks (Daedon Bank and Dongnam Bank) specialized in lending to small- and medium-sized enterprises. Also, the government intervened and rescued two troubled banks (Seoul Bank and Korea First Bank) in December 1997.

Disruptions in financial markets occurred in the last quarter of 1997. The pattern of rising interest rates and a declining stock price index in the midst of an increase in the number of default incidences had already been in place as early as September 1997. Interest rates jumped to an unprecedented level in December 1997, while credit flows to the non-financial sector was abruptly interrupted. Both of these events led the ratio of dishonored bills to reach 2.09 percent in December 1997.

1.2 Corporate Failures

Firms depended heavily on external borrowings to finance investments and other expenditures. Korea's financial crisis originates not only from cyclical downturns but also from structural deficiencies and delayed policy responses. As the Korean economy slid toward a stage of slower economic growth in recent years, firms had to change their business strategies from being volume-oriented to profit-oriented. Successive failures of business firms revealed, however, that many firms including big business groups neglected or failed to undertake restructuring efforts in the rapidly changing economic environment. Faced with slower economic growth, it was particularly important that business firms reduce excess capacity and high debt leverages.

Investors as well as lenders failed to subject investment decisions to a true market test or due diligence. Many commercial banks and merchant banks extended asset-based lending to business firms without prudent and proper credit assessment while profitability of the corporate sector was declining.

Due to high interest rates and the severe recession, the number of firms filing for bankruptcy surged from 11,589 in 1996 to 22,828 in 1998. As a result, the flow of bank credit came to a virtual stop. The number of bankrupt small- and medium-sized enterprises recorded 3,197 in December 1997 when the IMF bailout program began. Then the number of bankrupt small- and medium-sized enterprises increased to 3,323 and 3,377 in January and in February 1998, respectively.

The dishonored bills ratio jumped to 1.49% in December 1997. The dishonored bills ratio declined to around the 0.4% to 0.6% level during the first half of 1998, and then tapered off to 0.20% in November 1998. It plunged to 0.12% in December 1998.

<Table IV-2> Current State of Financial Restructuring (1998 ~ 2000)

	No. of Institutions as of end of 1997	As of End of 1998			As of End of 1999			As of End of 2000			No. of Institutions as of end of 2000
		License Revoked	Closure Through Merger	Liquidation & other	License Revoked	Closure Through Merger	Liquidation & other	License Revoked	Closure Through Merger	Liquidation & other	
Banks	33	5	3	-	-	2	-	-	1	-	22
Merchant banks	30	16	-	-	1	3	-	1	-	1	10
Securities companies	36	6	-	1	-	-	1	-	1	12	43
Investment trust companies	31	6	-	-	-	1	-	-	-	3	27
Life insurance Companies	31	4	-	-	-	-	-	1	5	-	21
Non-life insurance companies	14	-	1	-	-	-	-	-	-	-	13
Mutual savings & finance companies	231	22	2	4	21	10	6	28	13	2	147
Credit unions	1,666	69	14	9	105	45	-	83	42	-	1,317
Total	2,072	128	20	14	127	61	7	113	62	18	1,600

<Table IV-3> Number of Bankrupt Companies and Dishonored Bills Ratios

(unit : %, billion won)

	1990	1993	1995	1996	1997	1998	1999	2000
Number of bankruptcies	4,107 (-)	9,502 (6)	13,992 (5)	11,589 (7)	17,168 (58)	22,828 (39)	6,718 ()	6,693 ()
Dishonored bills ratio	0.04	0.13	0.17	0.14	0.40	0.38	0.33	0.26

Note: Figures in parentheses denote numbers of bankrupt large enterprises.

Source: The Bank of Korea.

The number of bankrupt companies was approximately 2,700 a month on average during the first half of 1998. However, as the dishonored bill ratio declined from the second half of 1998, the number of bankrupt companies began to taper off to below 1,000 in a month on average from November 1998. The number of bankrupt companies declined sharply to 599 in January 2000.

<Table IV-4> Bankruptcies in 1997 and 1998

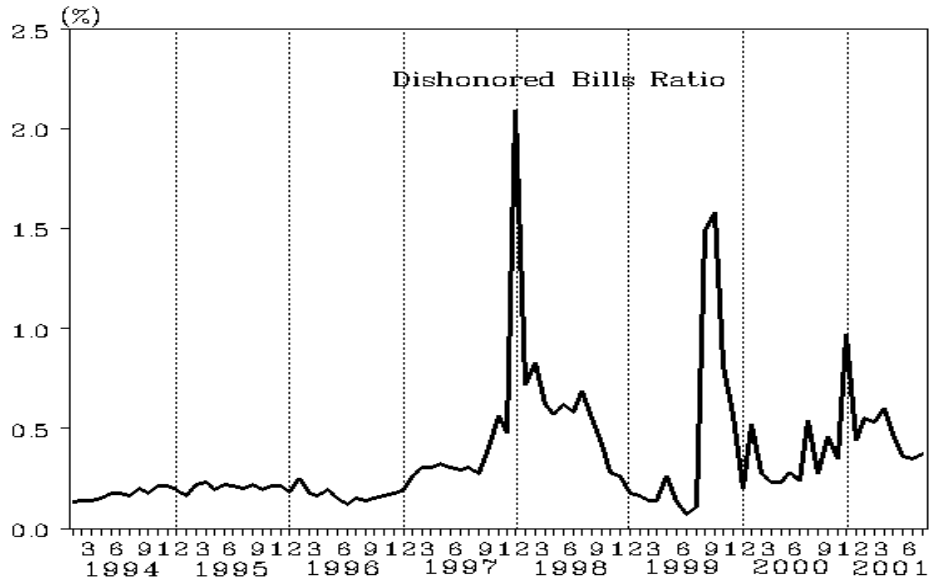
(unit: %, each)

	Jan. 1998	Feb.	Mar.	Apr.	May	June	July	Aug.	Sep.	Oct.	Nov.	Dec.	1998 (1997)
Dishonored bills ratio	0.53 (0.21)	0.62 (0.24)	0.47 (0.24)	0.42 (0.25)	0.45 (0.23)	0.42 (0.22)	0.50 (0.24)	0.41 (0.21)	0.31 (0.31)	0.20 (0.43)	0.20 (0.38)	0.12 (1.49)	0.38 (0.40)
Number of Bankruptcies	3,323 (1,115)	3,377 (1,060)	2,749 (1,268)	2,462 (1,318)	2,070 (1,257)	1,825 (1,215)	1,799 (1,384)	1,337 (1,215)	1,085 (1,235)	1,036 (1,435)	903 (1,469)	862 (3,197)	22,828 (17,168)

Note: Figures in parentheses denote numbers of bankruptcies in 1997.

Source: The Bank of Korea.

<Figure 2> Trend of Dishonored Bills Ratio



Source: The Bank of Korea, Monthly Bulletin.

2. Corporate Restructuring and Financial Structure of SMEs

The high level of corporate debt and weak governance in Korea resulted in debt-financed expansion by business conglomerates and small- and medium-sized enterprises – raising Korea’s vulnerability to the financial crisis in 1997. To facilitate corporate sector reform, the government has sought to create an environment conducive for active corporate restructuring. The government set up different approaches corresponding to the restructuring requirements of each of the following groups: conglomerates, and small- and medium-sized enterprises. Small- and medium-sized enterprises, which were

thought too weak to bear the costs of restructuring, made conditional arrangements for support with their creditor financial institutions, which provided restructuring funds worth 1.4 trillion won.

The equity-to-total assets ratio of small- and medium-sized enterprises has improved to 35.8 percent in 2000 from 23.0 percent in 1998. The debt ratio and current liabilities ratio of small- and medium-sized enterprises have been lowered to 179.7 % and 121.3 % in 2000 from 334.4 % and 219.7 % in 1998, respectively. Interest expense-to-total borrowings of small- and medium-sized enterprises has been lowered to 9.40 % in 2000 from 13.80 % in 1998.

3. Credit Crunch in the Financial Crisis and Bank Loans to SMEs

The credit crunch following the outbreak of the financial crisis was mainly caused by two elements of the IMF program: the high interest rate policy and the strengthened prudential regulation on banks. High interest rates spurred an increase in the defaults and credit risks of business firms, while the need to tighten prudential regulation induced Korean banks to reduce lending in order to maintain BIS capital adequacy ratios.

<Table IV-5> Financial Structure of Firms in Manufacturing Industry: Breakdown by Firm Size

(unit : %)

	1998			1999			2000		
	Total	Large firms	SMEs	Total	Large firms	SMEs	Total	Large firms	SMEs
1. Stockholders' equity to total assets	24.8	25.3	23.0	31.8	32.4	30.1	32.2	30.8	35.8
2. Debt ratio	303.0	295.4	334.4	214.7	208.9	232.4	210.6	224.6	179.7
3. Total borrowings & bonds payable to total assets	50.8	52.9	43.0	42.8	44.5	37.8	41.2	43.6	35.0
4. Current liabilities ratio	169.8	157.6	219.7	122.1	111.1	156.2	134.7	140.8	121.3
5. Interest expenses to total borrowings	13.51	13.45	13.80	11.54	11.93	10.22	10.49	10.83	9.40

Source: BOK, Financial Statement Analysis, 2001.

To overcome the credit crunch, the government implemented a comprehensive set of policies:

First, interest rates were lowered to reduce pressure on the financial system and the financing costs of business firms, and to promote capital market activities.

Second, a financial restructuring program was launched to re-capitalize viable banks and cover their losses. By the end of 1998, almost all commercial banks met the 8 percent capital adequacy ratios.

Third, loan guarantees of 33 trillion won were provided to small- and medium-sized enterprises to aid them in obtaining financing.

Finally, trade financing of US\$3.3 billion, consisting of World Bank loans and BOK's excess reserves, was extended to small- and medium-sized enterprises to compensate for the shortage of commercial banks' foreign reserves.

These policies helped ease the credit crunch, so that by the third quarter of 1999, bank lending to small- and medium-sized enterprises had increased by 17 trillion won, surpassing the level of 1997.

Due to a severe credit crunch after the financial crisis in 1997, loans to small- and medium-sized enterprises by deposit money banks decreased 3.3 percent in 1998.

Deposit money banks, however, have expanded loans to promising and healthy small- and medium-sized enterprises with high growth potential since 1999 and offered them lower lending interest rates. Deposit money bank loans to small- and medium-sized enterprises have increased 22.8 percent and 16.5 percent in 1999 and 2000, respectively (Table III-2). The average lending interest rate to small- and medium-sized enterprises has declined to 7.5 percent in June 2001 from 14.3 percent in December 1997.

<Table IV-6> Deposit Money Bank Average Lending Interest Rate to SMEs

(unit: % per annum)

	Dec. 1997	Dec. 1998	Dec. 1999	Dec. 2000	June 2001
Average Lending Interest Rate	14.6	11.3	8.6	8.4	7.9
SMEs	14.3	10.9	8.0	7.8	7.5
Large firms	17.1	11.2	8.5	8.7	7.8

Source: The Bank of Korea.

V. Financial Assistance to Small Enterprises

1. Importance of Small Business

More than 97 percent of all businesses in Korea are small businesses. Korea in 1998 had more than 2.5 million small businesses with fewer than 50 employees,

providing employment for more than 59 percent of all Koreans working in the private sector. Job creation is the most important contribution made by small businesses

<Table V-1> Status of Small- and Medium-sized Enterprises (1998)

(unit: person, %)

	No. of establishments	No. of employees
All Industries	2,629,868 (100.0)	10,177,797 (100.0)
SMEs	2,607,710 (99.1)	7,659,010 (75.2)
Small enterprises	2,562,500 (97.4)	6,062,035 (59.6)

Source: National Statistical Office of Korea (NSO).

2. Financial Assistance

The Special Act on Small Business Support came into being in April 1997. The Korean economy suffered from the surge in unemployment and witnessed severe economic difficulties of many newly- poor households after the financial crisis in 1997.

From April 1999, the government launched the Financial Assistance program for small businesses with the objective to support start-ups and improvement of small businesses. The government earmarked 300 billion won and 200 billion won in 1999 and 2000, respectively, for the program. The maximum loan amount was increased from

30 million won to 50 million won and the maturity of loan was extended from 3 years to 4 years.

From April 1999 to June 2000, 21, 657 loans for 1,141.6 billion won were made for start-ups and improvements of small businesses.

<Table V-2> Loans for Small Business Start-up and Improvement

(unit: 100 million won)

	1999	2000		Total
		1/4	2/4	
Recommendation	6,351	3,015	2,050	11,416
Loans	2,512	858	1,127	4,497

Source: Small and Medium Business Administration.

VI. Financial Assistance to Poor Households

1. Social Consequences of the Economic Crisis

The economic crisis has been followed by social repercussions in many dimensions: rapidly augmenting unemployment, decreasing wage and income, growing absolute poverty, and increasing health risk. In the wake of the financial crisis and subsequent economic recession in Korea, a rapid increase in unemployment was

inevitable as thousands of firms went bankrupt. The unemployment rate has steeply risen from an annual average of 2.6 percent (556,000 unemployed) in 1997 to 5.9 percent (1.23 million unemployed) in February 1998, to a record high 8.6 percent (1.78 million unemployed) in February 1999. In response to the record high rates of unemployment, the government has taken measures to increase employment, which include job preservation, general job creation, vocational training, and social care.

2. Public Loans through the Life Stabilization Fund

Since the financial crisis struck Korea, Korea's mid- and low-income earners have suffered from deteriorating living standards. If we define the middle income class as including those earning between 50 percent and 150 percent of the median income, the ratio of the middle income class has declined to 65.7 percent from the 68-70 percent level before the financial crisis. Unemployment hit the poor and disadvantaged population more severely, such as unskilled labor, small-and medium-sized firm workers, and female labor.

The government put forth a comprehensive unemployment package to minimize adverse impacts of the crisis in March 1998, which includes loan programs for the unemployed and venture businesses.

Public loans through the Life Stabilization Fund were provided to the unemployed who were excluded from unemployment insurance and the livelihood protection program, and whose assets were below a certain level. The fund was financed by sales of Employment Security Bonds (120 billion won) and the World Bank fund (300 billion won) in 1998. The loans had a low interest rate and 2-year repayment period beginning within two years of the loan disbursement.

In the early stage, restrictive eligibility requirements adopted by banks hampered the effectiveness of the program. Gradual relaxation of loan eligibility requirements eventually increased the number of beneficiaries. The amount of loans made per day also increased from 500 million won to 3 billion won.

The Resettlement Allowance Fund provided loans in 1998 to the increasing number of people returning to the countryside for agricultural work and to unemployed who started their own small businesses (200 billion won to 10,000 households). In addition to these loan programs, the National Pension Fund deployed a separate loan program (a total of 1 trillion won) for the unemployed who subscribed to the national pension.

In June 1999, the government formulated a policy aimed at stabilizing the living standards of mid- and low-income earners and allocated 1.1 trillion won for this policy.

3. Loan Guarantee Program for Start-up for Living

Since July 1997, the government has implemented the Loan Guarantee Program for Start-ups for Living with the objective to increase the availability of loans for the purpose of the establishment of small businesses for living to mid- and low-income earners and the unemployed. The maximum guarantee is 100 million won, and the guarantee fee is 0.9- 1.0 percent per annum. More than ninety-four percent of loans made were 50 million won or less.

The government allocated 200 billion won for the Program. The outstanding balance of guarantees provided by the Korea Credit Guarantee Fund for the Program has recorded 1,900 billion won for 70,000 loans made at the end of April 2000. The benefits of the Program can best be measured by its stimulation of job creation. According to government estimation, the Program has resulted in total additional employment of 215,000 persons from July 1999 to September 2000⁴. However, claims paid have soared from 0.13 percent of loans made in 1999 to 5.57 percent of loans made in September 2000.

⁴ Special Commission on SMEs, White Paper on SMEs, 2000, pp. 142-143.

VII. Conclusion

The share of loans to small- and medium-sized enterprises of all loans of deposit money banks has steadily increased for last forty years. Banks have, however, significantly expanded loans to households and tried to reduce their risk exposure to small- and medium-sized enterprises, as well as large firms, and since the financial crisis in 1997.

Small- and medium-sized enterprises in Korea have been well served by credit guarantee programs and the mandatory minimum ratio of bank loans to small- and medium-sized enterprises. The credit guarantee schemes in Korea have played an important role in inducing the banking sector to lend under circumstances in which, without the guarantee, they would be unwilling to lend. The government allocated about 40 percent of the budget appropriations for small- and medium-sized enterprise sector to credit guarantee programs in 1999. The sharp increase in credit guarantees has led to greater finance being provided to small- and medium-sized enterprises by banks and non-bank financial institutions since the financial crisis.

Loan guarantees and public loans through the Life Stabilization Fund stimulated start-ups by unemployed and low-income earners.

Greater finance to SMEs, mid- and low-income earners, and the unemployed from banks has led to additional jobs and lower unemployment rate in Korea. Small- and medium-sized enterprises in Korea provide employment for 81.9 percent of all Koreans working in the private sector at the end of 1999, compared with 74.4 percent at the end of 1997. The unemployment rate has declined from a record high 8.6 percent in February 1999 to 3.0 percent in September 2001.

On the other hand, the credit guarantee scheme has not been without cost to the state. The ratio of claims paid to lenders by KCGF and KTCGF on defaulted loans to the outstanding balance of guarantees soared from 4.8 percent in 1993 to 9.2 percent in 1998. The financial losses associated with defaulting businesses should be reduced. Losses can be reduced by lowering the percentage guaranteed or by raising the interest premium. Lenders, the KCGF, and the KTCGF should strengthen their capacity to evaluate creditworthiness of micro-enterprises and small- and medium-sized enterprises in a cost-effective manner, for example, through the use of credit scoring techniques. Controlling the high cost of the credit guarantee program and keeping the program responsive to users will remain a challenge in coming years.

The government may have to retrench policy funds for small- and medium-sized enterprises to reduce the budget deficit in coming years. A market-oriented strategy

should be taken to improve financing to micro-enterprises and small- and medium-sized enterprises. The market-oriented strategy focuses on reducing risks and transaction costs associated with loans to them, intensifying the capacity of banks and non-bank financial institutions to serve smaller customers, and augmenting competition in the financial market⁵. The government and the Financial Supervisory Service (FSS) should curtail barriers against entry to the financial market by revising the BIS (Bank for International Settlement) capital adequacy requirements and prudential regulations that may be unsuitable for regional banks and non-bank financial institutions serving micro-enterprises and small- and medium-sized enterprises.

Information on the creditworthiness of potential borrowers could be enhanced by establishing credit bureaus for micro-enterprises, small- and medium-sized enterprises, and households. The development of the model to evaluate creditworthiness of potential borrowers would help lenders reduce the associated high risks and transaction costs. The information asymmetry problem in loan decision-making could be improved by helping SMEs prepare reliable business plans and financial projections.

Demand for working capital of small- and medium-sized enterprises would grow when the Korean economy emerges from recession. Helping to create the environment

⁵ Kristin Hallberg, *ibid.*, pp. 11-13

in which small- and medium-sized enterprises can gain easy access to needed capital will be a key priority to policymakers and financial market participants with responsibility for encouraging the growth and development of SMEs on which jobs and wealth in Korean economy depend.

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