

VIII. BANK LOANS TO MICRO-ENTERPRISES, SMALL AND MEDIUM-SIZED ENTERPRISES AND POOR HOUSEHOLDS IN THE REPUBLIC OF KOREA

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Introduction

The economy in the Republic of Korea has achieved unprecedented growth in the last three decades. Between 1965 and 1995 per capita GNP increased from \$105 to over \$10,000 while the share of agriculture in GDP decreased from 38 per cent to less than 7 per cent during this period. Exports recorded a substantial increase from \$0.2 billion to \$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 SMEs are at least as important as large firms in the creation of gross and net new jobs in the Organisation for Economic Co-operation and Development (OECD) area.¹ In terms of innovation, SMEs have a greater tolerance for higher-risk initiatives and the capacity to reap substantial market rewards in niche markets.² 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 government has provided a wide variety of programmes to assist SMEs.

The international competitiveness of the Republic of Korea began to deteriorate in the early 1990s owing to amassed structural deficiencies within the economy. A major shock to the 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 corporate sector and faulty corporate governance in the country.

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

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

¹ OECD, *Technology, Productivity and Job Creation*, vol. 2 Analytical Report, 1996.

² OECD, "Regulatory reform, industrial competitiveness and innovation" (DSTI/IND/STP(96)7/REV2).

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 SMEs and to overcome the economic crisis. The government has given greater attention to the “finance gaps” in SMEs and made efforts to help them overcome the credit crunch during the financial crisis.

The economic crisis has been followed by social repercussions in many dimensions: rapidly augmenting unemployment, decreasing wages and incomes, and growing absolute poverty. In the wake of the financial crisis and subsequent economic recession, the unemployment rate has shown a steep rise, from an annual average of 2.6 per cent in 1997 to a record high 8.6 per cent 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 chapter, bank loans to SMEs, micro-enterprises, and poor households in the Republic of Korea will be discussed.

A. ECONOMIC DEVELOPMENT AND SMEs

1. Definition of small and medium-sized enterprises

In general, a firm is classified as an SME if the number of employees in a firm does not exceed 300. More specific standards on the classification of SMEs are stipulated in Article 2 of the Framework Act on Small and Medium-sized Enterprises as follows:

Table 1. Classification of SMEs

<i>Industry</i>	<i>Small and medium-sized enterprise</i>		<i>Small enterprise</i>
	<i>Employees</i>	<i>Assets</i>	
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	No standard	30 or fewer employees
Commerce and other services	20 or fewer employees	No standard	10 or fewer employees

Source: Framework Act on Small and Medium-sized Enterprises.

There are certain types of businesses that are classified as SMEs even though the number of employees exceeds the above standard. Some labour-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 the Republic of Korea

More than 99 per cent of all businesses in the Republic of Korea were SMEs (generally, firms having fewer than 300 employees in the manufacturing sector and fewer than 20 in the service sector) at the end of 1999. In 1999 there were more than 2.7 million small businesses with fewer than 300 employees, providing employment for 82 per cent of all Koreans working in the private sector.

Table 2. Status of SMEs, 1999

(unit : unit, person, percentage)

	<i>Total (A)</i>		<i>SMEs (B)</i>		<i>Ratio (B/A)</i>	
	<i>No. of establishments</i>	<i>No. of employees</i>	<i>No. of establishments</i>	<i>No. of employees</i>	<i>No. of establishments</i>	<i>No. of employees</i>
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

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

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

Table 3. The economy of the Republic of Korea

	1965	1975	1985	1995	2000
GDP (\$ billion)	3.0	21.1	93.4	489.4	457.4
Per capita GNP (\$)	105	592	2 229	10 823	9 628
GDP growth (real, %)	8.5	6.7	7.7	4.0	
Employment growth (%)	3.7	2.5	3.1	0.6	
Industrial (employment)					
Structure (%)					
Agriculture, forestry and 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 and services	41.9 (31.5)	44.1 (35.4)	53.4 (51.2)	61.0 (64.1)	59.9 (69.0)
Commodity exports (\$ billion)	0.2	5.0	26.6	124.6	175.8
Total exports/GDP (%)	9.5	28.5	35.5	31.0	45.0
National savings rate (%)	13.2	19.5	31.1	35.5	32.3
Foreign savings rate (%)	0.2	9.6	-0.6	1.8	-3.5
Tax burden/GDP (%)	8.6	15.3	17.1	19.1	18.7
Consumer price inflation (%)	14.0	12.0	5.8	2.0	
Won/US\$ (year-end)	273	484	890	775	1 265

(a) Development of SMEs in the manufacturing industry

In the 1960s, manufacturing SMEs accounted for 94 per cent of the increase in manufacturing establishments. However, they accounted for only 25-40 per cent of the growth in employment, gross output, value of shipments, and value added.

In the 1970s, owing to the heavy and chemical industry development policy which resulted in favouring 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 per cent.

From the early 1980s, the government started to strengthen support for SMEs 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 per cent 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. SMEs made a great contribution to economic growth. SMEs accounted for 99.1 per cent and 74.4 per cent in the number of establishments and the number of employees in all industries, respectively. In 1997, the manufacturing SMEs accounted for 99.7 per cent and 71.6 per cent in the number of establishments and employees in the manufacturing industry, respectively.

(b) The importance of SMEs in the economy of the Republic of Korea

The growth rates of manufacturing SMEs in the 1960s were only half 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 because of heavy and chemical industry promotion policies, which favoured 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 SMEs 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 heavy and chemical industry promotion policy.

Table 4. Growth rates: breakdown by firm size

(percentage)

<i>Items</i> \ <i>Growth rate</i> ¹	<i>1960s</i> <i>(1963-69)</i>	<i>1970s</i> <i>(1970-79)</i>	<i>1980s</i> <i>(1980-89)</i>	<i>1990s</i> <i>(1990-97)</i>
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

Source: Korea Federation of Small Business, *Economic Development and Contribution of SMEs*, 1998.

Notes: ¹ Annual average rate.

² 5-299 employees.

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

Table 5. Contribution ratios to economic growth: breakdown by firm size*(percentage)*

<i>Items</i>	<i>Contribution ratio¹</i>	<i>1960s (1963-69)</i>	<i>1970s (1970-79)</i>	<i>1980s (1980-89)</i>	<i>1990s (1990-97)</i>
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

Source: Korea Federation of Small Business, *Economic Development and Contribution of SMEs*, 1998.

Note: ¹ The contribution ratio is the percentage share of each group of enterprises to total increase.

² 5-299 employees.

B. 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 between surplus and deficit units. In addition, a financial intermediating system can be used to channel financial resources to certain favoured 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 SMEs, particularly in their early years. The current financial support system for SMEs aims to facilitate SME access to banks and non-bank financial institutions, and to lower the cost of borrowing from banks and such institutions. Financing for SMEs in the Republic of 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 SMEs.

**Table 6. Number of establishments in manufacturing industry:
breakdown by firm size and number of employees**

<i>Size \ Year</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>
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)

Source: Small and Medium Business Administration, SME statistics.

Note: The figure in brackets is the composition ratio.

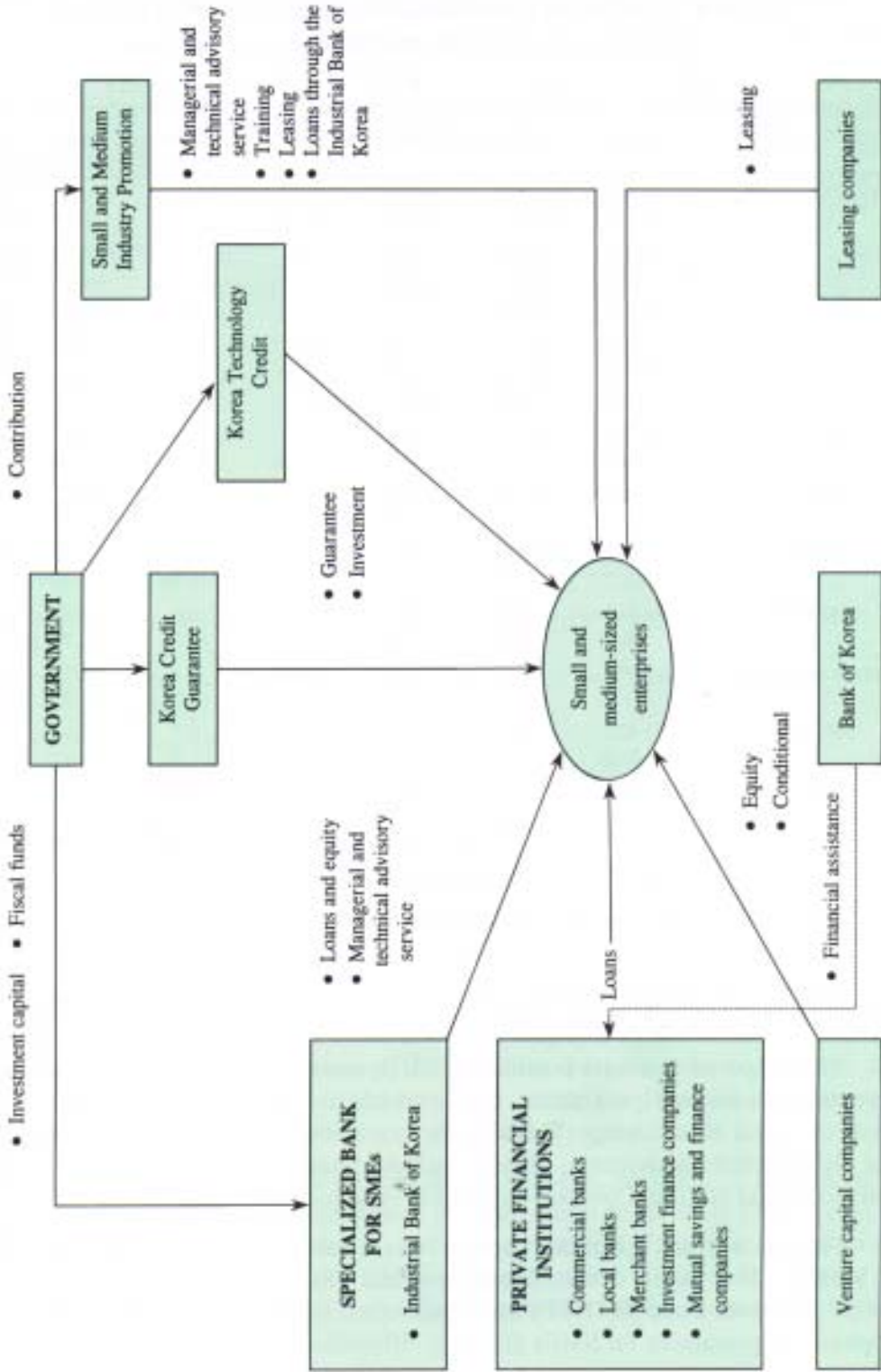
Second, the Industrial Bank of Korea, a special bank founded by the government specifically for SMEs, finances SMEs exclusively (Industrial Bank of Korea 1999).

Third, special loans are provided to SMEs under various schemes. These include government-sponsored programme loans, which are extended through the Industrial Bank of Korea to encourage SMEs in facility investment and to strengthen research and development 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 SMEs. The Korea Credit Guarantee Fund (KCGF) and the Korea Technology Credit Guarantee Fund (KTCGF) have undertaken guarantee businesses with a special emphasis on guarantees for SMEs that have difficulties in qualifying for bank loans.

The basic financial supporting system for SMEs in the Republic of 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 SMEs turn to debt financing at an early stage. Banks are the main lenders. Bank loans accounted for 79.7 per cent of total external financing at the end of 1999. Borrowings from non-bank financial institutions and corporate bonds recorded 7.5 per cent and 3.9 per cent, respectively, at the end of 1999. Borrowings from the private curb market declined to 0.6 per cent.

Table 7. SME borrowings: breakdown by source of funds (based on balances)

(unit : billion won, percentage)

	End-1998		End-1999		Change (%)	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
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 SMEs at the end of June 2001 are shown in table 8. Deposit money banks provided 41.9 per cent of total loans to SMEs at the end of June 2001. Banks have significantly expanded loans to households and tried to reduce their risk exposure to SMEs as well as large firms since the financial crisis in 1997.

Table 8. Deposit money bank loans to SMEs¹

(unit : 100 million won)

	December 1997	December 1998	December 1999	December 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

Source: The Bank of Korea.

Note: ¹ Based on banking account loans to SMEs.

² Numbers in parentheses denote increase rates over previous year.

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 SMEs. Banks were directed to make loans to SMEs.

According to the Credit Operation Guideline of the Financial Supervisory Service, all commercial banks are required to provide more than a specified proportion of their loans to SMEs. For example, nationwide commercial banks are required to supply more than 45 per cent of the increase in loans to SMEs. This mandatory credit extension system has contributed considerably to expanding bank loans to SMEs since 1965. The mandatory credit extension system, however, has intervened in the credit allocation of banks; the financial health of borrowers was often neglected when loan decisions were made.

Table 9. Mandatory minimum ratio of bank loans to SMEs

(percentage)

	<i>April 1965</i>	<i>Decem- ber 1976</i>	<i>Octo- ber 1980</i>	<i>March 1985</i>	<i>April 1986</i>	<i>August 1986</i>	<i>Febru- ary 1992</i>	<i>May 1994</i>	<i>July 1997</i>	<i>Febru- ary 1999</i>
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
Industrial Bank of Korea	90	90	90	90	90	90	90	90	80	80

Source: The Bank of Korea.

Note: Based on loans in domestic currency.

5. The aggregate credit ceiling system of the Bank of Korea

The Bank of Korea encourages deposit money banks to extend more funds to SMEs 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 who were facing difficulties in obtaining funds, and particularly, to encourage bank lending to SMEs.

In September 2000, the Bank of Korea changed its method of appraising bank performance on lending to SMEs. It did so in such a way as to assist banks that were expanding lending to SMEs to receive a larger allocation than other banks focusing on retail credit.

To encourage an expansion of bank lending to regionally-based SMEs 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 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 per cent 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 per cent of SME commercial bills discounted.

Table 10. 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
Bank of Korea 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 the corporate procurement loans scheme

In the Republic of Korea, business firms had for long made use of commercial bills for the settlement of commercial transactions. This practice, however, caused problems because SMEs, which had received commercial bills, had to wait for a considerable time before they could obtain cash settlement in full, aggravating their financial burden. The 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 the expansion of cash settlement. The corporate procurement loans scheme represents a new procedure for the settlement of commercial transactions 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 favourable 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 the rapid rise in the 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 per cent of total discounts of commercial bills.

Table 11. Trends of outstanding amounts of corporate procurement loans and commercial bills discounted

(unit: billion won)

	2000		
	June	October	December
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

Source: The Bank of Korea.

Note: ¹ Based on small and medium enterprises.

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 establishment, expansion and improvement of SMEs. KCGF and KTCGF provide lenders with a guarantee against losses incurred on loans. This support to lenders helps SMEs 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 \$2 billion consisting of loans from ADB and the World Bank to KCGF and KTCGF in order to enlarge loan guarantees to SMEs and venture businesses. Thanks to a sharp increase in government contributions, the outstanding balance of credit guarantees extended by KCGF and KTCGF 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 SMEs 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 per cent in 1993 to 8.1 per cent in 1995, and then to 9.2 per cent in 1998. The high cost of the Credit Guarantee programme has stopped the 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. KCGF, KTCGF and banks should strengthen their capacity to evaluate the creditworthiness of SMEs in a cost-effective manner, for example, through the use of credit scoring techniques.³

The Credit Guarantee programme has been successful in helping start-ups and other SMEs in the Republic of Korea gain access to needed capital for expansion and growth. The programme has succeeded as an economic development tool and is a good example of public sector/private sector cooperation. Its success has spawned similar guarantee programmes. However, controlling the high cost of the Credit Guarantee programme and keeping the programme responsive to users will remain a challenge in coming years.

Table 12. Credit guarantee activities of the Korea Credit Guarantee Fund and the Korea Technology Credit Guarantee Fund

(unit : 100 million won, percentage)

	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
Government 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

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

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

8. Policy funds for SMEs

Policy-related loans for SMEs are supplied from government policy funds, primarily through the specialized bank. Total policy funds to SMEs 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 and 18.1 per cent, respectively,

³ Kristin Hallberg, "A market-oriented strategy for small and medium-scale enterprises", Discussion Paper 40, International Finance Corporation, 2000, pp. 11-13.

in 2000. Equity investment in venture businesses increased from 20 billion won to 315 billion won in 2000.

The maturity of facility funds and technology development funds is eight years. The provision of long-term loans helped SMEs to modernize production facilities and develop a new product or process. The government budget appropriations for supporting SMEs increased in the 1990s and accounted for 4.6 per cent of the total government budget in 1999.

SMEs complain about complicated loan assessment and decision-making procedures of lenders. Banks place high priority on the 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 13. Trend of policy funds to SMEs

(unit : billion won, percentage)

	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 and others	4 620	1 661	1 036
Total	9 450	7 055	6 188

Source: Special Commission on Small and Medium-sized Enterprises.

Table 14. Trend of budget appropriations for SME support

(unit : 100 million won, percentage)

	Total government budget (A)	Appropriations for SME support (B)	B/A (Per cent)
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.

C. THE FINANCIAL CRISIS AND SMES

1. Financial crisis

(a) *Weak banking system*

There was evidence of deterioration in the balance sheets of commercial banks in the Republic of Korea up to four years before the crisis. In 1997, however, this trend took a turn for the worse, as can be seen in table 15.

Table 15. Non-performing loans of commercial banks

(Ratio to total loans, percentage)

	1994	1995	1996	1997	1998	September 1999
NPL ratio	5.6	5.2	3.9	5.8	7.4	6.2

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

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.

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

Fifteen merchant banking corporations were suspended in December 1997, and 13 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 SMEs. 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 dishonoured bills to reach 2.09 per cent in December 1997.

(b) *Corporate failures*

Firms depended heavily on external borrowings to finance investments and other expenditures. The financial crisis in the Republic of Korea originates not only from cyclical downturns, but also from structural deficiencies and delayed policy responses. As the Korean economy slid toward slower economic growth, 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.

Table 16. The 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
		Licence revoked	Closure through merger	Liquidation and other	Licence revoked	Closure through merger	Liquidation and other	Licence revoked	Closure through merger	Liquidation and 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 and 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

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 the profitability of the corporate sector was declining.

Owing 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 SMEs recorded 3,197 in December 1997 when the IMF bailout programme began. These increased to 3,323 in January and 3,377 in February 1998.

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

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

Table 17. Number of bankrupt companies and dishonoured bills ratios

(unit : million won, percentage)

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

Source: The Bank of Korea.

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

Table 18. Bankruptcies in 1997 and 1998

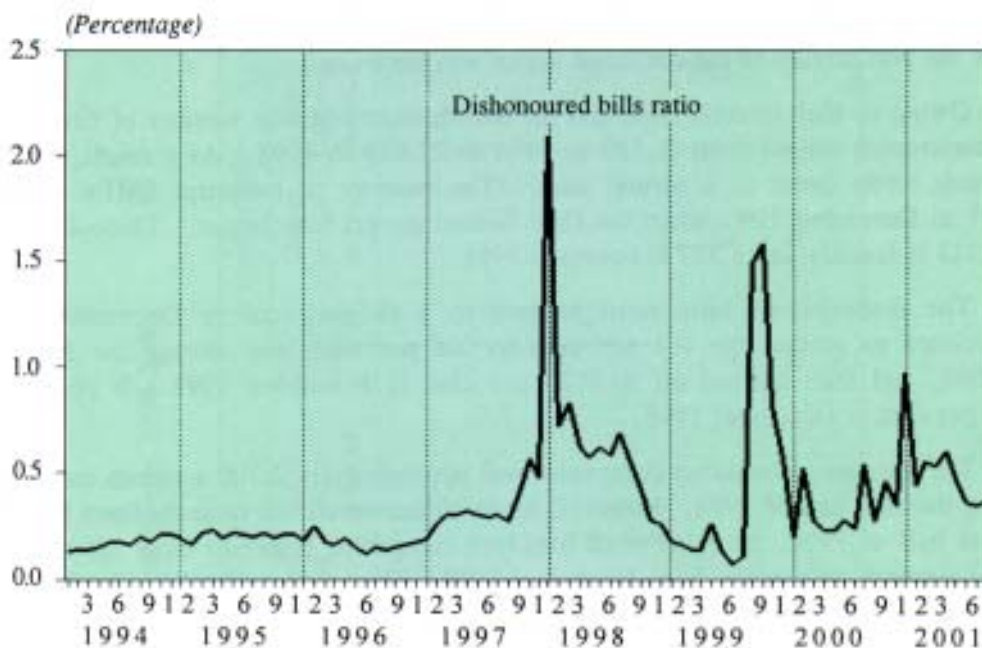
(unit: percentage each)

	January 1998	February	March	April	May	June	July	August	Sep- tember	Oc- tober	No- vember	De- cember	1998
Dishonoured 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)

Source: The Bank of Korea.

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

Figure 2. Trend of dishonoured 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 the Republic of Korea resulted in debt-financed expansion by business conglomerates and SMEs – raising the country'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. It set up different approaches corresponding to the restructuring requirements of each of the following groups: conglomerates and SMEs. SMEs 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 SMEs has improved to 35.8 per cent in 2000 from 23.0 per cent in 1998. The debt ratio and current liabilities ratio of SMEs have been lowered to 179.7 and 121.3 per cent in 2000 from 334.4 and 219.7 per cent in 1998, respectively. Interest expense-to-total borrowings of SMEs has been lowered to 9.4 per cent in 2000 from 13.8 per cent 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 programme: 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 19. Financial structure of firms in the manufacturing industry: breakdown by firm size

(percentage)

	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 and 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: Bank of Korea, Financial Statement Analysis, 2001.

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

- (a) Interest rates were lowered to reduce pressure on the financial system and the financing costs of business firms, and to promote capital market activities;
- (b) A financial restructuring programme was launched to recapitalize viable banks and cover their losses. By the end of 1998, almost all commercial banks met the 8 per cent capital adequacy ratios;
- (c) Loan guarantees of 33 trillion won were provided to SMEs to aid them in obtaining financing;
- (d) Trade financing of \$3.3 billion, consisting of World Bank loans and excess reserves from the Bank of Korea, was extended to SMEs 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 SMEs had increased by 17 trillion won, surpassing the level of 1997.

Owing to a severe credit crunch after the financial crisis in 1997, loans to SMEs by deposit money banks decreased 3.3 per cent in 1998. Deposit money banks, however, have expanded loans to promising and healthy SMEs with high growth potential since 1999 and offered them lower lending interest rates. Deposit money bank loans to SMEs have increased 22.8 per cent and 16.5 per cent in 1999 and 2000, respectively (table 8). The average lending interest rate to SMEs has declined to 7.5 per cent in June 2001 from 14.3 per cent in December 1997.

Table 20. Deposit money bank average lending interest rate to SMEs

(annual percentage)

	<i>December 1997</i>	<i>December 1998</i>	<i>December 1999</i>	<i>December 2000</i>	<i>June 2001</i>
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.

D. FINANCIAL ASSISTANCE TO SMALL ENTERPRISES

1. The importance of small business

More than 97 per cent of all businesses in the Republic of Korea are small businesses. In 1998 there were more than 2.5 million small businesses with fewer than 50 employees, providing employment for more than 59 per cent of all Koreans working in the private sector. Job creation is the most important contribution made by small businesses.

Table 21. Status of small and medium-sized enterprises, 1998

(unit: person, percentage)

	<i>No. of establishments</i>	<i>No. of employees</i>
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.

2. Financial assistance

The Special Act on Small Business Support came into being in April 1997. The 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 programme for small businesses with the objective to support start-ups and improvements of small businesses. The government earmarked 300 billion won and 200 billion won in 1999 and 2000, respectively, for the programme. The maximum loan amount was increased from 30 million won to 50 million won and the maturity of loan was extended from three to four 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 22. Loans for small business start-ups and improvements

(unit: 100 million won)

	1999	2000		Total
		First quarter	Second quarter	
Recommendation	6 351	3 015	2 050	11 416
Loans	2 512	858	1 127	4 497

Source: Small and Medium Business Administration.

E. 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 increasing unemployment, decreasing wage and income, growing absolute poverty, and increasing health risk. In the wake of the financial crisis and subsequent economic recession in the Republic of 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 per cent (556,000 unemployed) in 1997 to 5.9 per cent (1.23 million unemployed) in February 1998, to a record high of 8.6 per cent (1.78 million unemployed) in February 1999. In response to the record high rates of unemployment, the government has taken measures to increase employment, such as job preservation, general job creation, vocational training and social care.

2. Public loans through the Life Stabilization Fund

Since the financial crisis struck, mid- and low-income earners have suffered from deteriorating living standards. If we define the middle-income class as those earning

between 50 and 150 per cent of the median income, the ratio of the middle-income class has declined to 65.7 per cent from the 68-70 per cent level before the financial crisis. Unemployment hit the poor and disadvantaged population more severely, such as unskilled labour, SME workers, and female labour.

The government put forth a comprehensive unemployment package to minimize the adverse impacts of the crisis in March 1998, including loan programmes 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 programme, 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 two-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 programme. The 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 the unemployed who started their own small businesses (200 billion won to 10,000 households). In addition to these loan programmes, the National Pension Fund deployed a separate loan programme (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 Programme for Start-ups for Living

Since July 1997, the government has implemented the Loan Guarantee Programme for Start-ups for Living with the objective of increasing 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 per cent a year. More than ninety-four per cent of loans made were 50 million won or less.

The government allocated 200 billion won for the Programme. The outstanding balance of guarantees provided by the Korea Credit Guarantee Fund for the Programme recorded 1,900 billion won for 70,000 loans made at the end of April 2000. The benefits of the Programme can best be measured by its stimulation of job creation. According to government estimates, the Programme has resulted in the total additional employment of 215,000 persons from July 1999 to September 2000.⁴ However, claims paid

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

have soared from 0.13 per cent of loans made in 1999 to 5.57 per cent of loans made in September 2000.

F. CONCLUSION

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

SMEs in the Republic of Korea have been well served by credit guarantee programmes and the mandatory minimum ratio of bank loans to SMEs. The credit guarantee schemes 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 per cent of the budget appropriations for the SME sector to credit guarantee programmes in 1999. The sharp increase in credit guarantees has led to greater finance being provided to SMEs 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 the unemployed and low-income earners.

Greater finance from banks to SMEs, mid- and low-income earners, and the unemployed has led to additional jobs and a lower unemployment rate in the Republic of Korea. SMEs provided employment for 81.9 per cent of all Koreans working in the private sector at the end of 1999, compared with 74.4 per cent at the end of 1997. The unemployment rate has declined from a record high of 8.6 per cent in February 1999 to 3.0 per cent 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 per cent in 1993 to 9.2 per cent 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 the creditworthiness of micro-enterprises and SMEs in a cost-effective manner, for example, through the use of credit-scoring techniques. Controlling the high cost of the credit guarantee programme and keeping the programme responsive to users will remain a challenge in coming years.

The government may have to retrench policy funds for SMEs to reduce the budget deficit in coming years. A market-oriented strategy should be taken to improve financing to micro-enterprises and SMEs. 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 market.⁵ The government and the Financial Supervisory Service should curtail barriers against entry to the financial market by revising the BIS capital adequacy requirements and prudential regulations that may be unsuitable for regional banks and non-bank financial institutions serving micro-enterprises and SMEs.

Information on the creditworthiness of potential borrowers could be enhanced by establishing credit bureaus for micro-enterprises, SMEs, and households. The development of a model to evaluate the 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 by SMEs will grow when the economy emerges from recession. Helping to create the environment in which SMEs can gain easy access to needed capital will be a key priority for policy makers and financial market participants with responsibility for encouraging the growth and development of SMEs on which jobs and wealth in the economy depend.

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

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