THE EVOLUTION OF FOREIGN BANK REGULATION IN JAPAN AND KOREA: AN APPLICATION OF THREE ANALYTIC PARADIGMS

by

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ABSTRACT

The purpose of this thesis is to explain the evolution of foreign bank regulation using a multi-paradigm methodology, which is applied to two case studies: Japan and Korea. Three analytic paradigms, or models, adapted from those developed by Graham T. Allison, are applied to each country. Each model consists of an alternative framework of explanation.

The first model, the Rational Model, views the Japanese government and the Korean government as rational, unitary decision-makers who take decisions on foreign bank regulation (and financial liberalization in general) based on a set of objectives and strategic problems, in order to serve the national interest in the best possible way. The second model, the Organizational Process Model, views governmental actions as organizational outputs, rather than as rational acts and choices. Regulations governing foreign banking activities are explained as outputs of the decision-making processes of the financial authorities. The third model, the Political Model, focuses upon the strategic interaction of multiple stakeholders. This model views governmental actions neither as choices nor as outputs, but rather as the resultants of various bargaining games among players.

The evolution of foreign bank regulation and the process of financial liberalization raise some important questions which the models attempt to answer. The three models are applied in turn to each case study. The purpose is not to select the "best model" but rather to provide alternative explanations and gain additional insights into the subject of foreign bank regulation.

In Japan, the analysis using the Rational Model explains the liberalization process and the evolution of foreign bank regulation as the result of the country's mature domestic economy, high trade surpluses, expansion of its financial industries abroad, and foreign pressure. The Rational Model fails, however, to answer why financial markets in Japan are still more regulated than financial markets in other developed countries, and why foreign banks are not provided national treatment. In Korea, the analysis using the Rational Model explains the highly restrictive measures governing foreign banking activities as necessary considering the poorly-developed state of the domestic banking sector. However, the Rational Model fails to answer why government intervention in the banking sector has remained so strong, even though the size and complexity of the Korean economy calls for the introduction of a free and competitive financial sector.

Applied to Japan, the Organizational Process Model explains the slower pace of financial liberalization and the regulation of foreign banks as the result of the Ministry of Finance's organizational process. The process is characterized by the strong parochial objectives of the bureaus within the Ministry, the growth- and protection-oriented priorities of regulators, and the use of inflexible standard operating procedures. The Organizational Process Model applied to Korea explains the poorly-developed state of the banking sector as the result of the government's use of a centralized and autonomous policy-making process, which is outdated and in contradiction with the objective of financial liberalization.

The Political Model offers alternative explanations. In Japan, the numerous bargaining games among the powerful private interest groups and financial authorities have influenced the implementation of regulatory policy. Applied to Korea, the Political Model suggests that liberalization of the banking sector was never considered a viable option because of the government's involvement in several power struggles to retain its control over the financial sector.

The models can be seen to complement each other. Separating the analysis into three alternative frameworks of explanation has facilitated the generation of hypotheses and has highlighted features that might have otherwise been overlooked.

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CHAPTER I. INTRODUCTION

A. BACKGROUND

One of the major financial developments since the 1960s has been the growing internationalization of banking. Today, international banks are among the largest service corporations in the world. In many major developed countries for which data are available, the second largest position in both outward and inward investment in services from the early 1970s to mid-1980s, is occupied by banking, insurance and other financial services (UN, 1987, p. 27).

During the 1980s, the markets in which international banks operate have undergone significant changes. These have tended to blur the boundaries between national financial markets in the developed market economies (ibid, p. 41). The growing internationalization of banks has encouraged the development of world financial centres and offshore banking centres.

One of the most important factors contributing to the integration of world financial markets has been the trend toward deregulation. Increased market integration, in turn, has accelerated the process of deregulation as countries have been forced to respond to international market forces pressing for uniform regulation.

The banking sectors of practically all developed market economies are more rigidly regulated than any other commercial or industrial sector. Richard Dale, in his book Regulation of International Banking (1984, p. 53), provides four reasons for this relatively high level of regulation. To begin with, authorities want to control the quantity of bank deposit liabilities (money) through minimum reserve requirements. Secondly, since banks are a major tool for channelling financial resources to the rest of the economy, governments may want to control the direction of lending. Thirdly, banks raise funds partly through the public's savings, and therefore they ought to be subject to consumer protection legislation. Lastly, since they are vulnerable to financial collapse, banks may face extensive prudential regulation.

Governments have imposed extensive controls on their domestic banking sectors. Dale distinguishes between preventive regulation (capital adequacy, liquidity, permissible business activities, etc.) and protective regulation (deposit insurance, official support as "lender of last resort", etc.) (1984, pp. 55-69).

Regulations governing foreign banking activities tend to be even more restrictive. Generally, authorities implement a broad set of regulatory measures pertaining to the entry and form of establishment of foreign banks, acquisition by foreign banks of shares in local banks, operations of established foreign-controlled banks, and cross-boundary international banking operations (Pecchioli, 1987, p. 10).

Reasons for the application of these regulatory measures include the desire by authorities to control the competitive balance in the domestic banking sector, avoid "overbanking", avoid possible circumvention of domestic monetary policy and prudential controls, ensure capital adequacy, control foreign exchange resources, reduce capital movements across borders, etc.

The formulation and implementation of foreign bank regulation is a complex process because it involves many stakeholders domestically and abroad. It is influenced, not only by domestic political and economic developments, but also by events and trends in international markets.

B. PURPOSE OF THIS THESIS

The purpose of this thesis is to explain the evolution of foreign bank regulation using a multi-paradigm methodology (described later in this chapter), which is applied to two case studies: Japan and Korea.

The choice of these two countries provides an opportunity to examine the differences between the regulatory process in a major world financial centre undergoing a process of deregulation and a financial centre in a newly-industrialized country (NIC). It was expected that while regulators in a NIC could pursue a banking policy that is more insulated from demands for deregulation imposed by international markets, regulators in a world financial centre are more likely to respond promptly to such demands.

To explain the evolution of foreign bank regulation in Japan and Korea, we apply three analytic paradigms, each providing an alternative explanation to the question of foreign bank regulation. These models have been adapted from those developed by Graham Allison (1971).

C. ALLISON'S MODELS

Graham Allison, in his book The Essence of Decision - Explaining the Cuban Missile Crisis (1971), demonstrates that while governmental decisions are mostly analyzed in terms of actions taken by a rational, unitary actor - the government - this line of analysis is not sufficient by itself and fails to take into consideration other very important factors. According to Allison, governmental actions are too complex and involve too many players to be explained solely by rational motives, hence the need to go beyond a rational model of explanation. Government actions are also outputs of the government's organizational process and/or resultants of governmental politics.

In his analysis of the Cuban missile crisis, Allison used three analytic paradigms (models), each consisting of an alternative framework of explanation. The three models are the Rational Actor Model, the Organizational Process Model, and the Governmental Politics Model. These analytic paradigms are illustrated in Figure 1.1

Rational Actor Model: Allison (1971, pp. 2-3) argues that when we are puzzled by a happening in foreign affairs, the source of puzzlement is typically a particular outcome. When searching for an explanation, one typically puts himself in the place of the nation, or the government, and tries to find out why he might have chosen this particular outcome. Explanations offered are thus under the assumption that governmental behavior can be most satisfactorily understood by "analogy with the purposive acts of individuals" (ibid, p. 3).

Figure 1.1

ALLISON'S MODELS

THE RATIONAL ACTOR PARADIGM

1. **Unit of Analysis**: governmental action as choice

2. **Organizing concepts:**

   a) National Actor: nation or government conceived as a rational, unitary decision maker.

   b) Problem: action is chosen in response to the strategic problem the nation faces.

   c) Action as Rational Choice: components include goals and objectives, options, consequences and choice (rational and value-maximizing)

3. **Dominant Inference Pattern**: "if a nation or government performed a particular action, that nation or government must have had ends toward which the action constituted a maximizing means"

4. **Explanation of Event**: action is done given strategic objectives

5. **Predictions**: (what a nation or government will do or would have done) generated by calculating the rational action to take in a certain situation, given specified objectives

THE ORGANIZATIONAL PROCESS PARADIGM

1. **Unit of Analysis**: governmental action as organizational output

2. **Organizing Concepts**:

   a) Organizational Actors: actor is not a monolithic nation or government, but rather a constellation of loosely allied organizations on top of which government leaders sit.

   b) Factored Problems and Fractionated Power: each organization perceives problems, processes information and performs a range of actions in quasi-independence

   c) Parochial Priorities and Perceptions: primary responsibility for a narrow set of problems encourages organizational parochialism

   d) Action as Organizational Output: activity of each organization is characterized by goals which emerge as a set of constraints defining acceptable performance; sequential attention to goals; Standard Operating Procedures (SOPs); programs and repertoires (set of SOPs); and uncertainty avoidance

   e) Central Coordination and Control: government action requires decentralization of responsibility and power, but the necessity for decentralization runs headlong into the requirement for coordination.

3. **Dominant Inference Pattern**: "if a nation or government performs an action today, its organizational components must yesterday have been performing an action only marginally different from today's action."

4. **Explanation of Event**: identification of the relevant organizations and display of the patterns of organizational behaviour from which the action emerged.

5. **Predictions**: identify trends that reflect established organizations and their fixed procedures and programs.

Figure 1.1 - continued

THE GOVERNMENTAL (BUREAUCRATIC) POLITICS PARADIGM

1. **Unit of Analysis**: Governmental action as political resultant

2. **Organizing Concepts**:

   a) who plays; whose interests and actions have an important effect on government's decisions and actions

   b) what determines each player's stand: parochial priorities and perceptions, goals and interests, stakes and stands, and deadlines which force settlement of issues

   c) what determines each player's impact on results: power (effective influence on government decisions and actions)

   d) what is the game: action channels, rules of the game, action as political resultant

3. **Dominant Inference Pattern**: "if a nation or government performed an action, that action was the resultant of bargaining among individuals and groups within the government"

4. **Explanation of Events**: achieved by displaying the game - the action-channel, the positions, the players, their preferences, and the pulling and hauling - that yielded, as a resultant, the action in question

5. **Predictions**: generated by identifying the game in which an issue will arise, the relevant players and their relative power and skill.

The Rational Actor Model is the traditional model of explanation used by analysts to explain governmental actions. Each country or government under study is viewed as a rational, unitary decision-maker. This rational actor has one set of specified goals and objectives and, depending on available options and their consequences, takes a value-maximizing, rational decision (Allison, 1971, pp. 32-33).

Treating governments as if they were unified actors provides a useful shorthand for understanding policy. But this simplification obscures the persistently neglected fact of bureaucracy: "the maker of government policy is not one calculating decisionmaker but is rather a conglomerate of large organizations and political actors" (Allison, 1971, p. 3). Allison thus introduced two alternative conceptual models to provide a base for improved explanation and prediction.

<u>The Organizational Process Model:</u> This model views governmental actions as organizational outputs rather than as rational acts and choices. The decision-maker is no longer a monolithic nation or government, but a constellation of loosely allied organizations on top of which government leaders sit (Allison, 1971, pp. 80-81). Action is determined not by rational choice but by such elements as the parochial objectives, priorities and perceptions of the civil servants, the use of standard operating procedures, and the use of pre-determined programs and repertoires.

<u>The Governmental Politics Model:</u> The third model focuses on the politics of a government. This model, in contrast to the Rational Model, sees no unitary

actor, but rather many actors as players, or stakeholders. Each player pulls, hauls, bargains, and compromises, using the power at his disposal to achieve his own particular goals. Policy-making is therefore a process of conflict and consensus building (Allison, 1971, p. 157). This model views governmental action neither as choices nor as outputs, but rather as the resultant of various bargaining games among players within the government.

Although the models provide accounts which emphasize quite different factors in explaining governmental action, they can be seen to complement each other. Allison (1971, p. 258) states that the Rational Actor Model fixes the broader context and the larger national patterns. Within this context, the Organizational Process Model highlights the organizational routines that produce the information, alternatives and action. Within the second model's context, the Governmental Politics Model focuses in greater detail on the individual leaders of a government and the politics among them that determine major governmental choices. Allison (1971, p. 259) concludes that, "the best analysts of foreign policy manage to weave strands of each of the three conceptual models into their explanation."

To summarize, the Rational Model involves the fewest variables out of the three conceptual models, postulating that choices of actions and solutions to constrained optimization problems allows the analyst to formulate relatively sharp predictions or hypotheses (see Figure 1.1) Indeed, in policy domains where there is a consensus on national objectives and where the "technologies" of public management are perceived to be well understood, the specification of a rational model can be easily derived and its power of explanation should be sufficient. The problem with the Rational Actor Model is that it ignores two important facets of the regulators' process, 1) the role that uncertainty in determinig objectives and technologies play in the regulatory process, and 2) the "reactive" nature of the policy environment, i.e., the active role that other (than the government) stakeholders play in influencing the regulatory process and the implementation of regulations. Allison's Organizational Process Model postulates that organizational decisions are a reflection of organizational coping with uncertainty, in objectives and technologies. The Governmental Politics Model on the other hand deals with the reactive nature of the policy process.

The choice of the three models allows one to move from a deterministic formulation to two more complex ones: one focusing on uncertainty and the other focusing upon strategic interaction. (Of course, one could deal both with uncertainty and reactivity but such a model may be unmanageable.) The advantage of this analytic procedure is that it permits the analyst to economize in assumptions and "degrees of freedom". In the application of Allison's Organizational Process Model and the Governmental Politics Model, one may follow a similar strategy, starting in each with a restricted number of decision units (say two) and keep refining the model by subdividing and adding decision units until one explains all the key phenomena.

While Allison's conceptual models can be applied to many types of governmental action, one must adapt the models to the specific policy domain. In our case, the governmental action under study is the formulation and implementation of foreign bank regulation.

D. THE PROPOSED METHODOLOGY FOR THIS THESIS

The methodology in this thesis is similar to the one used by Allison, as we apply each of the three models in turn to two case studies of foreign bank regulation. The evolution of foreign bank regulation in Japan and Korea raises some important questions which the models attempt to answer. These models have been modified to take into consideration the purpose of this thesis, i.e., explaining foreign bank regulation. The three models used, variants of Allison's models, are the Rational Model, the Organizational Process Model, and the Political Model.

The Rational Model is very similar to Allison's Rational Actor Model. We view the Japanese government and the Korean government as rational, unitary decision-makers who take decisions on foreign bank regulation (and financial liberalization in general) based on a set of national goals and objectives, and strategic problems facing the nation, in order to maximize benefits, i.e., serve national interests in the best possible way.

The methodology used to apply the Rational Model to each case study consists of two parts: 1) assessing the major trigger events influencing governmental action, determining the assumed national objectives, the problems facing the nation, and the implied solutions that should be chosen, and 2) providing a descriptive account of the actual actions that were taken in terms of financial liberalization and foreign bank regulation. The main actor is the government, and foreign bank regulations are analysed as choices made by this single, unitary decision-maker. The evolution of foreign bank regulation in each country is divided into different time periods and is summarized in figures provided in each section dealing with its respective period. The reader will find it beneficial to refer to these figures as they illustrate the rational analytic framework of explanation. By comparing the actual measures implemented with the implied solutions, we can assess to what extent the model explains the regulations governing foreign banks. The elements mentioned above, which are also presented in the figures, are defined as follows:

-Trigger events: These are general conditions prevailing in world markets which can influence governmental action (world recession, world trend toward greater financial liberalization, situation of trading partners, etc.) as well as external events whose consequences are specifically directed at the country under study (foreign pressure for increased liberalization, oil crisis, balance of payments problems, etc.).

-Assumed Objectives: These are the stated national objectives of the country.

-Implied Problems: These are the major strategic problems facing the nation that constitute obstacles in attaining national objectives.

-Implied Solutions: These consist of governmental action (in terms of financial liberalization and foreign bank regulation) predicted by the model, considering the trigger events, assumed objectives, and implied problems.

The analysis under the Rational Model also provides an account of actual measures taken by the government. From these measures, we can derive the implied objectives lying behind actual governmental action. When implied objectives are different from the implied solutions predicted by the model, we must explain the discrepancies. Elements which are not, or only partially explained by the model, raise additional important questions that must be addressed. In order to do so, we have to go beyond a rational approach and apply two additional frameworks of explanation.

The Organizational Process Model used in this thesis is also similar to Allison's Organizational Process Model, except that the organization studied is not the government as a whole. The sections dealing with this model focus on the decision-making process of organizations responsible for policy-making and policy implementation in the banking sector. Thus, in Japan, we will focus our analysis on the Ministry of Finance, and in Korea, on the small group consisting of the President, the close presidential advisers, and the bureaucrats of the Economic Planning Board. The model attempts to demonstrate that actions taken by these organizations are determined mainly by features of their decision-making process, which are quite inflexible and resistant to change. In order to do so, we will identify the parochial priorities and perceptions of the different factions composing the organizations under study, their standard operating procedures, and their programs and repertoires.

The second alternative framework to the Rational Model is the Political Model. This model is a generalization of the Rational Model in the sense that it considers multiple stakeholders each making rational choices in a "strategic game". The Political Model used in this thesis differs somewhat from Allison's Governmental (Bureaucratic) Politics Model as it also takes into consideration the influence of players outside the government. The sections dealing with this model provide numerous accounts of power struggles, bargaining, and compromises among the various interest groups, all of which influenced the regulation of foreign banks and the pace of financial liberalization. While it is difficult to know the details of where every player stood behind the scenes, and what his stake was, the use of publicly available documents and newspapers can provide sufficient episodes and anecdotes to enable us to draw reasonable conclusions.

The reader should note that the purpose of this thesis is not to select the "best model", but rather to provide alternative explanations and gain additional insights into the subject of foreign bank regulation, starting with the most "economical" (or sharp) model and then augmenting its insights with two alternative models.

E. ORGANIZATION OF THE THESIS

Each case study employs, sequentially, the Rational Model, the Organizational Process Model and the Political Model. Specifically, Chapter II provides a historical perspective of foreign banks in Japan and a general assessment of the environment in which they compete. Chapter III applies the three models to the evolution of foreign bank regulation in Japan. Chapter IV and Chapter V provide the same analysis as Chapters II and III, but applied to the Korean case of foreign bank regulation. Lastly, Chapter VI consists of a general conclusion which highlights the main differences and similarities between the two case studies, assesses each model's contribution to explaining the regulation of foreign banks, and describes the broader lessons we can learn from these models.

CHAPTER II. FOREIGN BANKS IN JAPAN

A. HISTORICAL PERSPECTIVE

The presence of foreign banks in Japan can be traced as far back as 1870, when two British banks established branches. In 1898, another British bank opened a branch, followed by two each from the United States, France, and the Netherlands and one each from Germany and the USSR. By 1929, 10 foreign banks were conducting business in Japan through 23 branches (Ursacki and Vertinsky, 1989, p. 2). These banks concentrated their operations mainly in trade financing, particularly with their home countries.

World War II suspended foreign banking operations, but a dozen banks reopened during the American occupation, including three each from the United States and the United Kingdom, two from the Netherlands, and one each from France, Korea, India and China (Schiffer, 1962, cited in Ursacki and Vertinsky, 1989, p. 3).

In 1949, the American authorities turned over control of and responsibility for the banking sector to the Japanese government formed under the direction of General Douglas McArthur. A highly restrictive entry policy followed and from 1950 to 1967, only seven additional foreign banks were allowed to open a branch in Japan (Pauly, 1987, p. 179). Starting in 1955, the Bank of Tokyo and some of the city banks (large commercial banks) expanded their operations abroad, in line with the growth and globalization of their major clients.

Until the late 1960s, the banking sector remained highly regulated, with foreign banks and domestic banks both operating in their separate market niches. However, when Japan became a member of both the OECD and the IMF, liberalization of its financial markets was undertaken as a response to foreign demands for reciprocal access. Morgan Guaranty was the first to benefit from this process when it was granted a branch licence in 1969. This signal opened the door for many foreign banks to penetrate the market: in the following decade, 46 others opened a branch (Ursacki and Vertinsky, 1987. p. 3).

Although the number of foreign banks increased significantly, their presence was (and still is) considered marginal to the Japanese market. Their market share of deposits remained at the level of 1% and their share of the loans market increased from 1.5% to 3% (Ursacki and Vertinsky, 1989, p. 3). Profitability was also unimpressive, with return on assets (ROA) averaging less than .3% by 1979.

At that time, the picture was discouraging, with impact loans declining, increased competition pushing spreads down, inadequate access to low-priced yen funding, and small branch networks, to name but a few of the problems facing foreign bankers. Nonetheless, 22 other foreign banks entered the Japanese market from 1980 to 1986. By 1987, 79 foreign banks from 22 countries were operating in Tokyo. As of June 1988, there were 81 foreign banks conducting banking business through their 119 branches. However, they were stuggling for no more than .58 percent of the deposits and CDs market and 2.08 percent of the loans market (see Figure 2.1). The United States was the most heavily

Figure 2.1

Foreign Banks' Share of the Japanese Banking Sector
(percent)

	Total Deposits(1)	Loans(1)	Assets(2)
1980	0.95	3.27	4.06
1981	1.09	3.49	3.82
1982	1.13	3.50	4.73
1983	0.99	3.43	4.56
1984	0.98	3.40	4.35
1985	1.05	2.72	4.37
1986	0.72	2.12	3.49
1987	0.57	2.15	-
1988	0.58	2.08	3.82

Sources: Ministry of Finance, Annual Report of the Banking Bureau and The Bank of Japan, Economic Statistics Monthly cited in FBAJ, Japan Financial Statistics; OECD, Financial Statements of Banks; Peat Marwick, Mitchell & Co., Balance Sheet of Foreign Bank Branches in Japan.

(1) Includes those of city banks, local banks, trust banks and long-term credit banks, at September 30.

(2) Includes those of city banks and local banks, at March 31.

represented country, with 19 banks operating 28 branches. France had 13 branches of its own, followed by Singapore with eight branches, West Germany and the United Kingdom with seven branches, and Canada with six branches (FBAJ, 1989, p. 27).

B. THE ENVIRONMENT IN WHICH FOREIGN BANKS COMPETE

Following the Second World War, during the American occupation, banks were classified into three groups: ordinary banks (city banks and smaller, regional banks); specialized banks (dealing with international business, trust business, long-term credit); and "others" (a large number of local institutions dealing in specific sectors of the economy, such as agriculture and forestry).

However, it is more useful to classify the Japanese banks into five groups: the commercial banks, the trust banks, the long-term credit banks, the foreign banks, and others. Different laws regulate each of the groups: the Banking Law, for ordinary banking activities; the Trust Law and the Trust Business Law, for trust banking activities; the Foreign Exchange Bank Law, related to foreign exchange transactions and export/ import financing business; the Long-Term Credit Bank Law, for long-term credit banking activities; the Mutual Finance Bank Law; and the Law Concerning Credit Unions (Price Waterhouse, 1986, p. 213).

Commercial banks are subject to the New Banking Law, which is an extensive revision of the Banking Law enacted in 1927. The New Banking Law was enacted in 1981, but it was revised effective in April 1982. Under Article

10 of the law, the commercial banks are allowed to engage in the following activities: "acceptance of deposits; making of loans; handling of foreign exchange transactions; guaranteeing liabilities and accepting notes; the buying and selling of securities (limited to transactions made for the bank's own investment portfolio, and customers' accounts based upon their written order); lending securities; underwriting government bonds, local government bonds and government guaranteed debentures; and the safekeeping of securities, precious metals and other articles" (Semkow, November 1987, p. 11).

Included in the commercial bank category are the city banks and the regional banks. There are a total of 13 city banks located in major cities with branches spread throughout the country. These banks account for a little more than one-half of all banking assets in Japan and, as will be discussed in greater detail in the following sections, they provide the main competition to foreign banks. Some of them are large multinational banks which constitute the major lenders to Japanese industrial borrowers. As of 1986, approximately 60% of their lending facilities were employed in funding large enterprises (Price Waterhouse, 1986, p. 210). This situation is explained by Japan's relatively poorly developed securities market, which led large corporations to be dependent on the city banks for financing (US Treasury, 1984, p. 21). Most of the city banks' funds for lending purposes are acquired through deposits, especially time deposits.

There are 63 local or regional banks and, in accordance with Ministry of Finance regulations, they conduct business primarily in the prefecture where their main offices are located (US Treasury, 1984, p. 22). Regional banks typically offer short-term loans to small and medium-sized businesses, as well as providing funds to city banks in need (Spindler, 1984, p. 98).

Seven trust banks engage in general trust business by issuing loan trusts on medium-term savings certificates and are also strong participants in the domestic long-term lending market (Spindler, 1984. p. 98). The three long-term credit banks, which specialize in long-term financing, operate throughout the country, although their branch networks are much smaller than those of the city or regional banks. Their task is twofold: to alleviate commercial banks of the pressure of long-term financing and to substitute as a capital market (Ishi, 1982, p. 110).

The postal savings system, operated by the Ministry of Posts and Telecommunications, has been very popular in Japan. In July 1988 it accounted for 13.9% of the deposits, debentures, and trust markets, with over 23,000 "branches" in Japan (FBAJ, 1989, p. 15).

Also present in the market are a number of membership organizations such as mutual finance banks (Sogo banks), credit unions (Shingo kinko), credit associations, labor credit unions, and a number of specialized financing institutions. The role of these players is less significant for the discussion of this study.

The governmental organizations regulating these financial institutions center around the Ministry of Finance, which is principally responsible for policy formulation and regulatory, supervisory, and planning functions. The Bank of Japan handles the day-to-day implementation of these regulations in the money markets (Pauly, 1987, p.164). It also issues bank notes, serves as banker to the government and banks, and administers the enforcement of foreign exchange control regulations and the government's monetary policy (Price Waterhouse, 1986, p. 209).

The structure of the Japanese banking sector has undergone significant changes since the end of World War II. The banks were the instruments used to provide much-needed funds to rebuild the industrial sector. The Japanese government always maintained close relations with the banks and used its relationships to attain national objectives by employing what is described as government guidance. This close alliance, according to many observers, has helped to shape the industrial structure of Japan.

Liberalization of the financial sector began in the 1960s, with a much faster pace prevailing since the 1970s. According to Pauly (1987, p. 159), liberalization "refers to the changed needs of a maturing domestic economy reshaped by slower growth, persistent trade surpluses and the burgeoning external expansion of its industries."

Perceptions of the degree to which the banking sector in Japan is regulated differ among the various players. These conflicting views reflect the fact that regulation is often implemented through what is called "administrative guidance" rather than formal, written regulation. While many regulations have been eased, the system is still considered by many observers to contain many restrictions.

Compared to the American banking sector and those of major industrialized countries, the Japanese banking sector is more concentrated, with greater specialization of activities. The banking law has always separated banking, securities, and insurance activities and has compartmentalized banking into short-term lending (city and regional banks), long-term lending (long-term credit and trust banks), and trust banking. Japan is the only major economic power which maintains separate systems for short-term and long-term finance. When Canada completes the reformation of its trust operations system, Japan will be the only proponent among the major developed countries of a separate trust operations system (Sanwa Bank, April 1989, p. 4). In addition, only Japan and the United States separate banking and securities business. However, the differences between these activities have become less clear with the recent liberalization steps. Activities of banks in Japan, as a result of these steps, tend to extend beyond their different areas of specialization, but are still not as homogeneous as is the case in some of the other developed countries.

Among the most important liberalization measures were the amendments made to Article 65 of Japan's Securities and Exchange Law (equivalent to the US Glass-Steagall Act), which separates investment activities from commercial banking activities. The amendments permit Japanese banks to deal in government bonds over the counter to the general public. Commercial banks were allowed to be secondary dealers in Japan's government bonds in 1984. In the beginning, they could only deal in bonds with less than two years left to maturity. That restriction was lifted in 1985 at the same time as regional, mutual, and foreign banks were allowed into this market (Economist, October 18 1986, p. 82).

The Tokyo offshore market was established in December 1986. This allowed Japanese institutions to have special banking accounts, separate from accounts for domestic transactions, and to do business with foreign firms, governments and international agencies free from domestic regulation (Nobuhiko, 1988, p. 293). Transactions in this facility are exempt from interest rate regulations, deposit insurance and reserve requirements, and interest received by non-residents is tax-free (Euromoney, February 1989, p. 37). However, this offshore market, which was modeled on New York's International Banking Facility, opened with little excitement. Due to several types of control measures used by the monetary authorities, and the lack of proper tax incentives, some bankers said that the benifits were too small for them to invest large sums and that restrictions were too high to take business away from London, New York, Singapore, or Hong Kong.

Nonetheless, the Tokyo offshore market has grown steadily in terms of size. The Ministry of Finance recently announced that regulations restricting the inflow and outflow of capital will be relaxed starting April 1, 1989, in the hope that the liberalization of regulation will contribute to further internationalization of the yen and also encourage worldwide financial dealings of small and medium-sized banks which are not operating branches overseas (Japan Times, March 25 1989, p. 11). At the end of 1988, the balance of deposits totaled

US$ 414.2 billion, surpassing the New York and Singapore markets in scale, and nearly reaching the level of Hong Kong, the second largest market in the world after London (ibid).

Although slow compared with other developed countries, the liberalization process in Japan has continued to be implemented since 1986: interest rates payable on large-denomination term deposits, certificates of deposits (CDs) and money market certificates (MMCs) have been quite significantly deregulated. However, almost two-thirds of savings deposits and one-third of deposits in general are still under interest rate controls (Euromoney, February 1988, p. 37). The financial market is also not very well developed. A short-term money market exists "only in theory" in Japan. Collateral requirements in the bill and call markets are outdated and quite expensive by Western standards.

C. EXPLAINING THE REGULATION OF FOREIGN BANK ACTIVITIES

The Japanese banking sector has been the focus of many studies and publications by outside observers and analysts (EEC Commission, US Congressional task force, US Department of the Treasury, among others). The role and activities of the Japanese government, the financial authorities, and the domestic and foreign banks have always created great interest. Indeed, the development of regulatory policy in the Japanese financial sector raises some important questions, namely:

.Why is the Japanese banking sector still more regulated than other developed countries?

.Why has Japan not followed the world trend of liberalizing the financial sector, deregulating the four pillars, and providing full national treatment for foreign banks?

.Why has the liberalization process been so slow?

The development of regulatory policy governing foreign banking activities has also received enormous attention. This situation is quite peculiar, considering the marginality of foreign banks' activities in Japan. It is true that some regulatory measures were, and are, very particular to the Japanese financial market. Questions which thus arise are:

.Why are foreign banking activities so marginal?

.What motivates the legislation/regulation of foreign banks?

.Why all the fuss over the legislation/regulation of such marginal players?

To answer these questions, we must understand how the liberalization process and the regulation of foreign banks' activities have been implemented in Japan. For this purpose, we will use three models, each one consisting of an alternative framework for explaining how and why regulatory measures were implemented in Japan. Our three models are: the Rational Model, the Organizational Process Model, and the Political Model. The objective of the following analysis is not to select the "best" model, but to gain better insights into the evolution of foreign bank regulation in Japan.

CHAPTER III. APPLYING THE MODELS TO JAPAN

A. THE RATIONAL MODEL

1. Introduction

The development of Japan's financial system and the liberalization process are analyzed primarily in terms of actions undertaken by a single actor, the Japanese government, which is deemed to be pursuing a specific goal, or different goals, and is deemed to make rational choices by selecting alternatives whose consequences were (or were thought to be) optimal. In this context, the Japanese government and the monetary authorities are considered as value-maximizing actors, i.e., rational decision-makers.

The liberalization of the Japanese financial sector did not occur overnight, but rather was introduced gradually in the post-war era, responding to existing conditions. The authorities' decisions in adopting deregulatory measures can be explained as actions taken in response to changes occurring in the international environment as well as domestic problems and the need for economic reforms.

The Japanese banking sector is still relatively highly regulated for foreign banks compared to the sectors of other developed nations and, as we will see in this section, some regulatory measures are very particular to the Japanese market. Figure 3.1 provides a chronology of the major developments in foreign bank regulation and serves as a guide for the analysis using the Rational Model. The following discussion seeks to provide a rational explanation for the

Figure 3.1

JAPAN: MAJOR DEVELOPMENTS IN FOREIGN BANK REGULATION

Time	Measures
1951 - Mid-1960s	- Foreign banks granted licences under the first Banking Law enacted in 1927.
	- Foreign banks operate in specific market niches as they have a near-monopoly in trade financing and foreign currency-related transactions.
	- Strict set of regulatory measures govern foreign banking activities: 1) agreement not to solicit local deposits, 2) requirement for prior approval of yen loans to non-Japanese borrowers, 3) control of interest rates and volume of funds available by the Bank of Japan's window guidance, 4) imposed ceilings on interbank loans.
Late 1960s	- Foreign banks' role in foreign currency-related activities increase.
	- Foreign governments exert pressures for reciprocal openness; new foreign banks are permitted to open branches and an entry policy based on reciprocal opportunities is established.
1973	- First oil crisis causing Japanese banks to pay a "Japan premium." Foreign banks gain an "accidental monopoly" on impact loans, i.e., foreign currency lending to Japanese borrowers.
Mid 1970s - 1980s	- Japanese authorities further liberalize the banking sector and respond to foreign pressure by allowing an increase in the presence of foreign banks and a widening of their range of permissible activities: foreign banks can apply for additional branches, are no longer required to give prior notice to borrow in the call market and can issue yen CDs. As well, the MOF nullifies their letters previously submitted pledging not to solicit local deposits and increases their swap quotas.
	- Domestic banks are authorized to extend short-term impact loans, thus ending a major privilege enjoyed by foreign banks.
	- As opposed to previous years, foreign banks do not want to continue operating in specific market niches, but rather start putting forward demands for <u>national treatment</u>: concept by which foreign banks in one country are treated on an equal footing with this country's domestic banks, in terms of regulations governing their operations. This differs with the concept of <u>reciprocity</u>, which states that foreign banks should be permitted to do in a country what they are allowed to do in their home countries.
	- Delegations from the U.S. and Europe to discuss grievances of foreign banks in Japan; a U.S. Treasury report concludes that there is a substantial lack of national treatment for foreign banks in Japan.
1980	- Revisions of the Foreign Exchange and Foreign Trade Control Law are implemented; for foreign banks, this means liberalizing resident foreign currency deposits and foreign currency borrowing by residents (impact loans). As a result, foreign banks may become "authorized foreign exchange banks" and explains in part the increased number of foreign banks which establish branch operations. No major effect, however, in terms of increased business.
1982	- The New Banking Law becomes effective in April 1982 and is considered by Japanese authorities to represent a substantial progress toward national treatment but foreign banks argue that what is important is how the legislation is applied, not written. Foreign banks reply with demands for "effective national treatment."
1983	- The U.S. government pushes for new bilateral negotiations with Japan, and asks for more favoured treatment of U.S. banks.
1984	- Regulations regarding entry, activities of foreign banks, and the way foreign banks could compete have been relaxed: no more limits on lending yen overseas, permission to perform in direct bank-to-bank lending in the foreign exchange market, and relaxed regulations on accessing yen funds. However, national treatment is still not provided.
1985	- Nine foreign banks are allowed entry into trust business.
	- Major breakthrough for foreign banks. Authorities give branch licences to securities subsidiaries of foreign banks (maximum ownership of bank: 50%). This does not apply to domestic banks.
1986 - Present	- Foreign banks operate in a market which is less discriminatory but they do not have "effective national treatment" due to some remaining barriers: they play a minor role in trust business, their activities are still segmented, they have insufficient access to yen funds, and no access to a real short-term money market.

development of the current regulatory framework surrounding foreign banking operations in Japan.

Before analyzing the actual regulation, it is necessary to assess the context surrounding Japanese authorities when formulating and implementing the regulatory framework.

Japan has no substantial energy resources and has always depended heavily on imported natural resources. This dependence has helped to make economic issues a high priority in foreign policy. Andreas Prindl (1981, p. 4) describes well how this perception of vulnerability has shaped Japanese thinking both in the past and present. This feeling of fragility, according to him and many other foreign observers, can "lead directly to a sense of needing barriers or controls to withstand uncertain future events, whether political or economic". Capital is also a scarce resource and its allocation to specific sectors shapes the economy. In Japan, the allocation of the flow of funds by the central authorities often comes in contradiction with uses that market forces would have determined. It is argued that if Japan's financial system were fully liberated and left to "negative" forces from abroad, the vulnerable Japanese economy could be hurt. The oil crises of 1974 and 1979 certainly did not help to dispel such beliefs.

Furthermore, economic growth has been the goal of Japanese authorities in the post-war era, and measures taken to achieve this objective included indicative planning in both the public and private sectors, regulating competition using administrative guidance, keeping interest rates low, and controlling lending activities. These measures were easier to implement in Japan than in other developed countries due to the close relationships existing between businesses, politicians and bureaucrats existing in Japan. The industrial environment was also well suited to such growth: as opposed to the United States for example, Japanese firms operate in an environment where long-term goals can be pursued more easily (hardly any takeover bids, life-time employment, less emphasis on stock market values, etc.). What is more, ever since Japan regained its independence in 1952, the main feature of its political scene has been stability. Pragmatism is the basis for public policy, which follows the slogan "the economy comes before politics" (Hong Kong and Shanghai Bank, 1987, p. 4)

For the purposes of the following analysis, we can divide the post-war era into four periods, each one with different conditions present in the environment surrounding the Japanese financial market. These periods are: the heavily regulated period (1951- mid-60s); Japan's entry into the IMF and the OECD and the first oil shock (mid-60s to mid-70s); the second oil crisis up to the enactment of the New Banking Law (mid-70s to early 80s); and from the adoption of the New Banking Law to the present.

The reader will find it beneficial to refer to Figures 3.2 to 3.5 which illustrate the rational analytic framework of each period analyzed. For every period considered, two parts are compared. The first part summarizes the main events and assumed objectives of the government during the period in question, along with the problems and solutions that are logically implied. The second part summarizes the actions actually undertaken by the Japanese authorities in terms of foreign banking regulations and the implied objectives of such actions. This comparison can be used to assess whether or not the regulatory measures implemented truly reflect the proposed rational process of decision-making.

2. 1951 to Mid–1960s

Following the American occupation, control of the banking sector was turned over to the newly-formed Japanese government. Japan at the time had the main objectives of rebuilding its economy and regaining and maintaining domestic control. Objectives that specifically dealt with the banking sector were twofold: to protect the domestic banks, which were recovering from the war and were essential for economic reconstruction, and to avoid "overbanking" (Pauly, 1987, p. 179). Spindler (1984, p. 93) argues that the government thus considered the international capabilities of its local banks as a strategic resource. However, Japan faced several problems, namely lack of expertise, lack of foreign capital, and a weak banking sector. Hence, the measures implemented consisted of strict restrictions regarding the entry and activities of foreign banks, and on the inflow and uses of foreign capital, making it extremely difficult for foreign banks to operate a branch in Japan. Applications from small Asian banks were preferred to those from the industrialized nations, and other foreign requests were mostly rejected (Euromoney, March 1977, p. 33).

In a manner similar to many countries which had opened their financial sectors to foreign interests, Japan originally viewed the foreign banks as fulfilling special tasks in the economy. Those foreign banks which did have a branch operation in Japan had a primary task of helping their host country in its

Figure 3.2

Japan: Rational Analytic Framework - 1951 to Mid-1960s

Trigger Events	Assumed Objectives	Implied Problems	Implied Solutions

- Control of the banking sector was turned over to the newly-formed Japanese government	- Rebuild economy and "catch up" with other industrialized nations
	- Regain and maintain domestic control
		- Lack of expertise
		- Lack of foreign capital
		- Need to finance trade
		- American institutions are dominant
		- Japanese banks are weak but some very strong foreign players are already established
			- Protect domestic economy and financial sector
			- Promote domestic exports
			- Regulate foreign banks' entry and activities
			- Use established foreign banks to perform specific activities:
			  - finance trade
			  - import external financing
			  - provide special expertise

Actions and Results	Implied Objectives
- Strict restrictions on entry and activities of foreign banks; only 7 additional banks were allowed to open a branch - Strict restrictions on inflow and uses of foreign capital	- Protect domestic banks recovering from the war - Have foreign banks perform activities to fill in gap

international payments related to trade, importing external financing, and providing special expertise.

Foreign banks were granted licences under the first banking law, which had been enacted in 1927. National treatment was clearly out of reach for foreign banks, but the administrative actions and guidance by the authorities, added to a "de facto" policy of non-competition with domestic banks, gave foreign institutions a near-monopoly in trade financing and foreign currency-related transactions (Pauly, 1987, p. 180).

The highly restrictive policy translated into the following regulations on foreign banks: agreement not to solicit local deposits (foreign banks had to bring funds from abroad for their lending activities and use currency swaps); a requirement for prior approval of yen loans to non-Japanese borrowers; control of interest rates and volume of funds available by the Bank of Japan's window guidance (interest rates were often below equilibrium rates); and imposed ceilings on interbank loans (US Treasury, 1979, p. 75). All these factors contributed to a serious limitation of foreign banks' yen lending business. Restrictions were also imposed on the establishment of additional branches and expansion through acquisition.

Despite the rigid set of regulatory measures, the system drew almost no criticism, either domestic or foreign, for two main reasons. First, foreign banks enjoyed relatively large profits in their foreign currency lending activities. Second, the United States, which was the country with the most bank branches in

Japan, and hence the greatest incentive to exert pressure, was more preoccupied by strategic matters concerning Japan than by economic ones (Pauly, 1987, p. 182).

3. Mid-1960s to Mid-1970s

In 1964, Japan became a Chapter VIII member of the IMF and thus committed itself to the principle of free international flow of capital. By this time, other member nations had agreed that Japan could no longer be considered a developing or rebuilding nation in need of protection from capital inflows. But Japan felt that because its financial structure was different, it was more vulnerable to outside capital and needed continued protection.

Being a member of both the IMF and the OECD, Japan realized in the late 1960s that, in order to reduce the vulnerability of its economy, it had to secure access to foreign capital markets for the purpose of industrialization and deficit financing. The first oil crisis, in 1973, caused balance of payments problems and resulted in Japanese banks having to pay a "Japan premium" for deposits raised in the Euromarkets, thereby increasing their costs. Because of this, domestic banks were allowed by the Ministry of Finance to discontinue their foreign currency lending activities (Pauly, 1987, p. 180). Foreign banks thus gained an "accidental" monopoly on so-called "impact loans", a term describing medium-term foreign currency lending to Japanese borrowers (ibid).

With Japanese financial institutions finding it hard to raise foreign currency on acceptable terms, letting more foreign banks enter Japan and

Figure 3.3

Japan: Rational Analytic Framework - Mid-1960s to Mid-1970s

Trigger Events	Assumed Objectives	Implied Problems	Implied Solutions
- Parity with pre-World War situation - International pressure for trade liberalization and reciprocal access in the financial sector; no need to consider Japan as a developing nation in need of protection - First oil crisis which causes Balance of Payments problems	- Catch up with other industrialized nations (industrial growth and increased trade) - Maintain access to foreign capital for industrialization and deficit financing	- Domestic economy still sheltered and uncompetitive - Need more trade and integration for further growth but that increases foreign influence - Less foreign sympathy for protectionist measures; risk of sanctions - Japanese banking system outdated and restrains Japanese banks' expansion abroad - Japan premium on funds by Japanese banks: raises costs	- Begin integration process on a selective, paced basis - Join the IMF and the OECD to have more influence on world events (e.g., trade liberalization) - Implement measures that assure a balance between adequate access to foreign capital, liberalization of the banking sector, and protection of domestic banks - Increase the role of foreign banks in foreign currency activities because they can raise funds at lower costs

Actions and Results	Implied Objectives
- Authorities allowed more foreign banks to open branches	- Increase competition to reduce cost of foreign currency loans.
- Highly restrictive legislation concerning the activities of foreign banks, especially foreign deposits - Entry policy based on reciprocity	- Have foreign banks perform activities in which they are better than Japanese banks, but still in line with officials' objectives (e.g., foreign exchange and impact loans)
- Operations of foreign banks were marginal and not very profitable - Foreign banks gained a monopoly on impact loans due to Japan premium and Balance of Payments problems	- Give minimum concessions that reduce pressure in order to protect the domestic market

allowing them to engage in foreign currency-related activities became an attractive alternative because they could raise funds at a lower cost. In that sense, giving foreign banks a monopoly on impact loans was advantageous for both parties concerned.

Furthermore, at home, Japanese borrowers could not borrow sufficient yen because of the very tight domestic monetary policy intended to combat inflation in Japan. With the problems caused by the first oil shock and the very tight domestic monetary policy, assuring access to foreign capital became a major priority. From 1973 to 1974, there was a large increase in foreign capital inflow, from US$ 610.2 million to US$ 2102.9 million (Bank of Japan, October 1975).

Japan also realized the importance of involving its banking institutions in international operations, in the changing economic environment. The foreign presence of Japanese banks increased significantly: Japanese banks were operating close to 100 offices in foreign countries (Kon, 1977, cited in Pauly, 1987, p. 183). While this presence was still of small importance when compared with American or European banks, foreign governments were starting to put forward demands for reciprocal openness in Japan. Japan finally gave in to international pressure in the late 1960s and allowed new foreign banks to open branches, establishing an entry policy based on whether foreign governments provided reciprocal opportunities for Japanese banks (Pauly, 1987, p. 184).

Although authorities did allow more foreign banks to open branches, their activities were governed by highly restrictive regulatory measures, especially for yen deposits. Foreign banks were thus engaged primarily in the following types of business: foreign exchange, export and import financing, yen lending, and impact (foreign currency) loans.

4. Mid-1970s to Early 1980s

From the late 1970s to the enactment of the New Banking Law and its implementation in 1982, changing economic and financial conditions, as well as close links with the world economy, stimulated changes in Japan's domestic financial markets. The Japanese economy was less expansive following the first oil crisis of 1973, with a slowing of the growth of demand for funds. In the international sphere, Japanese investments abroad were increasing steadily and the banks started participating in syndicated loans to non-Japanese international borrowers. In mid-1981, Japanese banks handled approximately 15% of the market for medium and long-term loans in Euro-currency bank credits (OECD, 1982, p. 43).

The demand for foreign currency was a major factor in the process of financial liberalization. Even when the overall balance of payments in Japan turned into a surplus, the demand for foreign currency continued to be strong. The Japanese banking system had turned from a net capital exporter to a net capital importer position which amounted to US$ 14.5 billion at the end of 1980, compared with a net asset position of US$ 3.4 billion at the end of 1973 (OECD, 1982, p. 43). This trend in the net external position took place in the foreign currency sector, where the net external liabilities position amounted to

Figure 3.4

Japan: Rational Analytic Framework - Mid-1970s to Early 1980s

Trigger Events	Assumed Objectives	Implied Problems	Implied Solutions
- Trading partners (especially U.S.) experience slow growth with deficit problems, causing currency imbalances - Despite surpluses in the Balance of Payments, Japan is still a net capital importer - Changing economic and financial conditions in world markets; foreign financial markets are more developed than Japan's to meet demands for international financing - Delegations from Europe and U.S. to discuss the grievances of foreign banks	- Maintain relatively high growth in face of poor world economy - Finance government deficit at minimum cost	- Foreign pressure; risk of sanctions - Domestic banks are unsuited to achieve full integration with the economy: government deficit financing, controlled interest rates, etc. - Japanese banks and MNCs need free access to overseas markets to keep up with growth; increase the possibility of sanctions - Concessions made to foreign banks previously are now becoming obsolete (impact loans reduction) - Substantial lack of national treatment for foreign banks - Disagreement between Japanese and foreign officials as to whether or not the legislation is discriminatory	- Liberalize the banking sector by introducing more market oriented mechanisms - Concessions to foreigners - Provide more explicit regulations and less "guidance" which is broad and general, and involves a lot of interpretation

Actions and Results	Implied Objectives

- Amendments were made to the Foreign Exchange and Foreign Trade Control Law
- Officials further opened the banking sector to foreign banks
- "Authorized foreign exchange banks" were created
- Japanese banks were now allowed to grant short-term impact loans
- Banking sector was not all deregulated, especially for foreign banks:
  - not all market forces;
  - no stable source of yen funds for foreign banks;
  - use of administrative guidance was still important;
  - still very segmented
	- Buy time by granting a minimum of concessions to foreigners
	- Allow more foreign banks to enter the market to achieve specific objectives but not to enter new businesses; officials still want to control the banking sector

US$ 19.2 billion at the end of 1980, compared with a net external assets position of US$ 3.4 billion at the end of 1973, largely reflecting increased foreign currency lending by Tokyo banks to local industries (ibid). One of the reasons put forward to explain this relates to conditions in the domestic financial market. These caused credit demands to reach into foreign markets to provide more yen financing. Increased liberalization in the financial sector was thus viewed as essential. More specifically, the interest rate structure had to be based more on market forces.

Japanese officials found themselves in somewhat of a dilemna. On the one hand, Japan wanted to maintain relatively high growth in the face of a weak world economy. To keep up growth, Japanese banks and MNCs needed free access to overseas markets. On the other hand, the domestic banking sector was seen as not ready to achieve full integration with the world economy. At the same time, foreign banks were also demanding more national treatment for their operations because the 1970s proved to be the end of the high profits they formely enjoyed.

Gross national product was not expanding as rapidly as it had in previous years. With liquidity increasing as a result of this slower growth, borrowers began repaying their impact loans. This, coupled with the changes occurring in money markets, led to a decrease in the spreads on foreign banks' lending activities. In fact, from 1975 to 1979, the Bank of Japan had an easy monetary policy which resulted in spreads falling to .5 percent on loans granted by foreign banks. The foreign bankers were not pessimistic however, and thought that at the next liquidity crisis, spreads would jump up to 1.5% (Euromoney, January 1981, p. 53). This explains in part why new foreign banks opened branches during that period. Still, this situation, combined with inadequate access to low cost yen-funding (as explained above), made foreign banks' operations far less appealing than they had been previously.

Foreign bankers felt they had to argue their case with the financial authorities. Some favored a unified front to lobby the Minister of Finance, others wanted to express their demands on an individual basis (especially the large American banks), and the rest did not want to interfere in Japanese politics (Pauly, 1987, p. 191). For some foreign banks, not wanting to "interfere in Japanese politics" really meant not wanting to "rock the boat".

Delegations from Europe and the United States visited Tokyo and discussed the grievances of the foreign banks. Many contacts were then established with the local authorities in order to assess the situation and try to resolve the claims of discrimination expressed by foreign bankers. While the Japanese government stated that the legislation did not discriminate against foreign banks, adding that the discriminatory measures cited by foreigners were "misunderstandings", they were willing to engage in discussions with local and foreign banks. One must not forget that with Japanese interests expanding abroad, the risk of sanctions had increased. This situation certainly contributed to Japanese officials' willingness to meet with their foreign counterparts.

A number of reports, among them the US Department of Treasury

"Report to Congress on Foreign Government Treatment of US Commercial Banking Organizations" published in 1979, described the regulatory measures governing foreign banking activities in the late 1970s. The following passages represents highlights of the regulatory measures described in this document (US Treasury, 1979, p. 70):

- Foreign banks entering Japan were allowed to open only one branch and banks already present were not permitted to open additional branches. Japanese authorities stated that foreign banks should apply for additional branches.

- The Anti-Monopoly Law prohibited any financial institution, foreign or domestic, from owning more than 5 percent of the stock of another financial or non-financial company. Furthermore, merger laws and other legal complications also restrained foreign banks' expansion through the purchase or taking over of existing Japanese institutions.

- Foreign banks were not able to develop a stable source of yen funds. However, the Ministry of Finance did nullify the letters previously submitted by foreign branches pledging not to solicit local deposits. This was seen as an important move toward national treatment, although the results of this had yet to be seen.

- Foreign banks were no longer required to give prior notice to borrow in the call market. Flexibility in the call and discount markets had been improved, as well as the determination of interest rates which reflected more market forces. The Bank of Japan had stated that these markets would be, in general, free of administrative control. Ceilings on loans to foreign banks in the interbank market had also been removed. However, monitoring and guidance still exercised by the central bank could be discriminatory.

- Foreign banks had access to an additional source of yen funds. As of March 30, 1979, banking institutions were permitted to issue yen certificates of deposits (CDs) in minimum denominations of 500 million yen, with maturities of 3 to 6 months. Ceilings for foreign banks were 10 percent of yen lending and yen securities holdings.

- Swap quotas had been increased. This instrument had been a helpful development and continued to be important for foreign banks. The recent steps (see above) allowing foreign banks greater access to local funds were aimed at reducing their reliance on currency swaps as a source of local funds. With swap quotas denominated in dollars, the rise in value of the yen had reduced the amount of local currency available for US banks lending in the local market.

- The policy permitting foreign banks' participation in the import financing facilities of the Bank of Japan and the facilities of the Japanese Export Import Bank had been clarified.

- Domestic banks had been authorized to extend short-term impact loans but foreign banks still maintained their monopoly in long-term impact loans.

- Foreign banks were not required to purchase government securities and to participate in bail-out loans to local Japanese companies.

The authorities' decision to end the foreign banks' monopoly in short-term impact loans deserves some attention because this activity represented one of foreign banks' major privileges. In June 1979, Japanese authorities saw that rising oil prices would again affect the balance of payments negatively and weaken the yen. Therefore, yen defence packages were implemented by the government, with one of the measures allowing foreign and Japanese banks to extend short-term impact loans for the first time. Japanese banks did not miss the opportunity and quickly took part of the market, much to the detriment of the foreign banks (Euromoney, January 1981, p. 56)). Thus, one of the major operational advantages of foreign banks was eliminated: their "monopoly" had ended. This was explained by officials as a natural development.

Some other regulatory measures facing the foreign banks in Japan were described in the OECD Report: "Regulations Affecting International Banking Operations" (1982). Additional regulations to the ones identified above related to exchange control, minimum reserve requirements and interest rate control.

The exchange control regulation stipulated that, in principle, commercial banks had to match their net positions by foreign currency, and daily limits were set for each bank. Also in principle, the net foreign exchange positions of the commercial banks should match. Commercial banks acquiring foreign currency deposits for both residents and non-residents were subject to a minimum reserve requirement of .25 percent. Foreign affiliates of Japanese banks were not subject to this. Commercial banks holding domestic currency deposits for non-residents were also subject to a minimum reserve of .25 percent. Controls on interest rates enforced a limit on the interest rate paid on domestic currency deposits acquired by commercial banks from non-residents (OECD, 1982, pp. 48-49).

The US Department of Treasury concluded that Japan's financial sector had rapidly matured over the 1970s, but its "laws, regulations and administrative guidance had not kept the pace", and that this had resulted in a "substantial lack of national treatment and equality of competitive opportunity in practice for US and foreign banks in Japan" (US Treasury, 1979, p. 77). However, it viewed the recent measures adopted by the Japanese authorities as an indication that they would remedy the situation.

The Japanese authorities expressed surprise at allegations made by the foreign banks and their respective governments concerning the lack of national treatment. While the Japanese government claimed that foreign banks were treated equally, they did maintain a positive attitude in negotiating with foreign officials and banks. They also agreed that the Japanese financial system should be further liberalized in order to have a good reputation internationally (Pauly, 1987, p. 199).

In the face of international pressure, officials did further liberalize the financial sector, although not to the extent desired by foreign banks. The Ohira government had made clear its intention to internationalize the yen, but it still wanted to keep restrictive powers because "capital transactions by their very nature can offset very large sums in a very short period and upset the orderly workings of international and domestic markets" (Euromoney, March 1979, p. xiv). It was a frustrating situation for foreign banks, which saw their activities still quite restricted, a situation due primarily to their lack of a stable source of yen funds and to the still important use of administrative guidance by the monetary authorities.

While foreign pressure did influence the liberalization process, other major changes in Japan's financial markets were taking place simultaneously. As the Banking Bureau of the Ministry of Finance was working on a new banking law, developments in areas closely related to banking were also occurring. Exchange controls had been relaxed since the late 1960s in order to liberalize further foreign transactions.

Different economic and financial conditions in Japan as well as the expansion of Japanese interests abroad, increased the pressure for changes in Japan's domestic financial market. The revisions of the Foreign Exchange and Foreign Trade Control Law implemented in December 1980 constituted a major legislative change (US Treasury, 1984, p. 22). With this revision, all external transactions previously prohibited unless allowed were now authorized unless specifically prohibited. As far as the foreign banks were concerned, this meant liberalizing resident foreign currency deposits with authorized financial institutions in Japan and foreign currency borrowing by residents, or impact loans (ibid). Since then, certain Japanese banks and branches of foreign banks in Japan have become "authorized foreign exchange banks". These developments explain in part the high number of foreign banks establishing branch operations in Japan during this period (46 more from 1969 to 1979).

5. Early 1980s to Present

The revisions described in the previous period were closely followed by what is considered to be one of the major and most recent achievements in financial reform: the New Banking Law. This law, which became effective in April 1982, was the first comprehensive revision of Japan's banking laws since 1927. The process of revision started in May 1975, when the Ministry of Finance asked the Financial System Research Council for a study on the possibility of revising the banking law. In June 1979, when the Council submitted its recommendations, four considerations were identified which helped the Ministry in its revision of the law:

a) The profound changes in the economic structure in recent years had made the conditions under which financial institutions must operate much more difficult.
b) With the growing popularization and diversification of banking, the retail business of banks had gained in importance.
c) The large issues of government bonds had greatly increased the role of financial institutions in the absorption of such bonds.
d) The number of activities of foreign banks had expanded in Japan and the internationalization of financing had made significant progress (Banker, August 1981, p. 93).

The fragmented banking sector had been characterized as "over-stratified" and no longer adequate for the level of economic activity in Japan. Four problem

Figure 3.5

Japan: Rational Analytic Framework - Early 1980s to Present

Trigger Events

- Japan is now a capital exporter; more Japanese banks operating abroad and expansion of Japanese interests abroad
- Revaluation of the yen
- Securitization occurring in the world:
  - new financial instruments
  - developments which favor securities firms over banks
- Deregulation of the 4 pillars in other nations
- International pressure, from the U.S. mainly, to deregulate the banking sector for foreign banks and to internationalize the yen

Assumed Objectives

- Ensure free access for FDI by Japanese MNCs
- Develop the financial industry as part of restructuring the economy
- Have Tokyo become as large a financial center as London and New York
- Quicken the pace of the liberalization process
- Keep a strong banking sector

Implied Problems

- Barriers protecting vulnerable Japanese industries provide ammunition to foreign pressure groups attempting to protect their jobs and sovereignty
- Tokyo is over-regulated compared to other IFCs
- Still need to finance huge government deficits
- Continued pressure from foreign banks; low demand for some of their activities
- Decreased demand for domestic banking services; pressure from domestic banks for new privileges and opposition to foreign privileges

Implied Solutions

- Deregulate foreign transactions
- Full liberalization of the banking sector should be achieved; reduce government control
- Allow foreign banks to engage in new areas of operations; more national treatment
- Promote transparency in policy
- Change the role of foreign banks due to the reduction of foreign currency loans, increased competition, and limited access to yen funds
- Breakdown of 4 pillar (reduce segmentation)

Actions and Results

- Enactment of the New Banking Law
- Move toward national treatment; codify the banking regulations with clearer rules
- Permission for foreign banks to operate in the trust and securities business
- Full national treatment not enjoyed by foreign banks:
  - activities are still segmented
  - administrative guidance and other practices still result in discriminatory measures
  - access to yen funds still a problem

Implied Objectives

- Meet foreign requests (U.K., Germany, U.S.) to preserve position of Japanese interests abroad
- Implement measures which are not intended to provide full national treatment; measures represent more a stable balance between market efficiency, safety, and monetary control during the transition to a full deregulated banking sector or IFC

areas were identified by Prindl (1981, p. 37) to demonstrate the inadequacy of the banking structure at the time: changing banking needs; duplication of services; inadequate funding; and low profitability.

The major aspect of the 1982 law was to codify the banking regulations which, under the old law, had been very broad and general (not to say vague), and which had allowed authorities much discretion. This law was considered by many, especially the Ministry of Finance, to represent substantial progress toward national treatment.

The New Banking Law applies to foreign banks in the same manner as it applies to Japanese banks, except under special circumstances such as bankruptcy and liquidation, in which case only the domestic banks are subject to Civil Code provisions. However, with respect to entry, as stated in the report of the Federation of the Bankers' Association of Japan (1982): "... in actual application of the law, the principle of reciprocity with the country from which the foreign bank comes will be given importance more than anything else" (cited in Semkow, 1987, p. 13).

Even after the Banking Law was adopted, discussions of strong restrictions and discriminatory measures against foreign banks continued. Administrative controls were still influencing long-term interest rates more than market forces; banking, securities business and insurance were still separated; and banking was still compartmentalized into short-term lending, long-term lending and trust banking. The use of administrative guidance by the financial authorities caused several problems. First, many regulations were in the Japanese language and were difficult to decipher even for those foreigners fluent in Japanese. Second, the Ministry of Finance and the Bank of Japan enjoyed great bureaucratic discretion. Also, business practices which were often very difficult for foreigners to understand were enforced by sectoral trade associations, which resulted in the exclusion of even Japanese outsiders (Stevens and Nee, 1986, p. 240).

While national treatment was granted to foreign banks - in principle under the 1982 Banking Law, foreign banks are subject to the same regulations as Japanese banks - the informal way in which these rules were communicated made it difficult for foreign banks, who were less familiar with the regulatory environment and usually lacked contacts in the government, to know what was allowed and what changes were coming (US Treasury, 1984, p. 23). What foreign banks desired was "effective national treatment" and transparency. The Ministry of Finance stated that it would commit itself to offer foreign banks "equal competitive opportunity with domestic firms" as well as continuing to promote transparency in the execution of its policies on entry and operation of foreign branches in capital markets.

As for entry regulations, the following measures were in place. A foreign bank could establish a representative office or a branch operation in Japan. Generally, the initial entry had to be in the form of a representative office and the foreign bank could apply to open a branch only after several years of having a representative office in the country (Price Waterhouse, 1986, p. 216).

On a practical basis, the approval of a branch license was given on a country-by-country reciprocal basis. If a foreign bank decided to open a branch operation in Japan, it submitted an application for establishment with the Ministry of Finance, which had the authority to grant such licenses under Article 47(1) of the Banking Law. Certain documents had to be included with the application: the articles of incorporation of the foreign bank; a list of its principal shareholders; its most recent financial statements; and its financial projections for its proposed operations (Stevens and Nee, 1986, p. 235). In some cases, the Ministry of Finance would grant a license for a branch operation even if the foreign bank did not previously operate a representative office. Considerations for approval included the relative importance of Japan's economic and political relations with the parent jurisdiction of the foreign bank and also took reciprocity factors into account (ibid).

The liberalization measures described in the previous pages did not have the predicted effects on foreign bank operations. Domestic banks became direct competitors, profitability was very low, and when American observers compared the foreign banks' performance to that of the Japanese banks operating in the United States, it was a frustrating situation. Foreign bankers felt something had to be done, much to the consternation of the Ministry of Finance, which had just introduced the New Banking Law.

The US government pushed for new bilateral negotiations with Japan. They were concerned about the low value of the yen which had stimulated exports. Efforts to internationalize the yen have mainly been made by foreign officials whose nations trade with Japan. Further negotiations were established between the US and Japan during 1983-1984 over the liberalization of the financial markets. An extensive list of measures was drawn up by the Americans in October 1983 and US President Reagan's visit in November 1983 gave the matter high priority. A Yen/Dollar Working Group was set-up and an agreement was reached on further Japanese liberalization measures. The measures were grouped into four categories:

1) liberalization of Japanese barriers against the inflow and outflow of capital;

2) internationalization of the yen;

3) more favourable treatment of US banks and other financial institutions; and

4) deregulation of domestic Japanese capital markets, allowing more interest rates to be market-determined rather than fixed by the government (Frankel, 1984, p. 3).

The US government got most of what it had asked for, at least in the first three categories (ibid). The US Department of Treasury assessed the situation of foreign banks in its 1984 update of its previous Report to Congress of 1979. Restrictions which foreign banks faced at the time were classified into three categories: entry; limitations on the activities in which they could engage; and restrictions on the ways they could compete. The following summarizes these restrictions.

- Entry: foreign banks could enter Japan as branches, subsidiaries, or establish representative offices. However, opening a branch could be a frustrating process and might take over a year. The problem resided in the fact that written regulations were broadly defined and were less important than the way in which they were interpreted and applied by lower level officials. Also, while acquisition of Japanese banks was possible under the existing laws, this was very difficult to achieve due to the small number of Japanese banks and the reluctance of Japanese owners to sell.

- Limitations on the activities in which foreign banks could engage: these restrictions, as announced by the Ministry of Finance, would be eliminated so that foreign banks could engage in the full range of activities performed by banks in Japan. Although adopted, these measures had yet to be implemented at the time. Foreign banks could now trade Japanese public sector bonds, as of June 1984, and in addition, three US banks had joined the syndicate that underwrote medium and long-term government bonds. Trust business (for years exclusively performed by trust banks) was now opened to foreign banks.

- Restrictions on the ways foreign banks could compete: as of April 1984, foreign banks were not required to consult with the Ministry of Finance before lending yen overseas, and now there were no limits on the amount of such lending. Other changes included direct bank-to-bank trading in the foreign exchange market (except for US$ against yen); an increase in the ceiling limiting yen certificates of deposits to 50% of total yen assets; reduction in the minimum denomination of these certificates from 500 million yen to 300 million yen; reduction in the minimum maturity of these certificates from 3 months to 1 month in April 1985; elimination of swap limits in June 1984; and authorization of banks to issue and trade yen-denominated bankers' acceptances by the end of 1984. These measures were expected to help eliminate the problems that foreign banks faced when trying to obtain sufficient yen funds on acceptable terms.

Although there were no written rules concerning capital adequacy and liquidity controls, the Ministry of Finance did provide guidance as to the levels it judged acceptable (Dale, 1984, p. 114).

All the measures announced in the above description seemed to have resulted mostly from pressures and demands of foreign banks and their respective governments, especially the Reagan administration in the U.S.

At the time, Japan was a net exporter of capital due to the slowdown of domestic investment but consistently high savings rates. In 1970, Japan exported US$ 2 billion in long-term capital and imported only US$ 440 million in long-term foreign capital. In 1984, it sent abroad US$ 57 billion and received US$ 7 billion (Council on Financial System Research cited in Pauly, 1987, p. 170). The role of foreign banks was in need of change. Faced with reduced loan demand and increased competition, the foreign banks had been trying to enter new businesses such as consumer credit and factoring and leasing, as well as syndicated yen loans to foreign borrowers. However, limited access to yen funds remained the major problem. Tight restrictions on the money market were a hindrance as well (Banker, August 1981, p. 109). The liberalization of the foreign exchange and capital law did not provide foreign banks with the important role in the two-way flow of funds that had been anticipated.

These negotiations and liberalization measures have shaped a banking structure in which foreign bankers find it very difficult to gain additional market share. The liberalization process has not met their expectations. The market is considered to be "tough, with low profitability and a future which does not look too bright" (Euromoney, April 1987, p. 154).

Also, the foreign banks' traditional privileged position in the impact loan market has disappeared, with Japanese banks now allowed to make short, medium and long-term impact loans. In addition, the overall share of foreign banks in the yen loan market has steadily declined from 3.5% in 1982 to 2.15% (see Figure 2.1). One of the main problem is that some interest rates (especially for small deposits) are not completely deregulated, causing their operations to be marginally profitable.

Japanese banks, with their large number of branches spread throughout the nation, have access to, and profit from, funds provided of small depositors at low cost. This situation is the result of the inadequacy of regulated interest rates and yen funding mechanisms. Collateral requirements combined with the maturity of notes that can be traded have resulted in the fact that Japanese banks can lend 0.5% below the funding cost of the foreign banks (Euromoney, April 1987,

p. 154).

A minor breakthrough for foreign banks was achieved in mid-1986 when the Ministry of Finance allowed foreign banks to tap the Euro-yen bond market in an effort to help them reduce their overall funding costs. Due to strong opposition from Japanese banks, only a small number of issues had been completed as of 1987.

As far as the trust banking business is concerned, foreign banks have continued to play a minor role. Mr. Bruce MacIlwaine, chairman of the Institute of Foreign Bankers in Japan, did not think trust banking business would help improve the situation of foreign banks. As he explained, "Most Japanese pension funds are managed by trust banks or life-insurance companies within pre-war Zaibatsu family-dominated industrial and financial combines with old-established ties" (Banker, October 1985, p. 56).

Japan did make an important concession at the end of 1985 in giving branch licenses to securities subsidiaries of foreign banks, as long as the bank owns no more than 50% of the broker's equity (Economist, December 1985, p. 91). These concessions were a result of pressures from the United States and of threats by Britain and West Germany of retaliation if Japan did not open up its financial market. Like the United States, Japan separates investment banking from commercial banking, as stipulated in Article 65 of its Securities and Exchange Law. This law is similar to the US Glass-Steagall Act but it is more rigidly interpreted (Economist, December 1987, p. 15). Article 65 clearly separates banking activities from securities activities. Furthermore, the Anti-Monopoly Law limits Japanese banks' ownership to 5% of the equity in any company, securities firms included. This anomaly is somewhat less important in practical terms because the industrial group to which each bank belongs may control a significant share of the stock of a securities firm (Tokyo Business Today, February 1988, p. 42). Nonetheless, this important privilege granted to foreign banks deserves more attention and will be dealt with more detail in the second part of this chapter.

The separation of investment and commercial banking activities (of which the Ministry is a strong proponent) has been criticized strongly by both domestic and foreign banks. Japanese banks have lobbied the Ministry of Finance to be able to offer discount brokerage services and to extend their participation in the secondary bond market from government bonds to foreign public bonds.

While Japan follows a policy of national treatment when dealing with foreign banks, many European countries, namely the United Kingdom, have argued that Japan should offer reciprocal access since Japanese investment banks in London are allowed to engage in commercial banking activities. Their approach is simply, "we shall let your chaps do what you allow our chaps to do" (Economist, December 1986, p. 15).

The fact that Japan was a major exporter of capital strongly influenced the outcome of regulatory measures implemented by the authorities. With Japanese banks expanding abroad, foreign governments were applying pressure for their own banks to gain access comparable to that enjoyed by Japanese banks in their countries. Japan accelerated the liberalization process, realizing that the benefits of doing so far exceeded those of a policy of severe entry restrictions and heavy regulation. An example of such a move was the granting of permission to foreign banks to operate in the trust and securities business. However, the banking sector is still considered to be quite regulated and some analysts attribute this to the fact that regulation in Japan hopes to be a stable balance between the goals of market efficiency, safety and monetary control, and that changes in Japan take more time compared to changes in other Western markets due to cultural differences.

Compared with other developed countries, Japan's financial sector remains excessively compartmentalized. In view of the "securitization" and the deregulation of the four pillars occurring in world markets, the Japanese system is somewhat outdated. Similarly, while the Tokyo offshore market has increased significantly in size, it is still more regulated than most of the major offshore markets.

Interest rate liberalization has proceeded in January 1989, with the announcement by Mitsubishi Bank that it will apply its new short-term prime rate of 4.25%, a rise of a whole percentage point above the previous rate (Euromoney, February 1989, p. 39). This rate is considered as the last stage in the first round of financial liberalization. Authorities feel that in the long run, foreign banks should have more access to Tokyo money markets, low-cost yen funds, and eventually to retail banking. Since September 1988, the Bank of Japan has also given foreign banks greater access to unsecured call loans (ibid).

However, even with the introduction of several deregulatory measures, several types of deposits are still under interest rate controls, having the effect of restraining foreign banking activities.

Many of the foreign banks are diversifying out of lending and trade financing into foreign exchange trading, bond dealing and activities such as currency and interest rates swap, futures and options. Even if foreign banks are finding more opportunities open to them, they are not enjoying national treatment, or at least not "effective national treatment". Many barriers remain: their activities are still segmented, administrative guidance still results in discriminatory measures, access to sufficient yen funds on acceptable terms continues to be a problem, they do not have access to a real short-term money market, and Japanese banks banks have more advantageous capital asset ratio requirements (Euromoney, February 1988, p. 37). Lack of an effective short-term money market is considered to be the number one constraint which foreign banks are forced to cope with.

6. Conclusions

We have analyzed Japan's liberalization process from the government's and monetary authorities' point of view as a response to the country's maturing domestic economy, high trade surplus, expansion of its financial industries abroad and foreign government pressures. Policymakers formulate the most adequate regulatory measures according to these conditions.

The material discussed in the previous section certainly demonstrates that some regulatory measures are very particular to the Japanese financial market. The Rational Model provides a tentative explanation of the implementation of the the legislation and regulation of foreign banks in Japan. But by comparing each figure for every period considered, we realize that the activities undertaken and their implied objectives do not always correspond to the problems at hand and their implied solutions. The development of regulatory policy in the financial sector of Japan raises some important questions to which the model fails to answer or answers only in part.

.Why are there certain important discrepancies between the announced changes by financial authorities and the actual implementation?

.Why has there been a controversy in trying to assess whether or not foreign banks are given national treatment? In other words, why do Japanese authorities claim foreign banks are given national treatment and foreign banks reply by demanding "effective national treatment"?

.Why does it appear that Japan does not make any changes in its financial sector unless strongly pressured from other nations and facing the risk of sanctions?

.Did the United States pressures truly have as a goal the liberalization of Japan's financial markets? Was the further deregulation truly a result of such pressures?

.Why has the liberalization process been so slow?

For example, a rational explanation as to why there are discrepancies between the announced changes by financial authorities and the actual implementation is that officials say one thing to reduce the risk of sanctions and do another to preserve the profits of their own banks. But this approach of analysis fails to consider other reasons which are sometimes out of the government's control. To answer this question and the ones above, we have to depart from the traditional model of analysis and recognize that different interest groups and their process of decision-making play an important role in Japan's liberalization process. Regulatory measures often consist of organizational outputs and/or political resultants.

B. THE ORGANIZATIONAL PROCESS MODEL

1. Introduction

Using this model for our analysis, the main players - the Ministry of Finance, the Bank of Japan, foreign bankers, and foreign governments - must be viewed as organizations composed of loosely allied factions. Optimally, the effect of each organization's structure and decision-making process (its invoked goals, parochial objectives, priorities in defining problems, conventional practices, etc.) upon the execution of choice related to the regulation of foreign banks should be assessed. A decision or action, in this case taking the form of a regulatory measure, will be analyzed as an organizational output rather than a rational choice by a unitary actor.

In other words, regulatory measures described in the section using the Rational Model will be explained in this section as resultants of an organizational process. The previous section included some very specific regulatory measures governing the activities of foreign banks in Japan. There is no need to deal again with every single regulatory measure. Our model will provide alternative explanations of main issues in Japan's financial liberalization and in packages of financial reforms that were implemented or should have been implemented. In any case, there is not enough information available to use this model for every specific measure.

It is very important that the analysis be centered on the legislation as it is applied, rather than as it is written. As was previously noted, foreign banks and foreign governments have denounced the lack of national treatment for their operations in Japan. Although ministry officials have stated that the laws include no provisions which discriminate against foreign banks, foreigners have replied with demands for "effective national treatment", putting forward the argument that in Japan, the written rules are far less important than the way they are interpreted and, more importantly, applied.

The Ministry of Finance is the organization on which this analysis will be focussed in view of its indisputable position as leader in financial policy-making. Foreign banks, as a group, and the United States government will be analyzed in the latter part of this section.

2. The Ministry of Finance

a. Organizational Structure and Decision-Making Process

The Ministry of Finance works as a collection of functional bureaus rather than as a single, unified ministry. These bureaus, which compete with each other for influence and resources, are responsible for the Ministry's day-to-day operations, and their directors have considerable autonomy. The Ministry of Finance is composed of the following bureaus: Banking, Securities, International Finance, Tax, Budget, Customs and Tariffs, and Finance. This paper will deal mainly with the first three. The vice-minister (a public service appointee) is responsible for the co-ordination of these bureaus.

General policies are mostly in line with the government (Liberal

Democratic Party) preferences due to the long political stability (27 years with the LDP in power), and the close ties shared by these two bodies. When dealing with financial issues, the basic policy-making process works as follows. First, each "interested" bureau formulates its own stance. One of the assistant-directors in the responsible section prepares a report and presents it to a bureau meeting. If the report is accepted, it becomes the basis of bureau policy (Euromoney, October 1987, p.37). Next come the delicate discussions with other bureaus. Assistant-directors of each bureau concerned meet: minor conflicts are resolved directly by the assistant-directors; more important conflicts will be presented to the directors of the co-ordination divisions, then to the deputy directors-general, and if there is still no agreement, to the directors-general. Occasionally, the vice-minister is asked to mediate (ibid, p. 38).

This process, compared to alternatives in Europe or the United States takes longer but its proponents say that such a screening system takes into account all opinions. At each stage of consultation, advisory councils are set up to discuss the problem at hand. Policy is then communicated to the industry by using directives or by providing guidance which is channelled through a network of informal instructions to financial institutions (Economist, November 28 1987, p. 72).

An example of such an operational procedure is illustrated in the workings of the International Finance Bureau of the Ministry of Finance. This Bureau deals with policy on a whole range of issues affecting Japanese and foreign banks without resorting to legal constraints. If it is aware of something it does not approve of, it issues a directive which may not be legally binding, but which is universally obeyed. This Bureau also dictates how, when, and which foreign banks can operate in Japan, sets swap limits, and monitors impact loans to domestic borrowers.

To many foreigners, policy-making in the Ministry of Finance seems to be largely based upon the pursuit of harmony and consensus. In reality, this is not entirely true. Each bureau wants to protect its own interests (clients) and to control the process of policy-making within its own jurisdiction. A policy which faces strong opposition by one bureau may never be implemented. Also, the advisory councils which are set up to discuss problems throughout the process of policy-making have little power. Composed of academics, representatives of the industry, and other concerned parties, their main role is to give an appearance of consensus (Euromoney, October 1987, p.40). While these councils are said to be independent groups responsible for setting priorities and guidelines for policy formulation, in reality they only comment on drafts of guidelines prepared by bureaucrats. Serious discussions among themselves rarely occur (Shinohara and Yanagihara, 1983, p. 22).

Figure 3.6 provides a more detailed description of the Ministry of Finance's organizational structure and policy-making process. This figure will serve as a guide to this section, helping to demonstrate how the actual regulatory measures implemented can be the result of such an organizational process. The main characteristics of the process are as follows: the goal of maintaining the existing regulatory system and policies, the strong autonomy of each bureau and

Figure 3.6

The Ministry of Finance's Organizational Process

Organization	- The MOF works as a collection of functional bureaus rather than as a Ministry. - Policies are generally in line with the government (LDP) due to high political stability and close ties
Invoked Goals	- Goal is a mixture of pursuing national interest, and working with industrial group, while maintaining its own jurisdiction.
Parochial Objectives/Priorities	- Key factor is to operate the existing regulatory system and policies - the administrative process and career patterns encourage the maintenance of the existing structure. - Each Bureau wants the protection of its own interests when issues involve the jurisdiction of other bureaus. - Each Bureau tries to achieve stability of its sector. - Each Bureau wants to control the process of policy-making that deals with its own jurisdiction. - For policy-making purposes, the Bureau is the key unit.
Problem Definition/Priorities	- Problems are defined through the eyes of people whose background are legal studies and/or were involved in the economic rebuilding period. - Assume market failure, or at least, financial markets must have a degree of control over them. - Deficit financing is often a priority.
Responsive Action	- Exercise tight control over the banking sector. - Policies are generally managed in a routine manner. - Decisions are based on political stability, and if not, measures may be rejected. - Decisions that demand the MOF and its Bureaus to depart from their established programs and SOPs will face delays and/or never be accomplished.
Standard Operating Procedures	- Mixture of bottom-up and up-bottom process for decision-making; discussions and consultations at every level, within bureau and between bureaus; setting up of advisory councils which have little power. - To supervise the banking sector, the MOF uses administrative guidance, which is based on operational understandings and allows great discretion. - Each Bureau dictates policy by issuing directives. - Use of monetary tools and policies that worked so well in post-war rebuilding period. - Propensity to regulate.

its parochial objectives, the problem definition and the selection of priorities which are not necessarily related to financial market issues, responsive actions which are based on political stability, and the use of standard operating procedures.

Standard operating procedures of the Ministry of Finance are very important for this analysis. For large organizations (like the Ministry) to perform their tasks, the behaviour of the large number of bureaucrats must be coordinated. Coordination requires the use of standing operating procedures: rules which specify how things are done (Allison, 1971, p. 68). The decision-making process described above is generally performed in a routine manner, following the same standard operating procedures (SOPs). Similarly, to supervise the banking sector, the Ministry of Finance relies on operational understandings and administrative guidance. To communicate with the financial institutions, the bureaus issue directives.

The decision-making process of the Ministry of Finance is reinforced by a set of career and retirement patterns. It was estimated that of all career officers who entered the Ministry between 1942-1972, 78% came from the University of Tokyo and 65% from its Law Faculty alone (Sugiyama Keiichi, 1979, cited in Horne, 1985, p. 194). Horne (1985, p. 196) describes how this strong representation of law students suggested the administrative nature of a career in the Ministry of Finance. For a Ministry that deals to such an extent with financial, fiscal, and tax issues, one would have thought that a greater number of recruits would have come from economics or business faculties. Career patterns have also resulted in directors and assistant-directors changing jobs every two years, and relocation to another bureau is not uncommon.

For retiring officers (late forties or early fifties) of the Ministry, two main patterns are followed. Some of them go on to pursue a political career in the LDP. Others follow the custom of "amakudari" by taking important positions in the private sector, mainly in Japanese banks or securities firms (after two years of retirement). In 1986, 54 Ministry officials accepted positions in private industry, more than from any other ministry. Of these, 34 joined financial institutions or insurance companies (Euromoney, October 1987, p. 31). The result is that the upper positions of many Japanese banks are filled by ex-bureaucrats.

In contrast with the analysis using our first model, we will analyze the liberalization measures which apply to foreign banks' activities as the result of the Ministry's organizational structure, its policy-making process, and its career and retirement patterns, rather than as rational choices made by a unified ministry.

Understanding how the structure and practices of an organization like the Ministry of Finance or the Bank of Japan can affect the choice of a course of action helps to explain the discrepancy between the announced deregulation, the stated objective of national treatment, and the actual legislation implemented which does not provide effective national treatment. It also provides an explanation as to why the deregulation process in Japan has been so slow. The following discussion seeks to assess the effects of the Ministry of Finance's organizational process on financial liberalization and foreign bank regulation in

Japan.

b. Political Stability and Political Ties

The Ministry of Finance has a very strong and relatively autonomous role in policy-making in the financial sector. As Horne (1985, pp. 15-16) argues, it is clear that, even though senior LDP Cabinet ministers and officials are deeply involved in the management of macroeconomic policies, there is no continuous political overview. Lack of time and of immediate interest, added to the cost of acquiring information by ministers and politicians, partly explains their behaviour. Furthermore, 27 years of continuous government under an LDP administration and the fact that the Ministry and the LDP share the same values has reinforced the role of the Ministry of Finance in areas of routine policy (ibid). Theories of regulation would suggest that some regulations might be established at first for public interest purposes, but that over time the Ministry might become more concerned with the interest of groups within its jurisdiction than with broader national interests (ibid). However, the Ministry cannot push through policies which would create general opposition from the politicians. The LDP tends to intervene only in issues deemed to be politically sensitive.

c. Standard Operating Procedures of the Ministry

In order to function in an orderly fashion, the Ministry of Finance, like all large organizations, uses standard operating procedures or predetermined programs (routines) which process the different pieces of information and undertake action in an efficient and uniform manner. Decisions announced by government leaders trigger organizational routines for their implementation (Allison, 1971, p. 78).

However, actual action is determined by these previously established standard operating procedures. These procedures have been in use for so long that they have become quite resistant to change. Hence, issues which do not have standard characteristics, such as deregulation of the banking sector, are not handled appropriately. The end result is that only incremental changes can take place. Dramatic or major changes often occur only in response to "major disasters". This could explain why Japan never seems to make any move toward further liberalization unless strongly pressured by foreign governments, with the risk of sanctions. Changes in the Japanese government's announced attitude toward financial liberalization can occur with little change in the Ministry's standard operating procedures.

d. Standard Operating Procedure – Administrative Guidance

The most common standard operating procedures used by the Ministry of Finance to supervise the banking sector are based on operational understandings (administrative guidance), not written rules, and on directives issued by the different bureaus. These operational understandings can be discriminatory against foreign banks. When taking into consideration the impact of administrative guidance, the banking sector in Japan may be the most rigidly supervised market in the non-communist, developed world (Spindler, 1984, p. 103). Also, the more changes and reforms in regulatory measures that are produced at the Ministry level, such as through administrative guidance, the more effective is the Ministry's control of regulatory policy.

In a similar way, the Bank of Japan has provided extensive guidance on lending volume and interest rates through "window guidance". As Spindler (1984, p. 104) explains: "The Bank of Japan has relied on its informal but potent powers of persuasion to ration commercial credit and enhance official control over the country's money supply". As expressed by Japan's Banking Federations: "This [window] guidance... a sort of moral suasion, presupposes the cooperation of those financial institutions the Bank of Japan deals with" (Spindler, 1984, p. 104).

Many foreign banks employ full-time advisers who are retired officials from the Bank of Japan or the Ministry of Finance to help decipher the government's administrative guidance. Sometimes, there is even the problem of deciphering what the advisers have said. Also, conflicting instructions sometimes come from the Ministry of Finance and the Bank of Japan as a result of inter-ministerial rivalry.

Because of the great bureaucratic discretion enjoyed by both the Ministry of Finance and the Bank of Japan, foreign bankers need to consult with officials in these institutions on practically a day-to-day basis. This frequent consultation is quite time-consuming and creates difficulty in introducing new services or products quickly (Stevens and Nee, 1986, p. 241).

Increased pressure for liberalization with more transparency (i.e., clearer, written rules) imposes demands that the Ministry of Finance departs from its established programs and standard operating procedures. This triggers resistance in the form of delays and attempts to subvert the intended objectives of the policy directives (Allison, 1971, p. 94). The problem with such standard operating procedures that have been used so strongly and for so long, is that they do not constitute flexible adaptation to the issue at hand and are quite resistant to change. This has certainly been the case in Japan: even if the government announces plans for financial liberalization, or even if legislative changes have been introduced, the use of administrative guidance by the financial authorities is still in practice and can diminish the extent of liberalization measures.

e. Standard Operating Procedure – Propensity to Regulate

Japan has experienced enormous success in its past economic performance and has reached an advanced industrial status. Prindl (1981, p. 5) has characterized this success as "catch-up" growth. This success has been quite recent, and the people who were guiding the Japanese economy through the post-war rebuilding are now the senior financial officials (ibid). It is no surprise that their own backgrounds lead them to use the same monetary tools that worked so well in rebuilding the economy, even though these tools are now, by Western standards, out of date.

Historically, Japanese officials have tended to use the commercial banking sector to achieve several national objectives. The banking sector has been the main channel used to influence activities in specific sectors of the economy. In addition, the authorities, through signals, incentives and supervision, have been able to use the commercial banks in order to achieve growth in the corporate and industrial sectors (Spindler, 1984, p. 96). Specialization and compartmentalization of the banking sector in Japan were used by the authorities as a means to increase control over the system in the belief that each group could then be better supervised and influenced to obtain the desired effects.

Thus, the Ministry of Finance, in its operations, has a traditional propensity to regulate the financial sector. One of the characteristics of large organizations is that they tend to avoid uncertainty. Allison (1971, p. 84) argues that by "arranging a negotiated environment, organizations regularize the reactions of other actors with whom they have to deal". This bent has interfered many times with the progress of financial liberalization supported at times by the Japanese political leadership and demanded by foreign bankers and governments. Indeed, some deregulatory measures supported by one or more bureaus of the Ministry have not been implemented because of the unwillingness of other bureaus to give up control over what they judge to be under their jurisdiction. The Ministry's relatively autonomous role in policy-making in the financial sector has encouraged the use of this operating procedure. This propensity to regulate has been used for so long that it has become quite resistant to change. There are numerous examples to illustrate this point.

<u>The Securities Business:</u> The securities business open to foreign banks was seen in the first section as a major concession granted by Japanese officials. However, foreign bankers must establish a 50%-owned securities company with a three-year track record in the business. Moreover, transferring experience from the parent company was not necessarily permitted (Euromoney, February 1988, p. 36). The documentation that was required from foreign banks (in English and Japanese) was enormous and often under tight deadlines. The head of one bank-owned securities house said: "It really was just a matter of administrative

delay. There is no law, no set of rules, the foreign banks are totally reliant on what you [are] told verbally by the Ministry of Finance" (ibid). Also, the paperwork is staggering: 72 reports to fill out, on a daily, monthly, or yearly basis. Establishing a system to complete these reports is costly.

The Trust Business: As previously mentioned, foreign banks did not play an important role in the Japanese trust business. The major, although less evident reason explaining their difficulties, although the less evident, relates to staff. For approval purposes, the Ministry of Finance required that foreign banks employ staff with a high degree of experience in trust banking in Japan. Only Japanese trust bank managers had such experience and recruiting them was a problem. Most Japanese trust banks did not want to lose their employees to foreign competitors, and in addition, these employees would most certainly have been unilingual Japanese (Far Eastern Economic Review, 25 April 1985, p. 62).

The Call and Bill Markets: Regulatory constraints and a low level of liquidity support from the Bank of Japan appear to be the main reasons explaining the inadequate development of the interbank market. The brokers who operate in these markets are the "products" of the central bank. Rates which are quoted are under close control of the Bank and do not always respond to supply and demand. Foreign bankers have difficulty in finding dealers who take offsetting positions. One foreigner stated that the markets are essentially a clearing mechanism for Japanese banks (Euromoney, February 1988, p. 38). Development of a modern interbank market distanced from the Bank of Japan is essential before foreign banks can operate successfully. Many analysts say that neither the financial authorities nor the Japanese banks wish to have a fully developed interbank market. Authorities do not want to lose control, and Japanese banks do not want the competition.

The Offshore Market: The offshore market should benefit foreign banks, but in fact, it only serves domestic banks. The Institute of Foreign Bankers said that Japan's offshore market illustrates "the creation of a vehicle which in theory should contribute to the liberalization process, but in practice is mainly attractive for Japanese institutions because of the failure to introduce the necessary tax incentives" (Euromoney, February 1988, p.38).

The offshore market only means that transactions are accounted for by a separate computer programme. The Ministry of Finance, always determined not to lose control of the money supply, is set on preventing leakage. On a daily basis, a maximum of 5 percent of a bank's total assets and liabilities in its offshore account for the last calendar month can be moved onshore. On a monthly basis, the total amount of funds transferred cannot be a net transfer of funds (Banker, January 1987, p.77).

Mergers and Acquisitions of Foreign Banks: The last restrictive measure to be examined relates to the issue of limited expansion by foreign banks because of the almost prohibitive constraints on mergers and acquisitions. To the Ministry of Finance, the notion of a stronger foreign bank is not favourable because it would not be fully subject to the Ministry's administrative guidance. The Ministry openly claims that it is not opposed to mergers within the finance sector. In fact, to achieve banking rationalization and reorganization, it is possible that the purchase of Japanese banks by foreign banks could be tolerated as a base for such progress. It is argued that such an action would also give a solid impression that Japan has opened its financial market (Tokyo Business Today, January 1989, p.33).

While foreign banks are officially allowed to operate through subsidiaries, it is very difficult to do so. In order for a foreign bank to operate as a subsidiary or a joint-venture, it must receive approval by the appropriate government authorities under the Anti-Monopoly Law, the Banking Law, and the Foreign Exchange and Foreign Trade Control Law. Under the conditions in 1985, it was said to be next to impossible to obtain approval under all these laws (Ichikawa, 1985, p. 258). Also, no Japanese bank has ever been willing to come under foreign control. Mergers in Japan are often not concluded due to strong opposition from middle management, even if senior management is willing (Euromoney, April 1987, p. 169). Treatment of senior and middle managers is a crucial and delicate issue in Japanese organizations.

f. Standard Operating Procedure – Negotiating for Reciprocity

At the policy level, the Ministry of Finance holds very tightly onto the idea of reciprocity when negotiating with other governments or when banks or securities firms are demanding access to the Japanese market. This position might have been valid in the rebuilding period, but now is said to be the cause of needless frictions (Euromomey, April 1987, p. 104). For example, even though dismantling the barriers between securities and banking business represents a sound action, it is highly likely that it will not be undertaken until the United States government repeals the Glass-Steagall Act (the US equivalent of Article 65).

g. Parochial Objectives of the Ministry's Bureaus

Because the Ministry encounters many and diverse problems in its day-to-day operations, problems and power have to be divided among the various bureaus. Thus, each bureau perceives problems, processes information, and perform a range of activities in quasi-independence (Allison, 1971, p. 80). Every bureau's primary responsibility for a narrow set of problems encourages the existence of parochial objectives.

The parochial objectives of the different bureaus of the Ministry of Finance have contributed strongly to shaping the relatively segmented Japanese banking sector. The fact that each bureau tries to protect its own interests when issues involve the jurisdiction of other bureaus and that it wants to control the process of policy-making that deals with its own jurisdiction, has prevented the blending of financial activities. This has restrained foreign banks' activities because it has limited their expansion into new areas.

Hiroya Ueno (1988, p. 48) describes the financial system in Japan as composed of many separate subsystems, among which rights and privileges are coordinated. Ueno argues that only changes which disrupt the balance among these subsystems would create shifts in funds and provide large profits to one side while causing large losses for the other. He then argues that artificial coordination of rights is necessary in promoting financial deregulation in order to prevent the occurrence of such an event (ibid).

Because financial institutions in the past were protected by and have operated within this strict regulatory framework, strong interfirm competition never developed. Competition among financial institutions was more a matter of attracting customers and maintaining and expanding market share within single markets (deposits market, securities market, insurance market, etc.) which were "artificially segmented by regulation (Ueno, 1988, p. 63). Competition in financial markets was not truly based on cost, price, and quality of financial services (ibid). These features of the Japanese financial market are merely the consequences of the activities of firms and financial institutions under a given institutional framework (Shoichi, 1988, p. 77). Should regulations be relaxed, competition among financial institutions would change completely, but the present structure of the system and the way it is regulated constitute a strong barrier to change.

The project of de-segmenting the financial sector requires coordination of the programs of the different bureaus of the Ministry of Finance. While almost every observer seems to accept the rationale of such an action in light of the mature Japanese economy, it has never been accomplished, partly because of the parochial objectives of the bureaus,and it is unlikely that it will be fully accomplished in the near future.

h. Problem Definition and Selection of Priorities

Several issues had priority over deregulating the financial sector. During the period of high growth, the common goal of all ministries was to modernize the entire economy. This approach to planning led to procrastination in decision-making on major issues, such as financial liberalization. Reforms were thus apt to be put off unless very strong external pressures were present, for example, from the US government.

The main priority of the economic policy of the mid-1980s was to control the government deficit. Even today, bringing the debt down to virtually zero is an obsessing priority for certain bureaucrats, preventing total liberalization of interest rates because the ministry believes it would increase the cost of servicing the debt. This desire to rigidly maintain low interest rates has had a substantial influence in determining the range of options in financial development it can consider (Horne, 1985, p. 32). Also, when defining problems, some ministry officials assume market failure. America's experience of deregulation, which witnessed bank failures, volatile interest rates, and sudden shifts of funds from one home to another, has horrified bureaucrats.

However, one process of selecting priorities in problem definition did work to the advantage of foreign banks. Before the 1970s, international financial problems mattered very little to Japan. But with the Nixon shock, when the United States floated the dollar and put a 10% surcharge on Japanese imports, the International Finance Bureau started gaining importance. This Bureau continued to heighten its power because, since the early 1970s, Japan's economy has become internationalized, and there has been an increase in the number of foreign borrowers in the Japanese capital market and in the number of Japanese borrowing abroad. Therefore this Bureau could influence the legislation more, by identifying priorities to be studied, such as liberalizing the financial market further and allowing more foreign banks to enter the market. As described with the Rational Model, this was indeed the case.

i. Career and Retirement Patterns

The impact of career and retirement patterns on regulatory policy-making can be significant and can result in a slowing down of the pace of the liberalization process. Because career patterns favor short-term attitudes toward policy rather than long-term ones, and because retirement patterns provide links between the private sector and the Ministry of Finance, the extent of major changes in policy is reduced (Horne, 1985, p. 18).

The rotating system of career patterns has the effect of slowing down the development of policy. Often enough in the past, a director who wanted to introduce policy reforms would be relocated before the project was finished (Horne, 1985, p. 196). Even the top career man (never a woman) of the Ministry, the vice-minister, holds the position for one or two years before continuing his career in politics or in the private sector (ibid, p. 197). When controversial issues were at hand, their chances of being pushed through were small unless they were manageable within a short-term framework or had very strong support throughout the bureau.

The impact of the structure of the retirement system is also important. Many Ministry officials retire into the LDP. This not only reflects the shared values of the Ministry of Finance and the LDP, but also reinforces these values as well as their communication channels. Foreign banks lack the appropriate contacts and relationships with the Ministry which would allow them to better present their demands for change. This practice helps to strenghten the Ministry's power and autonomy in regulatory policy-making. Some say the situation is unlikely to change unless another party is elected, an event which is not foreseen in the near future.

Those officials who retire into private financial institutions also contribute to the creation of situations where deregulatory measures have not been pushed through by the Ministry of Finance. This custom of "amakudari" influences the decision-making process of the Ministry's bureaucrats. To push for deregulatory measures that would give foreign banks additional privileges, or enhance their activities (thereby increasing competion for Japanese banks) could destroy the bureaucrats' chances of a lucrative job later.

j. Communication and Use of Proper Channels

Throughout the liberalization process, the Ministry of Finance has claimed that the discriminatory measures denounced by the foreigners were "misunderstandings". Foreign banks expressed their feelings that the Ministry was not attentive and responsive to their problems, prompting officials to ask, "But what do the foreigners want"? (Pauly, 1987, p. 196). The financial authorities thought that their new banking law would solve foreign bankers' problems. Were these signals part of simple strategic bargaining between the two parties or could it be that information was not well conveyed?

The Ministry of Finance, with its guidance and informal links with other groups, certainly restrains foreign bankers' ability to gain pertinent information and awareness of forthcoming changes. The foreign bankers, on the other hand, were disagreeing among themselves as to how they should be organized to put forward their demands. Some wanted the formation of a unified front, others wanted to lobby the Ministry on an individual basis, while the rest did not want to get involved in Japanese politics. Furthermore, it was felt by many foreign bankers and Japanese officials that the foreign governments were pushing more for reforms than some of their respective banks were, especially in the case of the American authorities. Some foreign banks were amused by the Reagan administration exercising pressure for Japan to liberalize its financial system and assure economic reciprocity. One banker stated: "What? Be treated just like Japanese banks and forced to buy low-interest bonds every time the government needed to cover its deficit? No thank you" (Banker, August 1981, p. 93). All this certainly led the Japanese authorities to receive different versions of the problems and demands for change of the foreign banks. These problems of communication were accentuated by the labyrinthine structure of the finance ministry's bureaucracy. With bureaucrats being constantly assigned to different positions, it was very hard for foreign bankers to keep lines of communication open without an enormous effort.

The situation of mis-communication is reflected in the obligation to use the proper channels when dealing with the Ministry of Finance. Attempts to avoid the proper channels are time-consuming and bound to fail. Decisions that are imposed from the top, often the results of international negotiations, can meet resistance when they reach lower level desks, causing programs or reforms to be "bogged down" in the bureaucracy indefinitely.

k. Conclusions

As we have seen, the slow pace of financial liberalization in policy-making can be attributed to the organizational structure, the decision-making process, and the career and retirement patterns of the Ministry of Finance. Foreigners' claims of deliberate actions by the Ministry to prevent deregulation are sometimes inexact because they fail to recognize this organizational process and its effects on the implementation of regulatory measures.

Some foreign bankers unfortunately lack a strong understanding of the policy-making process of the Ministry of Finance. Often enough, they do not know at which level of the bureaucracy a particular problem is being dealt with, so they contact the wrong people. What is most important for them is: "who makes which decisions in the ministry; and what influences them?" (Euromoney, October 1987, p. 35). Dealing successfully with individual bureaucrats of the Ministry of Finance is a key to gaining information and speeding up the pace of change.

One of the concluding remarks in Horne's book is that the role of the public service in Japan is complex: it wants to pursue national interest, ensure the maintenance of its own jurisdiction, and work with industry groups. In terms of our organizational process model, regulatory changes would occur when there are shared values in the industry and the supervisory body approves, or when the supervisory body believes change is justified and has sufficient control of the policy-making process to ensure change (Horne, 1985, p. 219)

3. Foreign Bankers

When analyzing the foreign bankers as a group we find other explanations as to why the process of deregulation has been so slow. Why did the foreign bankers not demand more changes at an earlier time? Why did they wait until the late 1960s and 1970s to put forward their demands for national treatment? Possible answers are given when we use the bounded rationality or short-term approaches model (although for some organizations we should replace the words short-term with "fire fighting").

Organizations seek to avoid uncertainty in their daily operations, and one of the first rules they follow is: solve pressing problems rather than develop long-run strategies. This leads to the use of decision rules that emphasize short-term feedback (Allison, 1971, p. 77). Prior to the mid-1970s, foreign banks were enjoying large profits from the system. With their monopoly on impact loans - which, incidentally, was the result of guidance from the Ministry of Finance which advised Japanese banks to pull out of the foreign currency lending business due to the "Japan premium" they had to pay - they enjoyed positive discrimination and high profits. Therefore, devoting effort to pressing for changes, or to formulating long-term strategies to try to meet the predicted direction of the Japanese financial market, was certainly not a priority. Surely there were more pressing matters to attend to, and with relatively limited resources, short-term decisions often took priority over long-term ones. Criticism started to be expressed only when foreign banks' operations became less profitable.

4. The U.S. Government

Another reason for the slow pace of deregulation was the lack of criticism for many years from the most likely critic of the time, the United States. Prior to the late 1970s, the United States was more preoccupied with strategic issues than economic issues in its relations with Japan (Pauly, 1987, p. 182). The State and Defence Departments dominated American policy toward Japan. The organization that is the US government, through the eyes of these two Departments, perceived strategic problems as being more important than economic problems. This is a typical example showing that large organizations cannot solve every problem that arises. Choices and priorities have to be established, based on the perception of the different factions sharing power. Had it been the US Department of Treasury leading American policy, things could have been different. In fact, in 1979, when the Treasury was leading the negotiations, financial reforms were included.

In the late 1970s, foreign government pressure (especially that exerted by the US government) began to play a more prominent role in shaping the Japanese laws regarding foreign banking activities. Was the United States' decision to put pressure on Japan truly an action to liberalize the financial market or did it have another objective? First of all, what the United States wanted from liberalization and freer markets was an increase in the attactiveness of the yen over the longer term and an increase in the Japanese contribution to the free world. Once the yen started to appreciate, the issue of liberalization lost interest. A senior official of the Bank of Japan argued that the "fundamental purpose of the [US-Japan] committee has disappeared (Far Eastern Economic Review, 26 April 1984, p. 78). Secondly, had it not been for the strong trade imbalances, the United States may not even have bothered to exercise pressure at all, or at least not to the same degree. Treasury officials were used to dealing in conventional tariff and non-tariff barriers to trade, and the problems of Japan's financial markets hardly fitted their repertoire of programs that deal with trade issues. In that sense, the issue of liberalizing the financial sector was thrown in the global negotiation package. Without the strong trade imbalances, would the United States government have put out that much effort? Lastly, the reason the US Treasury led the negotiations (and therefore perceived economic issues as being more important priorities than the strategic issues) is because it gained dominance in the policy area while engaged in rivalries with the State Department and the Federal Reserve (Pauly, 1987, p. 194). Had any of these two factions of the United States government emerged as the leader in negotiations, the results could have been different.

The American pressure in early 1982 also stemmed from an increasing trade imbalance, and again the negotiations included the issue of banking in the overall package. Something had to be done about the trade deficit. As the above discussion illustrates, it is important not to characterize the pressure exerted by the United States as being simply a well planned action intended mainly to further liberalize the financial sector of their trade partner.

When negotiating for deregulation, practices of the Japanese and American negotiating teams differ significantly. In the Ministry of Finance, demands for further liberalization have to be dealt with a "positive" manner, proceeding step-by-step according to Japan's own timetable. The "shotgun" approach to financial liberalization used by the United States was perceived as ill-conceived by Japanese officials, and might indeed have been counter-productive (Far Eastern Economic Review, 26 April 1984, p. 78). Rather than putting direct pressure on deregulation itself, specifically in the case of domestic interest rates, negotiations tended to be "muddied with peripherals" (ibid). The aims of the US negotiating team were described as incoherent. In any case, the true effect of foreign pressure on the liberalization process of Japan's financial market is not clear. The development of Japan's regulatory system can certainly be at least equally explained as a response to different Japanese perceptions of their own situation, needs and problems. At the time the negotiations were conducted, changes in the Japanese market were also occurring. The process of changes had been under way since 1975, due to internal pressures. The best example was the passage by the Diet in 1980 of the New Foreign Exchange and Foreign Trade Control Law, which constituted a major legislative change. It is believed that the internal issues dominated the foreign ones in terms of priorities.

C. THE POLITICAL MODEL

1. Introduction

The previous model illustrated that the actual legislation governing foreign banking operations in Japan can sometimes be explained more as organizational output than as a rational choice made by a unitary actor. In this section a third model is applied which yields additional insights into the motivation behind the regulatory framework governing foreign banks.

The policy-making process of the Ministry of Finance is not sufficient to explain the implementation of regulatory or deregulatory measures. Relationships between different interest groups (different bureaus of the Ministry of Finance, Bank of Japan, Japanese banks, foreign banks, securities firms, etc.) are also very important factors influencing the direction of regulatory policy-making. These relationships within the financial sector change over time, shifting power between the different interest groups and consequently altering the direction of regulatory policy-making.

With this model, regulatory and deregulatory measures are explained as the resultants of bargaining, pulling and hauling between the different interest groups who share power. In this context, it is important to identify the different players in the Japanese market, where they stand, what their goals and objectives are, and what types of links and relative power they have. Although it is impossible to find out what every player thinks and what his position behind the scene is, careful examination of available information illustrates that regulatory measures are often the results of interaction and bargaining among different autonomous and competing groups. In this section, a series of episodes pertaining to the liberalization process will be described which illustrate this process.

2. Politics and Financial Reforms

Financial reforms in Japan, as well as all political and social issues that must be introduced in light of the economic restructuring, face great barriers formed by the country's political institutions. Politics in Japan is based on a series of financial and social obligations among a small political elite that has to share power with a "meritocratic" bureaucracy. Thus, power is diffused, and a political system has developed in which policy is less important than the various interests represented by politicians and bureaucrats (Economist, December 5 1987, p.20). Vested interests, have taken advantage of the dispersion of power, to stop or slow down the pace of change.

As opposed to Western practices, legislation in Japan is largely developed by the bureaucracy in close and private consultation with the appropriate LDP research committees. As well, ministers have a task which is the inverse of that of their Western counterparts. Their role is to support the departmental interest and their ministry's client industries, rather than to implement the political will of an elected government (Economist, December 5 1987, p. 20). Announced plans for further liberalization in the financial sector by the Japanese government may therefore be blocked by ministries representing interest groups which could be hurt by such liberalization. As Yasumoto Tajiri, mayor of Kumamoto, put it, "Democracy is not working well in Japan. The bureaucracy is vertically divided, with each ministry and bureau protecting the interests of the industries under its jurisdiction. The role of politics is to play a horizontal role, deciding which industry the country should invest in, but the politicians are not doing their job of fixing priorities well" (Euromoney, October 1987, p. 46).

3. The Sharing of Power Among Officials

Financial policy in Japan is the result of bargaining among politicians and bureaucrats from the Ministry of Finance, the Bank of Japan, and the financial institutions. As Pauly states (1987, p. 164): "[policy] reflects a subtle interaction between the Ministry, the Bank and the major players in those markets". By law, the Bank of Japan is supposed to be distinct from the government and is expected to provide independent advice, but in practice the liaison between the two is very close.

The strongest figure in this power game is the Ministry of Finance. This is partly due to the fact that every policy that involves government spending has to win the approval of the Ministry of Finance. By controlling the yearly budget-writing exercise, and having authority over tax-raising, it has easily been able to maintain its level of power (Economist, January 9 1988, p.).

The Ministry of Finance is not seen as an independent, autonomous organization (like the rational model depicts it) - at least not anymore. It is comprised of informal groups of issue-oriented Party men and legislators, the "zokus". The Ministry is subject to internal rivalries, and its different bureaus have been penetrated by some private players. The Ministry's policymaking process now closely resembles the interest group politics model. It is now viewed as a complex structure composed of different bureaucratic elements and political personalities who bargain among themselves. In the Ministry, the role of the individual in the process of liberalization is of vital importance. As a manager of one of the Japanese securities house said: "There are no ministry opinions, just individual opinions" (Euromoney, June 1979, p. 24).

This interest group model in Japan is not as strong as in the United States, however, because bureaucrats and industry executives are encouraged to reach a consensus for resolving issues. While this could give the impression that the Ministry is a well-greased autonomous group, consensus is encouraged by the Ministry officials for power purposes. For these officials, political intervention is something that must be avoided because it jeopardizes their autonomy, is time-consuming and it is dangerous in terms of career advancement. For businesses, lobbying can be very expensive, especially when competitors are also trying to obtain favors. For the government, technical issues (such as financial ones) do not represent any votes, and so, politicians are not well informed. Also, the Cabinet prefers to keep issues debated out of the Diet to avoid any embarrassment caused by the opposition (Pauly, 1987, p. 166). These maneuvers, which are performed by the Ministry to maintain its autonomy and level of power greatly enhance its independence in drawing up legislation that is to its advantage.

The determination of monetary policy is performed by the Bank of

Japan. Actual policy, however, used to reflect a combination of factors such as the state of economic activity, the rate of inflation, the relationship between the Prime Minister and the Bank of Japan, and the political expectations of the period (Horne, 1985, p. 34). As Japan's financial markets are subject to more open-market operations as instruments of monetary policy (the expertise of the Bank of Japan), tension between the Bank and the Ministry is increasing due to growing independence from the central bank (Pauly, 1987, p. 164). The Ministry was the key player until the end of the high growth period (early 1980s). It still remains a key player, but his power has been diminishing as a result of the increasing government debt and corporate liquidity along with a more competitive market and the globalization of Japanese industries and banks.

This shift in power is worth noting. As Wallich and Wallich (cited in Spindler, 1984, p. 108) state, "The evolution of Japan's banking system is the history of a continuing struggle between the government, which has a propensity to regulate... and institutions bent on an expansionary drive to broaden their markets". With Japanese markets expanding abroad and the Japanese banking system integrated more closely into international financial markets, the Ministry has lost some of its power to regulate the banking sector. In other words, it has become harder to implement regulations that would oppose market forces, which are not very manageable. With this shift to market forces occurring, the Bank of Japan gains power, to the detriment of the Ministry of Finance, and the Bank then has more input in the adoption of regulations that contain more open-market transactions.

Further liberalization of interest rates is a prime example of this shift in power. The Bank of Japan encouraged market determination of interest rates as a way to strenghten its position. It changed the method of determining interest rates in two short-term money markets, the call and the bill money markets (Horne, 1985, p. 24). In this light, interest rate liberalization can be considered less a rational action by authorities to further deregulate the financial sector than as a move by a central bank struggling to gain more independence and power from a strong, interventionist ministry.

An alternative explanation is that the Japanese authorities did not make a rational choice of modifying the regulations according to changing financial markets. Rather, changing financial markets affected the distribution of power between the banks, the Bank of Japan, and the financial authorities, with the former two groups witnessing an increase in their respective shares. This resulted in a formulation of policies more to their own interests. As described in the previous part of this chapter, the regulatory measures that were abandoned or relaxed dealt with issues related to free market forces. The slow pace of deregulation in the Japanese banking sector can be attributed to efforts employed by the Ministry of Finance to retain power.

4. The New Banking Law

Even the enactment of the New Banking Law, in 1982, which has so far been analyzed as a proper action to take in response to changing financial markets, can be explained in terms of the governmental politics model. It was the result of a lot of bargaining: it was supported by the leftist opposition parties, the ruling conservative LDP, the securities industry, and the foreign banks; it was strongly fought against at every step by Japan's city banks (Euromoney. September 1981, p. 58). The Ministry released the preliminary version of the New Banking Law before discussing it with the Banking Association, and this early version showed that the Ministry had planned to retain a substantial amount of authority and had also considered a continuation of the restrictions on banks entering the securities market (Banker, January 1982, p. 37). This was not well received by the other players, and the Banking Association fought the proposal strongly. Relations between some banks and the Banking Bureau were strained. The banks wanted to be allowed to deal in securities since they were required to absorb the bulk of government bonds to finance the national deficits and debt. The securities industry was vehemently opposed to this, however, and their stand had considerable weight due to the strong ties this industry had with politicians. The bargaining result was to allow banks to deal in government securities but be restricted from any other categories (ibid). It is clear that the Ministry of Finance did not come out a loser in the liberalization of the banking sector; in practical terms it still had as much power as ever through the use of its administrative guidance. It is important to make the distinction between changes in the institutional framework in Japan and the actual implementation of the new framework (ibid).

5. Retirement Patterns of the Ministry of Finance

The relatively high degree of consensus reached among different players when bargaining for their stakes can be explained partly by the custom known as "amakudari". As noted in the analysis of the second model, many retiring officials from the Ministry of Finance assume lucrative positions in the private sector, often in a bank. This assures solid personal contacts, allows Japanese banks to improve their awareness of ministry plans and thinking, and provides them with better understanding and communication with the government. Thus, amakaduri creates strong links between the financial bureaucracy and the leading banks, playing in favour of the domestic banks because foreign banks do not have political allies in Japan (Spindler, 1984, p. 106). One reason foreign banks do not get full national treatment is because they lack the proper network of contacts with ministry officials. As opposed to their Japanese counterparts, some foreign banks do not want to hire retired bureaucrats, and since foreign bankers stay in Japan for a maximum of 5 years, it is very difficult to build up close personal ties.

As a result, deregulatory measures which could permit foreign banks to increase their level of activities in areas traditionally restricted to local banks, will face strong opposition and a low degree of support. Horne (1985, p. 210) describes how the flow of personnel from the Ministry to the private sector is unlikely to promote financial deregulation because it serves the interests of neither the retiring officials nor the LDP.

Japanese financial institutions not only have numerous contacts inside and outside the ministry, but are also the most important contributors of funds to political parties (almost exclusively to the LDP). Thus they have a strong influence in the formation of policy regarding their activities (Euromoney, October 1987, p. 35).

Some retiring Ministry of Finance officers (more than any other ministry) go on to pursue political careers within the LDP. This retirement pattern has helped strenghten the flow of information between the two bodies and has solidified their relationships. Horne (1985, p. 211) argues that this situation has made the Ministry of Finance very aware of political constraints on policy-making. Because the LDP retained strong control over decision-making on politically sensitive issues,the deregulatory measures that were implemented were in the "non-political" sector where large banks and securities firms dominate. As described in the first part of this chapter which dealt with banking regulation, the major financial reforms dealt with activities performed by large city banks and the securities houses. The strong ties between the Ministry of Finance and the LDP contributed to the maintenance of the status quo in politically sensitive areas of banking (ibid). These included liberalization of interest rates on small deposits, activities of smaller financial institutions, compartmentalization of the banking sector, etc.

6. Strong Relationships in the Banking Sector

Japanese banks' relationships with client companies are very strong. These relationships often extend well beyond the commercial banking sphere. Banks in some industries possess the power to fill senior management positions within client corporations. Compared to their American counterparts, Japanese banks appear to possess significantly more detailed information on the operations of their customers (Spindler, 1984, p. 112). As well, banks are the largest shareholders in Japan, with all categories owning just over one-quarter of the outstanding shares in Japanese companies. If a borrower gets in trouble, the main bank coordinates rescue efforts, solicits government aid and absorbs the bulk of any losses that result. In return, total loyalty is expected by the bank. Borrowing from other sources often must be cleared in advance, as must any substantial changes in corporate policy. The main bank has unrestricted access to clients' books and retired bank officers frequently sit on the boards of larger customers (Euromoney, March 1984, p. 175). All these activities create an enormous barrier to entry for foreign banks.

What is more, the different banking sectors have relations with different industrial groups. Let us consider the long-term credit banks. Unlike the city banks, they do not possess close affiliations with single industrial groups. However, they maintain strong links with a number of different groups and consequently are well positioned to acquire extensive knowledge of entire industries. As a result, the long-term credit banks have often been coordinators and financial advisors to large projects involving many industrial groups. Also, they work informally with the Ministry of International Trade and Industry and are thus often asked to assist in strategic planning to reorganize or rationalize various industrial sectors (Spindler, 1984, p. 113). This allows them to be in a better position to offer more competitive long-term financing than commercial banks.

Thus, the position of each player in the market combined with the relationships each has with different interest groups, helps to maintain the present segmented structure (short-term vs long-term) of the banking sector, much to the dissatisfaction of the foreign banks. Ironically, every one of the compartmentalized sectors of the banking industry has lobbied strongly for the removal of artificial controls which protect other sectors while at the same time defending its own sector from experiencing the same fate. In addition, foreign bankers, with their small branch network and more limited resources, will find it quite difficult to become players possessing the quality of information described above and to gain significant power allowing them to pull strings when demanding changes.

7. Pressure from the U.S.

In the previous section, we asked ourselves if the United States government pressure was truly intended to have Japan open wider the door of its banking sector or could it be the U.S. was pursuing other objectives. First, as we have discussed, the pressure was mainly exercised because of the severe trade imbalance in favour of Japan. At home, the United States government was itself facing pressure from the manufacturing industries who were suffering directly from the trade imbalances (Frankel, 1984, pp. 1-2). Furthermore, the second round of negotiations (after the New Banking Law) took place in the fall of 1983. With a presidential reelection campaign just around the corner, it represented a chance to stop any unfavourable congressional action. These pressures can be seen more as trying to achieve political objectives than purely economic ones.

Usually, foreign pressure is not seen favourably by the Ministry of Finance because it constitutes a constraint on its power. However, the American pressure was not resented by some bureaucrats. In fact, it was even used to solve conflicts between the Ministry's bureaus. Bureaucrats of the International Finance Bureau are generally in favor of fundamental reforms for Japan's financial system and "offer an ear" to foreign bankers demands. The Banking Bureau tends to protect the interests of the domestic banking sector and the Securities Bureau those of the securities industry. As one would expect, they come into conflict with the International Finance Bureau. Since the latter bureau is in a minority, its proposals are often blocked. One tactic on which it did rely was to use foreign pressure to quicken the pace of reforms they were backing. The 1984 yen-dollar committee is a good example. The International Finance Bureau got the directors-general of domestic bureaus to attend the talks. This was the first time they had taken part in an international conference (Euromoney, October 1987, p. 37). The International Finance Bureau later expressed satisfaction with the fact that the other bureaus truly saw the problems from the foreign countries' point of view (ibid). In that sense, further liberalization of the banking sector was not truly the result of American pressure alone. The need for reforms was already identified by some bureaucrats; the foreign pressure was used as a catalyst to speed up the process of liberalization.

The following deregulatory measures adopted by the Japanese authorities will serve to further illustrate our model.

Taking advantage of negotiations for future deregulation, Morgan Guaranty and Nomura Securities requested permission to establish a joint venture trust banking corporation. The Ministry of Finance was against it at the beginning of the talks, but fearing that the talks would then be conducted between the US Department of State and the Ministry of Foreign Affairs, it finally agreed (Pauly, 1987, p. 219). This move was a much needed high-profile success for Prime Minister Nakasone, whose leadership at the time was in question. Needless to say, the Ministry of Finance was facing strong opposition from the existing trust banks and city banks (ibid, p. 222). The American Administration, politically, also needed a similar victory. However, as we have discussed in the previous section, the Japanese authorities probably knew that foreign banks would have great difficulty in gaining any significant market share in this sector. In that sense, allowing foreigners into the trust banking sector can be viewed as a small concession from the government which nonetheless brought them political recognition.

8. The Securities Business

Officially, government leaders in Japan reject any argument proposing that the separation between securities and banking businesses should be abolished (Euromoney, April 1987, p. 116). While some observers claim that Article 65 is as good as gone, barriers between commercial and investment banking in Japan remain high. Should this compartmentalization of the financial sector be reduced, the small regional and mutual banks and securities firms would likely be the main losers. Internal lobbies are created by the maintenance of this compartmentalization because bureaucrats of these sectors want to protect their interests.

The Securities Bureau of the Ministry of Finance has become very powerful in recent years, reflecting the growth of the securities houses. This

Bureau has significant influence in preventing commercial banks from entering the securities market. It is in the interest of the Banking Bureau to see banks engaging in securities activities. Although the Securities Bureau may not approve, many feel that, in light of world developments (securitization of banks) and foreign pressure, there is not much the Bureau can do, except ask the Banking Bureau to regulate more intensively the banks entering its sector.

It is certainly an odd situation where foreign banks can engage in securities activities while their domestic counterparts are still restricted from doing so. A rational explanation is that officials met foreign requests to provide reciprocal opportunities in order to avoid sanctions. This situation can also be explained by conflicts between the Banking and the Securities bureaus. With Article 65 weakening in its application, the banks and the securities firms are trying to enter each other's sector. Evidently, each group is supported by its own bureau. With a consensus-oriented type of decision-making, each bureau has the power of veto (Euromoney, October 1987, p. 37). The situation has been described as "stalled". To foreign banks, the anomaly represents a scheme by Japanese authorities to provide them with greater market access through lateral integration rather than letting them suddenly confont directly the local banks on their own ground. In that sense, the authorities are protecting their local banks since they have not been used to real competition. Others think that foreign banks have been allowed entry because their chances of success were limited. We can even push the latter argument further by suggesting that some Japanese banks support foreign banks as a precedent for them to enter later. This is accepted by opponents who figure the foreigners will not be able to do much anyway.

Nonetheless, the fact that Japanese banks still cannot enter the securities market reflects the Securities Bureau's power in policy-making. As a consequence of the compartmentalization of the financial sector, banks and securities firms have strong levers in their respective areas. Hiroya Ueno (1988, p. 68) argues that "in terms of the volume of funds, banks excel; in terms of negotiating ability with the support of their earnings power, securities companies excel".

A similar case occurred when yen-denominated certificates of deposits were introduced. The International Finance Bureau was in favour for a long time of having yen-denominated certificates of deposits made available to the Japanese financial community. But the Ministry of Finance Securities Bureau, which has a vested interest in seeing that the country's prosperous brokerage houses do not get too much unwanted competition, opposed it. Yen CDs were introduced in May 1979, but only after seven years of bargaining and persuasion by the International Finance Bureau. The introduction of these CDs was also backed by the Banking Bureau of the Ministry because the city banks would profit from them. The minimum issue was set at 500 million yen with strict yen-denominated collateral requirements being enforced. The result can be seen as a compromise: it does little damage to the securities houses and is of use to the city banks and foreign banks (although not many). In general, the Ministry of Finance's six other bureaus team up against the International Finance Bureau's efforts at financial reforms because they feel it gives in to foreign demands for reforms too easily.

The influence of the securities industry was exercised very recently. Options for reforming the financial system by relaxing rules separating the banking and securities businesses were proposed by a sub-committee of an advisory panel to the finance minister. These options ranged from allowing financial institutions to form separate subsidies to engage in banking and selling securities to creating a "European-style universal banking system" in which banks are allowed to engage in all areas of the securities business (Japan Times, March 17 1989, p. 5). However, Setsuya Tabuchi, chairman of the Securities Dealers Association of Japan, was opposed to such reforms because he described them as being biased in favour of the banking industry and he had doubts whether banks could undertake brokerage business in a "fair manner" (ibid).

9. The Trust Business

Foreign banks were pessimistic about their chances of making a profit in the trust business in Japan. Some bankers felt that much of the United States political pressure had been exercised without significant studies being undertaken on the part of the US trust banks to determine the viability of managing Japanese pension funds. It was said that some of the American banks which filled out applications may have done so out of political obligation: Japan had opened the door, so a decision not to enter could have jeopardized liberalization in other capital market areas (Far Eastern Economic Review, 25 April 1985, p. 61).

10. Interest Rate Liberalization

With rates regulated at artificially low levels, Japanese commercial banks have been enjoying low funding costs for many years. Fixed interest rates result, some foreign bankers say, in giving a significant "subsidy" to Japanese banks (over 3.5 trillion yen). This allows them to lower rates offered to large borrowers, preventing the foreign banks from entering the markets. It is unlikely that this situation will improve very soon. The Ministry of Finance is against further deregulation because it fears that it will bring economic dislocation among small and medium-sized banks. Also, one-third of all deposits (smaller) are at the Ministry of Posts and Telecommunications and interest rates are set by this Ministry.

Japan's postal savings bank has been the target of severe criticism as it is often blamed for being the cause of the regulation of deposit rates. It is true that it gets special tax and other privileges from its owner, the government. The postal's bank interest rates are set by the Ministry of Posts and Telecommunications, not by the central bank. Japanese and foreign banks are unhappy because these rates are higher than their own and also because the postal bank pays no tax and is not subject to the central bank's reserve requirements. And as far as small deposits are concerned, the MPT is quite a strong protector of its interests. The MPT has been strongly opposed to change the tax free small deposit savings system because it claims the resulting effect would be to force small depositors to switch funds into alternative investments. The success of the postal savings system has strenghtened the MPT's influence.

The savings deposit issue is a complex political problem. Officials say that if interest rates were deregulated, loans rates would increase significantly. The increased cost of funds would seriously affect many small and medium-sized entreprises which form an interest group important to the LDP (Horne, 1985, p. 40).

11. Conclusions

To outsiders, the Ministry of Finance appears to govern the financial system by itself. In a sense, this is indeed the case: interference by politicians and other ministries is extremely low. However, Japanese banks and securities firms are masters at "manipulating" the ministry. They exert significant effort to cultivate bureaucrats and they do get benefits in return. The main losers in this situation are the foreign banks. They just do not completely understand how policy-making in Japan works and they are quite inept at playing the "power game" (Euromoney, October 1987, p. 30). One of Horne's (1985, p. 219) conclusions is that irreconcilable conflicts between ministries and within ministries, which are the results of differences in jurisdiction, aims and vested interests, can immobilize the development of policy. Regulatory change could occur when a high degree of market instability forces those conflicting parties to compromise (ibid).

CHAPTER IV. FOREIGN BANKS IN KOREA

A. HISTORICAL PERSPECTIVE

Foreign banks were not present in Korea until 1967 when three American banks, Chase Manhattan (the first), Citibank and Bank of America, and two Japanese banks, Bank of Tokyo and Mitsubishi, opened branches in that country. From then until 1976, a few other banks from the United States, Japan, the United Kingdom and France established additional branches. But the years 1977 and 1978 both witnessed a huge increase in the number of foreign branches in Korea. The US Department of the Treasury (1979, p. 80) reported that by the end of 1978, there were 32 foreign bank branches in Korea, with American banks accounting for 12 of these, more than banks from any other country. These banks were obviously attracted by Korea's rapid economic growth and the borrowing needs associated with such an expansion.

The increased presence of these foreign banks is reflected in their share of foreign exchange loans, which rose from 15% in 1975 to over 38% of the total market just three years later (see Figure 4.1).

Such a penetration of the Korean banking market by foreign institutions led authorities to implement a broad set of regulations regarding the activities of those foreign banks. However, at the time, the government was faced with two conflicting objectives. On the one hand, the presence of an increasing number of foreign bank branches caused the government to fear strong foreign penetration of the local market.

Figure 4.1

Foreign Banks' Share of the Korean Banking Sector
(percent)

Year-end	Won Loans and Discounts	Won Deposits	Foreign Currency Loans	Total Assets
1975	2.7	1.07	15.5	3.1
1976	3.3	1.16	17.5	3.3
1977	4.4	1.09	39.9	4.4
1978	4.0	1.19	38.4	4.5
1979	3.3	0.95	39.2	5.3
1980	5.0	1.26	51.5	7.8
1981	5.3	1.22	50.1	7.7
1982	5.4	1.04	49.0	7.8
1983	5.6	1.29	51.9	9.3
1984	6.1	1.38	60.9	9.9
1985	6.0	1.26	67.4	10.6
1986	5.9	1.47	63.3	10.8
1987	5.8	1.26	44.6	10.5
1988 (Feb)	6.0	1.48	43.0	10.7

Source: Bank of Korea, Monthly Economic Statistics.

Includes commercial banks and specialized banks.

On the other hand, liberalization of the banking industry was also a policy of the Korean government. It appeared that to achieve this objective, the government adopted regulations regarding the entry and the extent and nature of foreign banking activities in Korea. Also, as stated in the Bank of Korea's "Memorandum Regarding Entry by and Activities of Foreign Banks in Korea", the authorities have favoured foreign banks from countries with which Korea has important trade and investment relationships.

From 1979 on, entry of foreign bank branches in Korea has increased steadily. As of the end of 1987, there were 54 foreign bank branches in Korea along with 19 representative offices (Bank of Korea, 1988, p. 38). Since the late 1970s, some regulatory measures governing the activities of these foreign banks in Korea have been eased. Many changes have also been introduced in the legislation, more or less in line with official announcements.

Foreign bank business has always been relatively profitable: since the late 1960s, foreign banks' earnings have increased steadily, except for 1986. In 1987 however, business was booming again. After-tax profits (excluding Japanese banks) increased by 30.2% from 1986 (Korea Business World, May 1988, p. 15). The year 1988 witnessed an increase of 24.5%. Return on assets averaged 2.12% for foreign banks, 0.45% for Korean city banks, and 0.59% for provincial banks (Korea Economic Report, March 1989, p. 41). Foreign banks' earnings have traditionally been higher than those of the Korean banks.

Foreign banks may open branch offices in Korea with the approval of the Monetary Board upon the recommendation of the Superintendent of Banks of the Bank of Korea, as stipulated in the provisions of the General Banking Act (Article 9). Since their principal business is commercial banking, their operations are governed by the General Banking Act. Article 1-2 (1) of the Act stipulates: "All banking institutions operating in the Republic of Korea, including the branches and agencies of foreign banking institutions, shall be operated according to the provisions of this Act, the Bank of Korea Act, and the orders and regulation issued by authority of such Acts" (Bank of Korea, 1985, p. 117).

Being classified as commercial banks, foreign banks can engage in the following types of bank business: short-term and long-term financing (from funds acquired mainly through deposits), securities investment, guarantees and acceptances, remittances and collections, foreign exchange, and receipts and disbursements of treasury funds as treasury agencies of the Bank of Korea. They may also engage in other businesses as permitted by the Monetary Board. However, as we will see, some regulatory measures governing foreign bank activities practically prevent them from engaging in some of the businesses performed by the domestic banks.

Although foreign banks realized higher profits than domestic banks, they are quick to point out that the numbers do not truly reflect the situation since they are overstated by not taking into account won exchange rate losses, imputed interest on capital, etc., and that they are mainly generated by short-term vehicles. In fact, many foreign bankers have expressed concerns for their future business in Korea. They feel the market has reached a plateau and that the government is unwilling to fully liberalize the banking sector. Also, while some of their former privileges have been eliminated or reduced, new privileges and easing of some regulatory measures have been slow to come. We will deal more with this in the next part.

B. ENVIRONMENT IN WHICH FOREIGN BANKS COMPETE

1. Introduction

Korea's banking system can be traced as far back as 1876, when the Daichi Ginko of Japan opened a branch in Pusan, and began issuing the country's only bank notes. However, the Korean banking system was fully established in 1950 with the introduction of the Bank of Korea Act and the General Banking Act.

In 1949, Arthur I. Bloomfield and John P. Jensen of the Federal Reserve Bank of New York went to Korea at the request of the Minister of Finance of the Republic of Korea, Dr. Kim Do Yun. The services of these two specialists were required to advise on, and assist in, a reorganization of the central bank and other financial institutions in South Korea, the drafting of new banking legislation, and the formulation of appropriate banking and monetary policies (Bloomfield and Jensen, 1951, p. 3). Their recommendations included, among other things, a draft of a new central banking statute and a draft of a new general banking statute. With some amendments, the drafts of the two banking statutes submitted by Messrs. Bloomfield and Jensen were passed by the National Assembly of the Republic of Korea on April 21, 1950, and a new central bank, the Bank of Korea, was established on June 12, 1950 (Bloomfield and Jensen, 1951, p. 3). The new General Banking Act was implemented in 1954.

2. The Major Players

The banking sector in Korea is composed of two major groups: the commercial banks and the specialized banks, together called the Deposit Money Banks (DMBs). A third group present in the financial sector and important for our analysis comprises the non-bank financial institutions (non-deposit institutions).

Commercial banks have played a major role in Korea's financial market. They form a branch banking system with nationwide or province-wide networks. They engage in long-term financing in addition to their short-term operations, and are quite dependent on borrowings from the Bank of Korea to meet persistent shortages in their own supply of loanable funds. As of 1985, more than one third of their total loans and discounts was financed by the Bank of Korea. This reflects the fact that money and capital markets in Korea are not well developed and therefore business firms depend heavily on commercial banks for their financing (Bank of Korea, 1985, p. 21). The commercial banks group includes the nationwide city banks, the local (regional) banks, and the foreign bank branches.

The nationwide city banks (seven of them as of 1984) which were denationalized by 1983, constitute the core of the Korean banking system and account for approximately half of the commercial banking activities. All of these banks have their head offices in Seoul and have quite long histories. In addition, ten local banks, one for each povince, were established during the period

1967-1971. The activities of these banks (all privately owned) are similar to those of the nationwide city banks but must be performed within the boundaries of their own regions. Their main task was to maximize domestic savings mobilization to achieve a balanced dispersion of banking business and to achieve regional economic development. In terms of assets, the size of local banks as of 1985 represented about one-eight of that of the nationwide city banks. Foreign banks will be analyzed in the next section.

The second major group within the Korean banking sector consists of the specialized banks which were established in the sixties to help implement the economic goals formulated at that time. These banks were to provide financing for specific sectors of the economy, such as housing, foreign trade, agriculture, and small business. There are seven specialized banks in Korea and they play a significant role in the banking system as a whole. As of 1985, they represented 40% of the assets, 41% of the deposits and 42% of all loans and discounts outstanding of all banks (Bank of Korea, 1985, p. 27). The Korea Exchange Bank and the Small and Medium Industry Bank are two examples of specialized banks.

The third group consists of many non-bank financial intermediaries, most of which were established in the 1970s. Included in this group are development institutions such as the Korea Development Bank, the Export-Import Bank of Korea, and the Korea Long Term Credit Bank. The remaining institutions consist of a number of savings institutions, investment companies, and life insurance companies.

It is worth noting that the non-bank financial institutions' share of the loans and deposits market has increased significantly while the Deposit Money Banks' (DMBs) share has decreased sharply. DMBs' share of loans went from 68% in 1976 to 48% in 1987, while their share of deposits went from 75% to 42% in the same period. NBFIs, on the other hand, saw their share of the loans market jump from 32% in 1976 to 52% in 1987, and their share of the deposits market from 25% to 58% (Bank of Korea, Statistical Bulletins).

Commercial banks are subject to the provisions of the General Banking Act as well as the orders, instructions and regulations issued by the Monetary Board in accordance with the Bank of Korea Act. Specialized banks are, in principle, directed and supervised by the government under the special laws which established them. However, some areas of their business operations, such as minimum reserve requirements and ceilings on interest rates, are subject to the control of the Monetary Board of the Bank of Korea.

The Bank of Korea, which was established in June 1950, acts as Korea's central bank. As such, its principal functions are serving as issuer of bank notes and coins, being banker to the banking sector as well as to the government, being responsible for formulating and implementing monetary policy, and supervising banking operations. Four major components form the Bank of Korea: the Monetary Board, the Governor, the Superintendent of Banks, and the Auditor. The Monetary Board is the supreme policy-making organ of the Bank of Korea and has the general directory or regulatory, and supervisory responsibilities over the activities of banking institutions as well as the operations of the Bank

(Korea Herald, March 1989, p. 4).

Compared to central banks of many developed countries, the Bank of Korea is far less autonomous in making and implementing monetary policy decisions. Government's influence on monetary policy was strongly reinforced by the amendment of the Bank of Korea Act in 1962, which basically transferred much of the power granted to the Bank of Korea in the original charter to the government. The Ministry of Finance, which presides over the Monetary Board's meetings, can request reconsideration of resolutions adopted by the Board and, if the request is rejected by the Board, it can ask the President to make the final decision (Bank of Korea, 1985, p. 9).

3. Developments in the Banking Sector

Since the mid 1950s, Korea's banking sector has experienced several developments. One of the financial objectives of the mid-1960s was to get the "financial prices right", and thereby to promote financial deepening (Cole and Chul Park, 1983, p. 8). In September 1965, a major financial reform called the monetary reform of 1965 was introduced, translating into a significant increase in the interest rates on time deposits of the deposit money banks (commercial banks and specialized banks).

Since then, the government has taken a series of steps to improve the banking system, including a revision of the General Banking Act at the end of 1982, denationalization of the nationwide city banks, authorization of new activities for commercial banks (trust services, short-term commercial paper, underwriting of government securities, etc.), increased autonomy for the banks' management, and lower interest rates. In fact, efforts to further liberalize interest rates have been undertaken by the government in the past few years with mixed results. Although these steps were all means of realizing the government's objective of deregulating the banking sector, it is still considered as being tightly regulated, with strong government control over interest rates, policies, and decision-making. Many bankers (local and foreign) deplore the slow - some would say stagnant - pace of the liberalization process.

In fact, the banking sector is considered to be the weakest of all Korea's economic sectors, which are by contrast much more dynamic. The following statistics offer some indication that the banking sector has been a "laggard". The ratio of bank deposits or other financial assets to sales of non-financial business enterprises has decreased significantly in the past years. The growth rate in general bank loans has been lower than the rate of current GNP growth. Also, even if there is only a small number of nationwide commercial banks, the "site" of individual banks is very small: total deposits of the five nationwide city banks (there were only five in the early 1980s) were approximately equivalent to the deposits of a local bank in Japan (Nam and Park, 1985, p. 164).

The government's excessive (and sometimes duplicate) investments in the heavy and chemical industries and in overseas construction projects led the domestic banks off the track. Commercial banks were required to make "policy loans" in these target sectors to support the government's economic plans, even without the proper reserve requirements. Specialized banks were authorized to accept deposits to mobilize funds to be funneled into selected sectors of the economy. However, poor government-directed investment choices in these industries exposed the inherent inefficiency of centralized control. Also, the weakness of some policy loans became apparent as a result of structural economic changes. This situation caused great strain on the banks' funds and therefore on their development, and the number of "bad loans" that were granted only helped to further deteriorate their positions. Korean banks' operations have always been marginally profitable. In addition, government control has restrained the Bank of Korea's ability to control the money supply.

Another major indication of the ineffectiveness of the banking sector is the existence for many years of an underground private loan market. According to Kim Dae-Jung (1985, p. 65), the presence of this market, called kerb, unorganized, unofficial, unregulated, or illegal, is explained by government intervention in credit allocations and interest rate determination. The unregulated market, which is the traditional and quite unknown financial market in Korea , has been operating side-by-side with the official financial market, which is the more modern, structured, regulated, and recorded market (Cole and Chul Park, 1983, p. 39). The government has attempted many times to achieve control of this unofficial market and by legalizing it, but with no success.

Today, the mood of Korean bankers is at an extreme low compared to the generally active and energetic economic scene. This mood will not change until the Ministry of Finance offers a comprehensive package of reforms for the entire financial market. The lending business is especially poor; it had started to stagnate in 1985, but now, officials have put an extra ceiling on this activity, reducing large borrowers' access to the services of the commercial banks. These banks were never very profitable; now it is even worse (Asian Finance, July 15, 1988, p. 41). The much needed reforms deal with: full managerial autonomy of the banks, a deregulated interest rate market, a redefined and broader business area for different types of financial institutions (moving toward the concept of universal banking), and last but not least, the creation of an autonomous central bank (ibid).

The government has announced many plans to improve the efficiency of the banking industry by the early 1990s. One of the objectives is to allow Korean banks to perform all activities except stockbroking and insurance (Euromoney, July 1987, p. 111).

Although there is a consensus that the authorities should, and probably will, further deregulate the banking sector in the near future, it may very well be a most difficult action to undertake due to the present regulatory and political structures.

C. EXPLAINING THE REGULATION OF FOREIGN BANK ACTIVITIES

As a developing country which has industrialized so successfully, Korea's experience of financial liberalization and foreign bank regulation raises some important points. In many ways, the Korean case is quite different from Japan. The structure of the banking industry, the financial institutions, the foreign banking activities, the government's policy-making process and Korean politics are very particular to the country. Generally speaking, the banking sector is more regulated than the Japanese one, and direct government intervention is far more frequent.

Financial development in Korea raises the following general questions:

.Why has the banking sector been lagging all the other sectors of the economy to such an extent? Why has it not accompanied economic growth?

.Why has strong government intervention and heavy regulation continued in such a strong and complex economy?

.Why has the liberalization process been so slow, sometimes even stagnant?

.Why have domestic banks been so unprofitable?

The above questions are very important for our analysis of foreign bank regulation. Unlike our study on Japan, we cannot always make a separate case for foreign banking activities without taking into consideration the activities of domestic banks, at least not to the same extent. We cannot explain foreign bank regulation without explaining the regulation of domestic banks because they are very interlinked: Korean authorities will not allow increased competition from foreign banks unless domestic banks are ready to compete.

Nonetheless, there are some important questions regarding foreign banking activities and regulation:

.Why have foreign banking activities been so heavily regulated?

.Why has the government pursued the dual (often conflicting) objectives of liberalizing the banking sector by easing foreign bank regulation, and protecting the domestic market?

.Why has the government's regulation governing foreign banking activities often represented a form of compromise, i.e. no access to certain activities but granting of some unique privileges?

.Will foreign banks ever be granted national treatment in Korea?

As we did in our analysis of Japan, we will apply our three models, the Rational, Organizational Process, and the Political Models, in an attempt to provide a series of explanations regarding the evolution of foreign bank regulation and to answer the above questions. Again, the purpose of our study is not to select the "best model", but rather to gain some sound insights into the subject.

CHAPTER V. APPLYING THE MODELS TO KOREA

A. THE RATIONAL MODEL

1. Introduction

As a guide to the following analysis, Figure 5.1 provides a chronology of the major developments in foreign bank regulation. As we have mentioned in the last chapter, we cannot analyze foreign bank regulation independently from the regulation of the domestic banking activities, since the former is directly influenced by the latter.

Our methodology will be similar to the one used for the Japanese case. We have divided our analysis using the Rational Model into three periods, as can be seen in Figures 5.2 to 5.4. The first period starts in 1961 when President Park took over the leadership of the country and launched the industrialization drive. The second period extends from the early 1970s until the economic distress and political turmoil of the late 1970s. The 1980s, with a new leadership and new economic orientation, represent the third period. These periods were determined based on different economic events and conditions as well as the prevailing political climates. The reader will notice that there is litte material concerning foreign banking activities as such in the first period. However, the contents are an essential preamble to our analysis of foreign bank regulation described in the following two periods.

Figure 5.1

KOREA: MAJOR DEVELOPMENTS IN FOREIGN BANK REGULATION

Time	Measures
1967	- Foreign banks' entry and activities are primarily governed by the General Banking Act.
	- Five foreign banks open branch operations in Seoul; their primary task is to provide foreign capital.
Early 1970s - 1980	- Many other foreign banks enter the Korean market; some are beginning to move out to Pusan.
	- Highly restrictive regulations govern foreign banking activities: strong limitations on their won lending business, controls on their rates of return, impossibility to open a second branch in Seoul, low access to won funds, and no access to the Bank of Korea's discount window.
	- Foreign banks enjoy some advantages as compensation for the above regulations: access to a swap facility which guarantees a spread margin, exemption from income and corporate taxes on certain revenues, exemption from government-directed lending (policy loans), and no limitation on the amount of export promoting lending.
1982 - 1983	- Government introduces financial reforms to achieve further liberalization of the banking sector by privatizing all city banks, revising the General Banking Act (1982) to give banks more managerial freedom, and increasing competition by establishing two new city banks.
1983	- U.S. government starts to exert pressure; Korean government promises national treatment for foreign banks by 1986, but raises concerns for the suffering domestic banking sector.
1985	- New privileges for foreign banks include access to the rediscount facility for export promotion, and an increase in their capital funds.
	- With new measures, previous privileges are reduced: reduction of swap limits, extension of 25% of total loans to small and medium-sized firms.
	- Eleven foreign banks allowed to engage in trust business.
	- Foreign banks complain of the strong restrictions on accessing local funds and of regulated interest rates.
1986	- With current account surplus, Korea starts to repay its debt; reduction of foreign banks' lending activities. As well, trust business is not very appealing.
	- Foreign banks allowed to use the Bank of Korea's rediscount facility for commercial bills, and to handle CDs; again swap limits are reduced.
	- Foreign banks can choose between "A" or "B" classification. It was believed that national treatment was likely to be given only to "A" banks.
1987	- Class "A" foreign banks allowed to deal in futures, options and swaps on foreign currency and interest rates.
	- Foreign Bankers Group submit to the Federation of Korean Bankers several proposals to develop the country's money market.
	- U.S. Treasury Secretary James Baker exerts pressures; the Korean government announces plans to move toward full liberalization.
Present	- With current account surpluses, the demand for foreign capital from foreign banks is far less important. Foreign banks' operations are at a standstill: limited expansion, no money market and no true won deposit base. Their activities are primarily related to wholesale business, trade financing, foreign currency lending, and foreign exchange operations. They are far from enjoying national treatment in Korea.

2. 1961 to Early 1970s

Since 1945, Korea has been a divided country, the South having a market economy, the North a communist, centrally planned economy. In 1953 South Korea, hereinafter Korea, after three years of civil war, started to rebuild its industrial base. Industrial growth started mainly in the early 1960s.

At the time, Korea was one of the world's most impoverished rural societies. Per capita GNP was only US$ 79 in 1960, compared to US$ 2826 in 1987 (Economic Planning Board, cited in Lee Yang-Pal, 1988, p. 5). In 1962, Manufacturing accounted for only 16.4% of GNP, whereas agriculture represented 37% of GNP (ibid). Exports amounted to less than 2% of GNP.

Industrialization began with President Park Chung Hee who, in a military coup in 1961, took over the leadership of the country. Park's coup on May 16 1961, in David Steinberg's (1988, p. 21) words, "was to change the complexion of Korean economics as no single internal event since the Japanese occupation of Korea in 1910."

Park's policies, among other things, were formulated and implemented to achieve the following major objectives: to overcome the country's economic underdevelopment, and launch the nation's economic development through rapid industrialization. Another important, although more personal, objective for Park was to secure political legitimacy. His military coup in 1961 had overthrown a popular government and he needed good economic results to justify his forced leadership.

Figure 5.2

Korea: Rational Analytic Framework - 1961 to Early 1970s

Trigger Events	Assumed Objectives	Implied Problems	Implied Solutions
- Korea is one of the world's most impoverished rural societies - Military revolution: President Park, after a coup, takes leadership of the country	- Overcome the country's economic underdevelopment - Launch the nation's economic development through rapid industrialization - Secure political legitimacy	- Limited capital stock, few natural resources and a large population - Lack of sufficiently skilled and experienced people - Too poor to rely on domestic demand to get economy moving - Poorly developed financial sector; regulated interest rates, low savings.	- Implement export promotion policy - Centralize economic planning to overcome shortages of skilled manpower and allow concentration of priority sectors - Borrow abroad directly or through foreign bank branches - Restructure interest rates to increase national savings - Exercise close control of banks to ensure funds are directed to priority sectors

Actions and Results	Implied Objectives

- Government achieved consolidation and centralization of political, economic and administrative power
- Strict control of the banking sector:
  - regulated interest rates
  - credit rationing (policy loans)
  - nationalization of banks
  - borrowed heavily abroad through commercial banks
  - specialized banks were set up
- BOK Law was revised to put it under MOF control
- Interest rate reform in1965
- Small number of foreign banks were allowed to open branches
	- Give manufacturing priority in terms of policy; promote the nation's export capabilities
	- Efficiently use limited financial resources to contribute to rapid industrialization
	- Mobilize the banking sector as a tool to back up industrial growth
	- Get access to more foreign capital to finance industrialization

But, to say the least, a series of problems limited the country's development at this early stage: a limited capital stock, poor natural resource endowments, a large population (Korea is one of the most densely populated countries in the world), and a low national savings rate. Domestic savings represented only 0.82% of GNP in 1960, compared to 17.43% in 1970 (Bank of Korea, 1978, cited in Cole and Chul Park, 1983, p. 267). Korea was too poor to rely on domestic demand to get the economy moving. Lacking foreign capital as well, the country was in need of foreign exchange to buy its food, oil, and capital goods.

Furthermore, for many years prior to the war, the Japanese had occupied most of the middle and top positions in the banks, industry, and government (Moskowitz, cited in Cole, and Chul Park, 1983, p. 48). After the war, Korea did not have sufficient skilled and experienced people able to run the country. Also, division of the country, an imposed US government in 1945, a new government in 1948 (not experienced at all), and the war with North Korea, only added to the problems (ibid).

The external and internal events created serious problems for its financial institutions and explain part of their decline. The Korean financial sector was poorly developed. One of the major problems was the regulated interest rates which were not reflecting the supply of and the demand for money. Horne Jones, in his report (June 1968) prepared for the US Operations Mission to Korea, said that in the mid-1960s: "The single greatest cause of financial failure has been the unwillingness to permit freedom of interest rate determination... The managed interest rates have promoted inflation while the inflation has made still more unrealistic the managed interest rates" (cited in Cole, and Chul Park, 1983, p. 9).

All this resulted in a serious lack of domestic savings. Coupled to the lack of foreign capital, commercial banks had insufficient funds to support national economic development.

Many solutions, implied by the problems facing Park's administration are presented in Figure 5.2. It was important for the country, while moving toward an export promotion policy, to centralize economic planning and determine priority sectors, due to the lack of funds and of skilled people. Also, assuring access to foreign capital was a necessity that could be achieved by importing it through foreign banks operating in the country or by borrowing abroad. More market-oriented mechanisms had to be introduced in the determination of interest rates. Lastly, due to the limited funds available, exercising close control of the banking sector was an optimal course of action because it would ensure that funds were directed to sectors considered priorities. In short, the government had to ensure the efficient use of limited financial resources while achieving rapid industrialization.

Park's actions were numerous and the country did experience high growth due to the successful implementation of economic development plans. One of his most important accomplishments was to consolidate and centralize political, economic, and administrative power (Steinberg, 1988, p. 21). Mainly, he placed economic power directly under his control. The Economic Planning Board was established, unifying planning and budgeting (ibid).

Park's policies did recognize the problems facing the country, and he borrowed heavily and invested in export industries in a manner that was described as a "terrific gamble with other people's money (Economist, May 21, 1988, p. 15). Most of the money came from the United States. The export promotion policy was considered to be the single most important and enduring attribute of Park's regime (Steinberg, 1988, p. 20). In order to attain maximum benefits, the government chose sectors in which precious capital resources were to be invested. Investment priorities were thus established based on the expected contributions each respective industry might make to the overall growth (KDB, 1988, p. 1).

Regarding interest rates, the government did implement a major reform. Authorities had the objective of "getting the financial prices right" (Cole and Chul Park, 1983, p. 8). As described in the previous section, a major financial reform (the monetary reform of 1965) was introduced in September 1965, translating into a significant increase in the interest rates on time deposits of the Deposit Money Banks (commercial banks and specialized banks).

As well, a major institutional change came about in 1962 when the Bank of Korea Law was revised in order to bring the central bank under the control of the Ministry of Finance.

As for the financial sector, we have to take into consideration that not many governments in developing countries appear to believe in the allocational efficiency of the financial system. Financial sectors of these countries are often the most heavily regulated sector of the economy. Extensive government intervention is common practice, especially in setting interest rates and allocating credit. The belief is that without such intervention, credit allocation would not "reflect the social and economic priorities often set by the government themselves" (Cole and Chul Park, 1983, p. 172). The Korean government certainly did not (and still does not) depart from such a tradition. As we will see in the following discussion and in the next sections, government intervention was one of the most important characteristics of Korean banking operations.

Within the banking sector, all banks were nationalized to better exercise control. By repossessing the stocks of the commercial banks, the government was responding to concerns that the privately owned banks would contribute to the concentration of economic power as experienced by Japan (Cole and Chul Park, 1983, p. 57).

The government did keep close control of the banking sector. Its strong intervention in this sector was justified as a way of achieving the transition to export orientation and sustained economic growth. The banking sector was used as one of the most important tools for this. Commercial banks were facilitating foreign lending activity although they were not actually intermediating between the foreign lenders and domestic borrowers (Cole and Chul Park, 1983, p. 61). The banks' decision-making role was very limited; they were not developing skills in lending activities as they were merely responding to government policy.

Most of the Korean specialized banks were set up at that time to complement the commercial banks which lacked sufficient funds to sustain economic growth. These specialized banks funneled large sums of money to sectors that were judged to be of extreme importance to national economic development. Most of the funds consisted of government loans, foreign loans and debentures instead of deposits (Korea Busines World, March 1987, p. 49).

As for foreign banks, they were granted permission to open branches in Korea in 1967. Chase Manhattan was the first foreign bank to open a branch. Two other American and two Japanese banks established branches in the same year. Their primary task being to provide foreign capital, their share of deposits, until the early 1970s, never surpassed 1% (Bank of Korea, cited in US Treasury, 1979, p. 79).

3. Early 1970s to 1980

a. General Overview

The early 1970s was the end of the country's transition from being a largely agricultural economy to an emerging industrial market economy. In 1970, GNP was US$ 8.1 billion compared to US$ 1.9 billion in 1960. Per capita GNP went from US$ 79 to US$ 252. The 1970s witnessed very strong economic growth: at the end of the 1970s, GNP totalled US$ 60.3 billion and per capita GNP was US$ 1,589. Exports, which represented 17.2% of GNP in 1970, now accounted

Figure 5.3

Korea: Rational Analytic Framework - Early 1970s to 1980

Trigger Events	Assumed Objectives	Implied Problems	Implied Solutions

- Nation's status changes from being a largely agricultural economy to an emerging industrial market economy
- Economy is becoming more complex and sophisticated
- First oil shock which causes Balance of Payments problems and high inflation
	- Achieve rapid export-led economic growth
	- Increase investment in social infrastructure
	- Gradually start liberalizing the economy
	- Curb inflation
		- Large fiscal deficits
		- Trade deficits and rapid accumulation of debt
		- Export dependent
		- Economy is outgrowing the need for centralized decision making (such policies are now counter productive)
		- Banking is seriously lagging the manufacturing sector; lacks funds to support strong economic growth; lacks autonomy
		- Weakness of some policy loans becomes apparent as a result of structural economic changes
			- Although some intervention can still be productive, the role of the government should change; as the economy becomes more sophisticated, government control should be relaxed, especially in the financial sector
			- Give banking sector more autonomy; increase competition in the banking sector
			- Allow foreign banks' presence to increase in order to:
			  - increase access to foreign capital
			  - increase access to international markets
			  - introduce high banking technology

Actions and Results	Implied Objectives
- Still high growth approach to policy and centralization of economic decision making - Government control over the banking sector increased; still requires banks to grant policy loans - Large conglomerates (chaebols) emerged - Government created development institutions - Increase in the number of foreign banks' branch licenses - Activities of foreign banks highly regulated and largely restricted to foreign exchange lending and trading - Foreign banks enjoyed unique privileges (swaps, tax exemptions, etc.) enabling them to earn above-average returns on capital - Entry policy of foreign banks based on general contribution to Korean economy	- Again, the banking sector is used mainly as a tool to back-up export-led industrial growth and is not intended to be an independent industry; works by government fiat, not market forces - Provide incentives to foreign banks to make loans in Korea, but in a way that minimizes interest paid and business surrendered.

for 36.7% of GNP. As for domestic savings, they went from 17.4% to 27.2% of GNP in the same period (Bank of Korea, 1978, cited in Cole and Chul Park, 1983, p. 267). These numbers are quite a change from the previous period. President Park and his administration did achieve very high economic growth and overcome the stagnation and poverty that prevailed until the early 1960s.

With such an expansion of its economy and of its exports, Korea became more exposed to events occurring in world markets and more subject to conditions prevailing in its major trading partners' economies. The best example is the first oil crisis which caused balance of payments problems (an increase in the current account deficit) and high inflation. In 1974, consumer prices went up 24% (Euromoney, 1980, p. 3). Curbing inflation was thus one of the objective of this period.

Other major objectives of the time consisted of continuing rapid export-led economic growth, increasing investment in social infrastructure (education, hospitals, etc.), and gradually beginning liberalization of the economy, in light of its constantly expanding size.

However, new problems faced the authorities. The present economy was outgrowing the management capacity for centralized decision-making. Monetary pressures were also a problem. These pressures were the result of the large fiscal deficits which were run in order to meet the government's commitments on public expenditures. The public sector in the 1970s was viewed as a priority. Monetary pressures often caused high inflation, hurting Korean export competitiveness. By the end of 1978, inflation had reached 20% (Institutional Investor, May 1981, p. 257).

Rapid economic growth brought along another problem: rapid accumulation of debt. Outstanding external debt rose from US$ 4.5 billion in 1973 to approximately US$ 15 billion in 1978, reflecting the country's borrowings needed to cope with the first oil shock and to finance its heavy and chemical industry development plan (Iqbal, 1988, p. 141). Borrowing abroad was never a problem. Korea's access to international capital markets improved constantly over the years because of its strong balance of payments positions and rapid growth of exports. Korea's firms also established sound credit ratings. Through most of the 1960s and 1970s, loans accounted for nearly 95% of foreign capital inflows into Korea (and of its stock of external liabilities), while foreign direct investment accounted for approximately 5%. In that sense, Korea has been different than most other LDCs (ibid).

The rapid economic growth created structural problems especially in the banking industry. Park's economic policies, as far as the banking sector was concerned, had become counterproductive. The more the economy grew, the more money was needed. Both the commercial banks and the specialized banks were lacking the necessary funds to support such economic expansion. Furthermore, as we have seen in the previous section, the government's requirement that commercial banks grant policy loans to support its economic plans seriously hurt the banks' assets portfolio. The weakness of some policy loans was becoming apparent as the result of poor investment decisions. All this resulted in a banking sector which seriously lagged behind the manufacturing sector, lacked autonomy and lacked sufficient funds to support such economic expansion.

A solution supported for years by the country's technocrats was to curb inflation and to liberalize the economy by allowing more market forces to allocate resources. The World Bank, in a country report on Korea, suggested that there may "be a need for a fundamental change in the role of government in the economy. As the economy becomes more complex and sophisticated, it [may] be desirable to gradually relax government controls in the economic sphere - particularly in the financial sector" (Institutional Investor, May 1981, p. 258).

Proposed solutions regarding the banking sector were numerous. Allowing more competition in the banking sctor was a solution advocated by many observers. Bank managers had to be more involved in the risk analysis of lending money. Also, financing domestic needs had to be performed more by issuing equity than by the traditional practice of lending large sums of money which put strains on the companies as well as on the banks.

Because of the large accumulation of foreign debt, allowing foreign banks access to the Korean market was a beneficial solution. Access to foreign capital and foreign markets would be increased. Another benefit was the high banking technology that would be imported which would help domestic bankers develop more adequate skills. From the foreign banks' point of view, they would take advantage of a country which was experiencing high growth and had a booming foreign exchange business.

Actual actions of that period were numerous, some of them not always in line with recommendations of the technocrats who were proponents of a more open and liberalized market and financial sector. Government control over the banking sector was stronger than ever. Excessive investments were still undertaken in the heavy and chemical industries and overseas construction. Domestic banks still had to grant cheap loans , or "policy loans", to these sectors in order to achieve government plans.

As well, large conglomerates, the chaebols, were formed. These conglomerates had near monopoly control over a wide range of manufacturing, finance, and service sectors and were seen as the foundation of the country's success (Globe and Mail, March 27 1989, p. B23). It would appear that the government encouraged these companies to grow in size by merger and other means (Lim, 1981, p. 46).

Instead of increasing the scope of business of its domestic banks, the government created "development institutions" (part of the non-bank financial institution sector) to provide more financing to these large conglomerates.

b. Foreign banks

As we have seen in the previous part of this chapter, in 1967, Chase Manhattan was the first foreign bank to open a branch in Korea. In the second half of the 1970s, many other foreign banks entered the Korean market. The foreign banks which followed Chase's decision were also beginning to move out to Pusan, Korea's second largest city.

The years 1977 and 1978 witnessed a huge increase in the number of foreign bank branches in Korea. According to the US Department of Treasury (1979, p. 6.), there were 32 foreign bank branches by the end of 1978. The United States had 12 of their own. Such an increase of foreign penetration of the Korean banking sector is explained by the high demand of foreign capital resulting from the economic expansion.

In an interview in 1977, Finance Minister Kim Yong-Hwan stated that Korea was going to compete with other countries as an international financial centre. He said that Korea was a market economy pursuing free trade principles which had to be supported by trade credits. This was one of the reasons Korea had foreign banks operating in Seoul (Euromoney, April 1977, p. 7). At the same time, foreign banks were allowed to compete with local banks and financial institutions. But the Minister did not feel totally satisfied with the degree of liberalization. He claimed that gradually, they would liberalize the permitted activities of the international banking institutions in Seoul. He did not intend to set about forming an international money market in Seoul but as the government was pursuing a liberalization policy, he thought that the environment of the financial market could evolve to a situation where an international money market could be formed (ibid).

However, as we have seen in the previous section, the authorities were in fact faced with two conflicting objectives: liberalization of the banking sector to attract foreign capital on advantageous terms, and protection of the domestic market to reduce fears of such foreign penetration. Protection of the domestic banking market was an important issue, as expressed, in part, in a letter addressed to the United States Embassy in Seoul, signed by the governor of the Bank of Korea (US Treasury, 1979, p. 81):

> Compared to developed countries, Korea lags behind especially in the banking field. As a result, the Korean Monetary authorities have had to take measures to maintain a balance between domestic banks and foreign banks and to assure a viable domestic financial market. We feel such balance is essential for a sound financial system in Korea... The measures which are pointed out as discriminatory treatment of foreign banks are taken mainly for this objective.

Foreign banks found the environment surrounding their operations to be quite restrictive as they were faced with many discriminatory measures. The major restrictions were the ones limiting their won lending business. Each foreign bank, in the late 1970s, faced a limit on the amount of swaps of foreign exchange for Korean won it could transact with the Bank of Korea. A foreign bank's initial capital was (and is still is) classified by the Bank of Korea into two types: Funds A and Funds B. The total capital each foreign bank could have was limited; since the amount of won it could lend was based on its capital, this limit restrained foreign banks' lending activities. It is worth noting that domestic banks faced no limits of this kind. At the time, Funds A were defined as the bank's paid-in capital and had to consist of a minimum of three billion won before a foreign bank could open a branch. Funds B represented the amount of reserves that foreign banks obtained through swaps and was limited to an amount representing 400 percent of Funds A capital.

As of August 1980, there was an overall limit of swaps for all foreign banks of US$ 250 million available on a first come, first served basis. But at the beginning of 1980, the amount outstanding was nearly US$ 400 million; the US$ 250 million limit was clearly restraining foreign banks' operations (Euromoney, December 1980, p. 33).

Another major restriction on foreign banks' lending operations related to the controls on the rates of return on their won lending. The Bank of Korea assumed that foreign banks were funded at LIBOR rates and therefore retained all but 1 percent of the difference between LIBOR and Korean lending rates (Euromoney, December 1980, p. 33).

Other regulatory measures facing foreign banks in the late 1970s were described in the US Department of the Treasury "Report to Congress on Foreign Government Treatment of US Commercial Banking Organizations" (1979). The major points are summarized as follows:

- Foreign banks were not permitted to open a second branch in Seoul. Branches could be established in small and medium size cities. This restriction was a means of counteracting the fact that authorities were less capable of controlling inflation due to significant inflows of foreign exchange, and to halt the increase in foreign banks' share of the local market.

- Each foreign branch was a separate entity, as opposed to domestic banks which did not have to capitalize each branch separately. Since the amount each foreign bank was allowed to lend was based on its capital, this restriction limited foreign banks' lending activities.

- No bank was allowed to lend more than 25% of its capital to a single borrower. This restriction, combined with the previous ones, was limiting foreign branches' lending capacities, and put them at a competitive disadvantage vis-a-vis domestic banks.

- In 1979, foreign currency lending was also limited by the Ministry of Finance, with a total of $US 1.8 billion to be allocated as follows:
.$US 430 million directly to foreign banks;
.$US 820 million directly to domestic banks;
.$US 550 million to any domestic or foreign bank upon application.
The $US 550 million remaining was allocated in a way to favour exports and other specific targets of the industry.

- Foreign branches were limited in their ability to acquire local funds. The Korean Bankers Association's rules stated that foreign branches were not permitted to receive certain types of household deposits.

- Foreign banks, unlike domestic banks, were not allowed to issue short-term debentures, and were not given government deposits of subsidized funds for export financing. As well, foreign banks did not have access to the Bank of Korea's "discount window", which is a low-interest rediscount facility, including discount lending for commercial bills and export promotion. These rediscount facilities constituted a very important source of funds to domestic banks. However, as compensation, there existed a "swap facility" with the central bank whereby each foreign branch deposited foreign currency at the central bank and received local currency under a closed-out swap, thereby eliminating all exchange risk. This arrangement was the most important source of local funds for foreign branches and guaranteed a profit margin of 1 percent. However, there was a swap limit related to the maximum amount of foreign currency lending allowed, as explained in the above regulatory measures.

- The Korean Alien Land Acquisition Law effectively prohibited a foreign bank from acquiring real estate at a foreclosure auction. While foreign banks were allowed to receive real estate as collateral for loans, this law, in practical terms, restricted them from doing so.

- Foreign banks did not play an effective decision-making role in the Korean Bankers Association. They had not gained membership in this organization which had important influence in the formulation of banking policy and practices.

- Foreign banks were not permitted, under the General Banking Act, to purchase or establish local subsidiary banks.

- Foreign banks were prohibited from offering trust accounts or investing in finance and insurance companies.

- American banks were not permitted to finance trade deals for Korean imports of U.S. government subsidized commodities, under Korean foreign exchange regulations.

As far as entry regulations were concerned, the Ministry of Finance used the following criteria for approving the establishment of foreign bank branches:

1) the economic relationship between Korea and the bank's country of origin;
2) the bank's status in international financial markets;
3) the reciprocal opportunity for Korean banks to establish branches abroad;
4) the foreign bank's willingness to open a branch (or a second branch) outside Seoul;
5) the bank's technical expertise in international finance;
6) the bank's potential contribution to the Korean economy;
7) whether the bank's country of origin was already represented in Korea (Euromoney, December 1980, p. 33)

As the above description indicates, foreign banks were faced with many discriminatory measures when compared to their domestic counterparts. Nonetheless, in spite of these regulatory measures and the intense competition, foreign banks, as a group, still managed to earn above-average rates of return on capital due to the following advantages they enjoyed:

- Foreign banks had access to the swap facilities which guaranteed a relatively high profit margin with no risk.

- Foreign banks were exempt from income taxes and corporation taxes on revenues obtained as interest and/or commission in connection with foreign currency lending to domestic borrowers.

- Foreign banks were exempt from corporate taxes on earnings received for arranging foreign capital inflows to Korean enterprises.

- Foreign banks were free of government interference which directed Korean banks' lending into channels considered important.

- Foreign banks were not obliged to contribute even indirectly by subscribing to low-interest government loans.

- Foreign banks were exempted from the special deposits operations of the Bank of Korea; they did not have to deposit local currency with the Bank when it was "mopping" up liquidity.

- Foreign banks were free of any limitation on the amount of export promoting lending they undertook and they were free to expand lending to joint ventures (Euromoney, December 1980, p. 31).

In fact, foreign exchange loans to exporters were encouraged. Foreign bankers were constantly asked to lend to industries wishing to modernize export facilities (Euromoney, April 1977, p. 22).

Their relatively profitable operations are illustrated in the following numbers. From 1975 to 1980, foreign banks' share of total won deposits was approximately 1.2% and their share of foreign currency deposits averaged 5%. But in 1979, they accounted for a little over 13.5% of profits (Euromoney, December 1980, p. 33). This shows that their operations were quite profitable although profits were not large in absolute numbers.

4. 1980 to Present

a. General Overview

The beginning of this period was quite tumultuous in terms of social, political, and economic events. In October 1979, President Park was assasinated, creating political instability. On the economic front, the second oil crisis was a major blow to the Korean economy: oil prices went up and interest payments also rose sharply. Gross foreign debt outstanding represented approximately 33% of GNP in 1979 and interest payments were about 1.9% of GNP on average in 1977-1979 (Lee Yang-Pal, 1988, p. 21). In 1980-1982, interest payments even reached 4.9% of GNP (ibid). As well, economic growth fell sharply. In 1980, real GNP fell by 5%, while inflation rose to 35% (Economist, October 5, 1985, p. 69).

In that sense, high economic growth was not the only priority any more. The new president, Chun Do Hwan (another military leader), said in an interview that the country had to "work to defend the peace of the country, to

Figure 5.4

Korea: Rational Analytic Framework - 1980 to Present

Trigger Events	Assumed Objectives	Implied Problems	Implied Solutions

- Several shocks at beginning of period:
  - assassination of Park
  - 2nd oil shock
  - first economic downturn
 	
- Expansion of Korean firms abroad
 	
- Massive trade surpluses with the U.S.; pressure to liberalize the financial sector
 	
- In the mid-80s macroeconomic context is more favorable for financial liberalization (lower inflation)
 	
- In 1986, current account surplus for the first time; major turning point
 	
- Election of Roh in 1988 initiates period of greater democracy
	- Maintain social and political stability; reassure foreign lenders
	
	- Maintain high economic growth (but not as only objective)
	
	- Switch from an export-led high growth economy to a more balanced development and income distribution
	
	- Shift policy stance from a government-oriented economy to a market-oriented economy
	
	- Reduce reliance on conglomerates
	
	- Reduce debt
		- Korea's international credit standing dropped temporarily in 1979-80
		
		- Investments in heavy industrial development are too important to pull out
		
		- Economy's efficiency is now impossible without the introduction of a free competitive system
		
		- Trade surpluses with the U.S. create risks of sanctions
		
		- Due to policy loans, banks have billions of dollars of non-performing assets (threatens their solvency)
		
		- Specialized banks have lost their distinct features
		
		- With c/a surplus, the need for foreign banks' capital has decreased
		
		- Foreign banks' relatively high profits are used as an excuse to limit their operations
			- Gradually loosen government control as bank management becomes more capable of independent decision-making
			
			- Strong need for reform: establish an independent market-oriented financial sector to allocate funds
			
			- Balance the need for increased competition in the financial sector against recognition of banks' portfolio weakness
			
			- Internationalize the banking sector; let more foreign banks enter (increase competition)
			
			- Move toward national treatment for foreign banks as a long-term objective
			
			- Use foreign banks as a way to modernize the banking sector

Actions and Results	Implied Objectives

- Debt has been reduced
 	
- Many announcements by gov't. officials calling for reforms/liberalization
 	
- Some structural liberalization efforts in the banking sector
 	
- Practical continuation of previous policies; gov't. control still very strong
 	
- As a result of pressure from U.S., authorities eased some foreign bank regulations: trust services, rediscount window
 	
- Some privileges also eliminated: reduction in swap limits, reduction in swap spreads, etc.
 	
- Activities of foreign banks still very restricted and may have reached a plateau:
  - limited expansion
  - reduced demand for foreign capital
  - no money market
  - no true deposit base (won)
	- Have more "comfortable" financing of debt as opposed to becoming a liberalized market economy; pursue a delicate balance between debt growth and export growth
	
	- After 1986 (capital surplus), authorities want foreign banks' presence less for foreign exchange than for contributing to the advancement and sophistication of the local industry by providing new banking technology
	
	- Obtain foreign capital with the objective of limiting the activities of foreign banks until such time as local banks are strengthened and dependence on foreign debt eliminated (e.g., "buy time")
	
	- Dual objectives (conflicting) of protecting domestic market from foreign banks and liberalizing the banking sector

achieve sustained economic growth, and maintain social and political stability" (Institutional Investor, February 1982, p. 188). A more balanced development replaced the previous objective of export-led growth.

Park's death was viewed by many as giving Korea the chance of making a new start. More government officials and market participants were favoring a shift in policy from a government-oriented economy to a market-oriented economy. In any case, it was important to reassure foreign lenders and investors because Korea's international credit standing had dropped somewhat in 1979-1980.

Following the social and political chaos, the end of 1980 witnessed increased stability. In the early 1980s, the economy started to improve gradually and Korea's credit standing was restored. In 1986, for the first time, Korea had a current account surplus. By 1988, the trade surplus was mounting and the country was swamped with liquidity, a situation that will have many repercussions in the financial sector. The current account surpluses not only increased the capacity to solve the debt problem, but it also enabled the expansion in overseas investment (Korea Economic Journal, March 20 1989, p. 24). Massive trade surpluses occurred notably with the United States. Faced with this situation, the American government was starting to exercise pressure on Korea to liberalize its market and financial sector.

By the late 1980s, annual GNP was more than US$ 200 billion and the volume of trade around US$ 100 billion (Korea Herald, March 19 1989, p.

S2). Korea was then the 17th largest economy in the non-communist world and the 12th largest trading nation (Economist, May 21, 1988, p. 3).

Apart from the temporary drop in Korea's international credit standing in 1979, other problems faced Chun's government. For one, gross foreign debt outstanding in 1985 (the year prior to the first current account surplus) totalled US$ 46.7 billion or 55.8 percent of GNP, the highest level ever (Lee Yang-Pal, 1988, p. 10). Also, progress in liberalizing the economy was slow (and still is) because the country was too deeply involved, in monetary terms, in heavy industrial development to suddenly shift policy orientation. In general, the economy was now too complex to be administered in an efficient way by a centralized system. Efficiency was now impossible without the introduction of a free competitive financial system: Korea's financial needs had changed but the regulated framework had not. Any further advance in the economy was compromised without the introduction of a smoothly functioning financial system.

Government policy of previous years had not been very successful: several companies failed and rescue packages had to be organized by government-controlled banks which now had billions of dollars of non-performing assets on their books (Banker, February 1989, p. 67). Financial institutions were also separated from each others' activities by strict regulation, and domestic banking in particular was too constrained. This had negative effects on the development of the banking sector. In general, Korean banks were largely undercapitalized, controlled (in terms of ownership) by large conglomerates, and too dependent on the Bank of Korea for credit (Leipziger, 1988, p. 128).

Foreign banks also had their problems. As a result of such economic growth, Korea was on its way to becoming a net creditor nation and did not need as much capital from the foreign banks. Furthermore, their relatively higher profits were used as an excuse to limit their operations. The foreign banks' situation will be covered in more detail in the following pages.

The consensus reached on what solutions the government should adopt was quite remarkable. Almost everyone seemed to agree that in general, the size and complexity of the economy called for a substantial reduction in government control, especially in the financial sector, and for decentralization of decision-making.

In terms of solutions for the banking sector, reforms had to be a priority as indicated by the domestic banks' huge amounts of non-performing assets. Government control had to be reduced significantly and an independent central bank had to be allowed to conduct monetary policy. Many specific steps had to be taken. Disposing of non-performing assets of the commercial banks was primordial. Liberalizing interest rates, or at least narrowing the interest rate gap between the Deposit Money Banks and the non-bank financial institutions was also a priority. The latter group had enjoyed some liberalized rates and had been able to offer rates two or three percentage points higher than banks. Boundaries separating businesses of commercial and specialized banks had to be abolished since, in practical terms, specialized banks had lost their distinct functions. Many felt transforming them into commercial banks (or privatizing them) would be optimal. Another solution was to adopt a universal banking system. In any event, it was primordial that competition be increased in the banking sector by liberalizing interest rates, increasing managerial autonomy, reducing the use of policy loans, and allowing foreign banks to compete more head-to-head with them. This notion of increased competition was very important for foreign banks because they were not to have a wider range of business open to them until the domestic banks were ready to compete.

Korea also needed to internationalize its banking sector. In that sense, allowing more foreign banks to enter the market and widening their scope of business was a viable solution. Not only would they help increase competition in the banking sector, they would also bring the necessary skills and technology, which Korean banks lacked, to modernize the banking industry. As the government pursued financial liberalization, domestic and foreign banks had to be allowed to provide a wider range of services, with less government intervention. As a long-term objective then, giving foreign banks national treatment was a rational solution.

Actual measures undertaken by the government did not reflect all of the above recommendations, and sometimes were not in line with its own announcements calling for reform/liberalization of the banking sector. Some structural liberalization efforts were introduced. The government had indicated that it would push forward banking reform in two ways: managerial autonomy and business autonomy. As part of the reforms, the government privatized all the city banks between 1981-1983. In addition, the General Banking Act was revised at the end of 1982 in an attempt to give banks more leeway in dealing with their managerial affairs. To increase competition, two new city banks were established in July 1982 and March 1983 (Korea Business World, March 1987, p. 48). Domestic banks could also offer new services to their customers.

To some domestic and foreign banks, the results were below expectations due to the practical continuation of previous policies. Government intervention was still strong, the Bank of Korea was still under the Ministry of Finance's authority, the activities of financial institutions were still very segmented, government appointment of top banking executives still continued, and short-term interest rates were still largely set by the government.

The evolution of foreign bank regulation in this period was also more or less in line with government announcements and solutions put forward by officials, market participants, and foreign bankers themselves.

b. Foreign banks

In the five years from 1980 to 1985, regulations were eased somewhat to offer foreign banks additional advantages and provide a less discriminatory environment. By 1984, the number of foreign bank branches had increased to 48 (from 38 in 1979) and they experienced a further significant increase in their market share of foreign currency loans, from 39% in 1979 to almost 61% in just five years (see Figure 4.1). Although small, their share of the total loans and discounts market almost doubled from 3.3% to 6.1%. However, they continued to play a very minor role as far as the won-deposits market was concerned, with no significant improvement over 1979, when their share amounted to just a little over 1%.

In the 1984 update of its report to Congress, the US Department of the Treasury (1984, p. 29) related the major developments introduced in the legislation since 1979. These developments are summarized below:

- The minimum capital for a foreign branch was increased to US$ 3.8 million.

- Since 1982, banks which had been established in Korea for at least 10 years, had total exposure of US$ 1 billion, and had total assets of 200 billion won, were permitted to purchase their business premises.

- Since 1983, foreign banks were allowed to participate in the same securities activities performed by the nationwide city banks, which consisted primarily of underwriting government securities.

As mentioned previously, the US was starting to exert pressure on Korean policy-makers. When President Reagan visited Korea in November 1983, the issue of liberalization was raised. US concerns with the issue was highlighted again when Donald Regan, Secretary of the Treasury, came to Korea in March 1984. To reduce the risk of sanctions, i.e., protectionist measures against imports of Korean goods and a reduction in US investment, the Korean government responded to US pressure by promising the following significant changes that would provide national treatment for foreign banks by 1986.

1) In 1984, foreign banks would be given membership in the National Banks Association and the Clearing House, enabling them to play a more active role in the Korean banking sector.

2) Capital for foreign bank branches would be redefined in broader terms in order to allow increases in A-Funds and B-Funds, thereby increasing the foreign banks' capacity to lend or issue guarantees and acceptances.

3) In 1985, foreign banks would be allowed to start trust services currently offered by domestic commercial banks (nationwide city banks had been managing trust funds for one year, while local banks had been doing so for two years).

4) Starting in 1985, foreign banks would be given access to the central bank's rediscount window (rediscount facilities). These facilities would be available only for export financing in 1985, but by 1986, they would be fully available on the same terms faced by domestic banks (US Treasury, 1984. p. 30).

Foreign banks were not too convinced that real change would occur, especially regarding the promise of full national treatment.

In an interview conducted in 1985, Minister of Finance Kim Mahn-Je stated that the government was still implementing its liberalization plans, which would progressively eliminate restrictions on foreign bank activities. The objective of these plans was to have foreign banks enjoy national treatment. However, he did express concern for the suffering domestic banking market which needed to be "strenghtened to compete on an equal footing with foreign banks" (Euromoney, October 1985, p. 13). Profitability of domestic banks had been well below that of the foreign banks, a situation caused mainly by bad loans granted in the past.

The government, while announcing the withdrawal of certain restrictions, also made it clear that the foreign banks would concurrently lose some of their privileges, bringing them more in line with domestic banks. Use of the central bank's swap facility would be reduced according to the amount of local currency each foreign bank could raise through the rediscount facility. Also, for 1985, 25% of each foreign bank's new won loan exposure would have to go to small and medium-size firms. This portion would reach 35% in 1986.

Some of the announced modifications did come into effect. In February 21, 1985, foreign branches were allowed access to the rediscount facilities for export industries. Also, their B-Funds limits were expanded to an amount equal to six times that of their A-Funds and their reserve funds. Foreign branches were also instructed to extend 25 percent of their total loans to small and medium-sized firms. These measures were viewed by the authorities as a step toward promoting fair competition between domestic banks and foreign banks. Finally, on September 18, 1985, the government allowed Chase Manhattan Bank and 10 other foreign banks to engage in the trust business (Yonhap News Agency, 1986, p. 138).

However, the Bank of Korea also reduced the limit of extra swap privileges of foreign banks by approximately 50% of the funds in local currency raised through the Bank's rediscount facilities, in efforts to offset part of these new funds. Along with that, the guaranteed profit margin on these swap transactions with foreign banks was reduced from 1% per year to 0.75% a year (Bank of Korea, 1986, p. 35).

Many foreign banks at the time formulated their requests for further easing of restrictions, namely: elimination of separate capitalization for branches, access to the domestic securities business, authorization to issue certificates of deposits (CDs), which domestic banks had been doing since 1984 , greater involvement in the domestic money market, and authorization to purchase property (for loan collateral purposes). These restrictions were all related to some extent to foreign banks' access to local funds, which had always been a much-debated issue. Also, lack of liberalized interest rates was pointed out as a major obstacle to their operations.

In 1986, the Monetary Board of the Bank of Korea permitted foreign banks to use the Bank's rediscount facilities for commercial bills and to handle CDs and CD loans. These measures were explained by Bank of Korea officials as having the purpose of satisfying requests from abroad to open up the domestic financial market and providing conditions for fair inter-bank competition (Bank of Korea, 1987, p. 11). Some of the privileges enjoyed by foreign banks were again reduced: their ceiling on swap transactions was lowered and their guidelines on loans to small and medium-sized firms were adjusted upward.

Under the change, foreign banks were required to lend 35 percent or more of any increase in outstanding loans to small and medium-sized firms, the same as was required of the nationwide commercial banks (Bank of Korea, 1987, p. 11). In addition, regulated interest rates made it difficult for foreign banks to issue CDs.

Many foreign bankers expressed concerns that the government was eliminating the swap facility without providing alternative sources of funding. Since foreign banks were allowed to rediscount commercial bills at the central bank, officials took measures to reduce the Bank's swap transactions with them. Also, as of July 10, 1986, the guaranteed profit margin on these swap transactions was reduced to 0.5%. In August of the same year, the upper limit on extra swaps was reduced by 75% of actual borrowings from the Bank of Korea. However, those foreign banks which had applied for rediscount of commercial bills, saw their extra swap limit reduced by only 50% of borrowings. General swap limits were also reduced in that year. Foreign bankers felt that the new measures (CDs and commercial bills). were not as significant as swap reductions.

Another change was introduced regarding the foreign bank's status. Foreign banks could choose between a "A" or "B" classification. "A" banks had full access to the rediscount window of the central bank but had to extend 35% of loan money to small and medium-sized firms. "B" banks had access limited to export financing only but had to extend just 25% of loans to small and medium-sized firms. It was believed that national treatment was likely to be given only to "A" banks. However, we should note that not all foreign banks are optimistic about the idea of national treatment. For certain banks, especially the smaller ones, further liberalization to achieve national treatment would mean loss of some very important privileges, tougher competition, and increased uncertainty. The swap facility system provided a high profit margin with no risk, and some foreign banks feared that with the elimination of this facility, they would lose much of their won-based business. Also, the trust business was not all that it appeared to be. Bankers commented that in Korean terms, "[trust business] means little more than being able to raise term deposits" (Euromoney, July 1986, p. 66). It seems that, as far as national treatment was concerned, interests differed between large and small banks, the former group being in a better position to face increased competition and to serve new markets in Korea.

Nonetheless, some restrictions, as we have described, have been phased out: since 1986, all foreign banks have enjoyed the same rediscount facilities with the Bank of Korea as domestic banks, that is, they have been allowed to use these facilities for all their operations. Since October 1987, the Ministry of Finance has allowed class "A" foreign exchange banks to deal in various forms of contracts, including futures, options, and swaps on foreign currency and interest rates (Korea Business World, May 1988, p. 17).

However, foreign banks were not satisfied with their situation. In April 1987, the Foreign Bankers Group submitted to the Federation of Korean Banks, several proposals to develop the country's money market for the banking sector including, of course, the foreign banks. The major recommendations were:

- Establishment of a discount house or brokering house as an intermediary;

- Elimination of the physical money market; establish a telephone money market;

- Abolition of the discrimination between the transaction market for foreign banks only and the main transaction market;

- Increase the role of CDs and commercial bills;

- A closer relationship between money market interest rates and the prevailing prime lending rates;

- Determination of rates on lending and savings based on risk and period;

- Elimination of differentials between banks and non-banking financial institutions (Korea Business World, May 1988, p. 17).

Shortly after this, the government announced plans to move toward full liberalization of the banking market, step by step. This announcement resulted more from the pressure of US Treasury Secretary James Baker than from the Foreign Bankers Group proposals. Responding to the US pressure, the Bank of Korea and the Ministry of Finance drafted a plan containing the following measures:

- Allow foreign banks to "possess and dispose of" collateralized real estate (government permission would still be needed but officials said it would be granted swiftly);

- Allow foreign banks to open more than one branch in a single city or across the country;

- Relax regulatory measures to encourage foreign banks to finance more small businesses; and

- Change restrictions so that foreign banks can use CDs as a source of won currency (Korea Business World, April 1987, p. 37).

Even if foreign banks remained optimistic about the announced measures, many of them remembered previous announced plans that were not pushed through.

Presently, as described in the first part of this chapter, the banking sector's environment is considered stable, if not stagnant. Reduction in the demand for foreign currency loans, reduced swap margin spreads, strict credit restrictions on the large conglomerates, and restrictions on onshore foreign currency lending, have all created an environment which foreign banks find hard to cope with. With current account surpluses, foreign banks are losing some of their business. High levels of liquidity have reduced Korean enterprises' reliance on foreign banks for capital. The government is even officially discouraging foreign borrowings to reduce Korea's external debt (Korea Business World, April

1987, p. 34). In fact, Korea is to repay US$ 5.3 billion in foreign debt, US$ 2.4 billion ahead of schedule, to become a net creditor country for the first time this year (Korea Herald, March 19 1989, p. S1). Furthermore, in 1987, the current savings ratio of almost 33% exceeded the investment ratio by about four percentage points. Korea does not need foreign money and it shows (Korea Business World, April 1987, p. 34).

Korean banks are lobbying strongly to limit the expansion of foreign banks due to the low profitability of their operations in recent years. It appears also that from the officials' point of view, the role of foreign banks in the Korean market has changed since their entry in the 1960s and 1970s. Now, the government "hopes they will play a leading role in motivating domestic banks to improve the banking practices and managerial skills (Bank of Korea, 1985, p. 25).

Foreign banks are not very optimistic about their future in Korea and feel that the market may have reached a plateau. This stagnant situation is reflected in the following numbers. Since 1985, there has been no significant improvement in the foreign banks' share of either the won deposits or loans and discounts markets. Their share of the won deposits market went from 1.26% in 1985 to 1.48% in early 1988; for the same period, their share of won loans and discounts remained at 6% (see Figure 4.1). To add to this situation, their share of foreign currency loans has dropped from 67% to 43%.

However, foreign bankers have a hard time finding a sympathetic ear to their problems because of the higher profits they have realized compared to their domestic counterparts. Foreign bankers believe those profits do not constitute a stable foundation for future growth and market development in Korea. For foreign banks wishing to maintain a long-term presence in Korea, they are concerned about profits coming more and more from short-term products. In such a context, it is difficult for foreign banks to convince their customers that they will be there for a long time.

Today, foreign bank activities are primarily related to wholesale business, trade financing, foreign currency lending and foreign exchange operations. Some major American banks have expressed their intention to penetrate the retail banking and the short-term credit markets, as well as to provide credit card services. Retail business is not interesting for most foreign banks because a true deposit base has not developed. So, for many foreign bankers, foreign exchange is the answer, an area where they have a comparative advantage in terms of expertise.

Foreign banks are thus far from enjoying full national treatment. Furthermore, it is a difficult task for them to implement strategies in an environment made uncertain by government regulations that may be temporary. In short, deregulation of the general financial sector in Korea is far from being achieved and expectations are mixed as to whether it ever will be.

5. Conclusions

The Rational Model is best applied in the first period of our analysis. It was optimal for the government to centralize decision-making process and use the banking sector as a tool to back up industrial growth. In the following periods, the evolution of foreign bank regulation is rationally explained as the result of Korea's economic development, the need for foreign exchange, the status of the domestic banking sector, etc. However, some questions are raised.

As the economy grew stronger and more sophisticated and the current account turned into persistent surpluses, why has government intervention in the banking sector remained so strong? While almost everyone, including the authorities, seem to agree that the economy would be run far more efficiently with a deregulated financial sector, liberalization of the banking sector has been extremely slow. Why has the government not liberalized interest rates, increased competition, given more managerial autonomy, and allowed the deepening of the banking sector, s as it has announced so many times?

The most frequent rational answer given to explain the highly regulated environment surrounding foreign bank activities relates to the status of the domestic banking sector. Foreign banks' main obstacle to their expansion is the weakness of the domestic banks, which need protection against the superior efficiency of the foreign banks. Thus, foreign banks will not be given a wider range of business until such time as the domestic banks are strenghtened.

However, this argument has been given for so many years that it loses credibility. The government has announced many times that the banking sector would be gradually liberalized. It has also acknowledged that as a whole, the economy would benefit from a free-competitive financial sector. One has to wonder why the authorities have not taken any serious steps to achieve liberalization and modernize the banking sector.

Rationally, the Korean banking sector would be free of such government control. This will be the centre of the following discussion since the status of the domestic banking sector affects the regulations governing foreign banking activities. The following analysis will provide arguments to support that the situation of the Korean banking sector and the foreign bank regulation are results of the government's organizational process and of political interaction among various interest groups.

B. THE ORGANIZATIONAL PROCESS MODEL

1. Introduction

This section will analyze the domestic and foreign bank regulation as resultants of the government's organizational and policy-making processes, not as rational choices by a unitary actor.

The major part of our analysis, unlike Japan, will not be devoted to the internal workings of the Ministry of Finance. First, the Ministry's operations are not described in as many details in publicly available documents. This reflects the fact that, unlike its Japanese counterpart, it does not operate as autonomously. In addition, the Korean government's role in policy-making regarding the banking sector is more important than in Japan. For these reasons, we will analyze the policy-making process performed by the authorities as a whole, that is, the government, the Ministry of Finance, and the economic planners.

2. General Description of the Policy-Making Process in Korea

Korea has been described as an economy with "strong policy formulation and implementation leadership at the apex, technocratic insulation and autonomy in policy execution, and a highly centralized bureaucratic and military command system that reaches to the most remote rural regions" (Steinberg, 1988, p. 30).

Kwang Suk Kim (1983) describes the general procedures of the traditional Korean policy-making process. In his view, Korea is run by a highly centralized government; local governments are merely agents responsible for carrying out the decisions of the central government. The executive branch has been the dominant power of government (as is the case with many presidential systems in developing countries). Within the executive branch, development planning is the responsibility of the Economic Planning Board.

The perception of strong government intervention is created by the powerful Economic Planning Board, the government agency responsible for planning, budgeting and implementation of the plans by the relevant ministries under its jurisdiction, that is, the ministries of Commerce and Industry, Finance, Construction, Transportation, Communication, and Agriculture and Fishery (Lim, 1981, p. 9). The EPB announces targets for all the major economic variables. The board and the ministries also have had the power to change interest rates, use of foreign exchange, new business, taxes, tariffs, etc. without approval of the National Assembly (ibid, p. 10). The EPB has also been responsible for price policy, fair trade administration, investment project appraisal, and monitoring and evaluation of performance (Kwang Suk Kim, 1983, p. 45).

The EPB, having budgetary control over the ministries, was considered to have appropriate institutional power to carry out its functions of economic planning and policy coordination (ibid). Actual responsibility for development planning rests on the Bureau of Economic Planning of the EPB.

Each ministry participates in planning through its Office of Planning and Management. The EPB and each ministry's office are thus the organizations responsible for development planning in Korea. Actual implementation of any development plan has been handled by the many ad hoc committees formed to support the activities of the above organizations (ibid, p. 46).

The formulation of every five-year plan contains the following stages of planning: draft guidelines, sectoral plans, planning coordination, and finalization. Of more direct concern for our paper is the formulation and implementation of short-term economic management policy. The short-term management policy is of vital importance to the private sector, and may or may not be tied in with the implementation of a medium-term plan (Kwang Suk Kim, 1983, p. 64). Such a policy can directly influence decision-making in the business sector. Regarding the banking sector, short-term government policy may apply to interest rates, preferential credit, etc.

Short-term economic policy is usually initiated or designed by the officials of the ministry concerned. The Ministry of Finance usually formulates short-term proposals that have to do with exchange rates, interest rates, etc. (ibid, p. 65). Proposals have to be approved at the Economic Ministers' Meeting before receiving the President' final approval. This group is composed of the ten economic ministers and the deputy prime ministers. They have become the formal institution for deliberation on any ministry proposal to "enact economic laws and presidential decrees or to amend existing laws and decrees" (ibid).

Usually, all concerned ministries have already agreed on proposals and it is just a matter of getting the formal approval of the ministers. As a result, very few controversial proposals or policy issues are likely to reach the Economic Ministers' Meeting. Discussion of policy proposals has traditionally been closed to the public (ibid, p. 67).

In addition, the Economic Ministers Consultation Meeting discusses important policy proposals that require coordination among the concerned ministries. Complete agreement of all related government agencies is difficult to obtain because of the competitive attitudes of bureaucrats in each ministry. Bureaucrats tend to take the position that best represents their ministry's interests, hence the need for the Economic Ministers' Consultation Meeting.

Policy decisions may be made by a small number of bureaucrats. Even when policies are discussed at the Economic Ministers' Consultation Meeting, the policy-making process involves a small number of government officials (ibid, p. 68). Ministerial committees are believed to function as a rubber stamp that approves what is proposed by the ministry. Policy decisions are systematically implemented to achieve the desired objectives. Jones and Sakong (1980, cited in Kwang Suk Kim, 1983, p. 68) state that "Koreans are even better at implementation than at planning".

The major weakness in the Korean policy-making process is that it lacks a consensus- building procedure. Individuals can be extremely influential in the decision-making. Today, one of the most influential personalities is Deputy Premier-Economic Planning Minister Cho Soon, considered to be the top economic policy-maker in Korea (Korea Times, March 23, 1989, p. 8). Important policy decisions have thus often been made by a small number of bureaucrats and government officials without much public debate. Decisions have been rapid and seldom based on public support.

3. Features of the Policy-Making Process

a. Priorities

The priorities of Korea's president can determine the direction of the whole economy. President Park was obsessed by the modernization of Korean industry and economy said a Korean economist (Institutional Investor, May 1981, p. 254). Korea was aiming at being an industrial state by the 1980s, so the country had to have large industries. Lee Jim Sul, at the time Director-General of the Economic Planning Board, said that President Park "had very expansionist economic policies - sometimes beyond the nation's economic and financial abilities (ibid).

As described in detail using the Rational Model, one persistent policy goal has always been at the forefront of every government's plans: export-oriented industrialization and growth. Therefore, the manufacturing sector was the main recipient of precious funds. On average, this sector received 45% of total bank lending (Cole and Chul Park, 1983, p. 177). The pace of the liberalization process has been slow as a result of government policy requiring strong investment in heavy industrial facilities. The large companies needed cheap funds to survive. The status of the domestic banking sector is also a result of this priority of achieving growth; profitability of banks has always been of secondary (and usually very minor) importance. As the following sections will demonstrate, in Korea, items such as exports and imports, and government policy are more important than finance to explain the development of the banking sector.

b. Perceptions

Not many governments of developing countries appear to believe in the allocational efficiency of the financial sector. The Korean government has certainly been no exception. Korean officials have controlled the banking sector to such an extent and for so long that we must conclude that indeed, they have assumed market failure.

Also, Korea has had foreign exchange shortages for many years and a "deficit mentality" still exists despite the surpluses of the last years. Restricting the free flow of foreign commodities and capital under the excuse of defending the international payment balance should be a thing of the past. However, even though some time has passed since Korea first recorded a current account surplus, this persistent deficit mentality of officials hampers the government economists (Korea Herald, March 19 1989, p. S1). With current account surpluses, policy-making should move toward allowing free capital transactions.

Bureaucrats as well limit the extent of financial liberalization. Korean bureaucrats are stability-minded people who, among other things, fear inflation and often consider curbing it the top priority.

c. Parochial objectives

Contrary to what some people might think, the Korean government is technocratically impressive. A third of the civil servants in the Economic Planning Board have second degrees from American universities (Economist, May 21 1986, p. 17). Ministries are run by very knowledgeable people. The EPB minister has run companies, the education minister is an educator and the defence minister a general (ibid). The objectives of these technocrats have been quite different from those of the bureaucrats or the president's close advisers.

For years during President Park's regime, these technocrats had been pushing, among other issues, for allowing free market forces rather than the government to allocate resources. The government's objective was to strenghten the state. The technocrats submitted proposals to the government but they were vetoed by members of President Park's inner circle of advisers, many of whom were old friends from his military days, and agreed on goverment intervention (Institutional Investor, May 1981, p. 254). Korea's economic difficulties of the late 1970s can be considered as by-products of the single-minded pursuit of export-led growth under the Park regime. Either the technocrats were responsible or their recommendations were ignored by Park. According to many sources, the second explanation is the real one. After a while, it became senseless for the technocrats to submit proposals (ibid).

4. Implementing Policy through the Banking Sector

Like many developing countries, Korea has used its banking sector as a major tool to assist industrial growth. The Korean banking system has been the most important channel for the implementation of allocative policies of the Korean government. It has been considered to be the sector of the financial system most affected by interest rate ceilings and forced lending policies (Virmani, 1985, p. 63). From the start, the objective was not to have free interest rates but rather to lower the effective cost of capital for favored uses (ibid, p. 9).

Government controls over credit allocation were exercised at first through a system of guidelines which determined loan priorities for different sectors. In the early 1960s, the government took an active role in guiding resource allocation. It interfered with the allocation of credit and gradually took over the rationing of credit from the Bank of Korea and other financial institutions. Because many Korean products were anything but price-competitive internationally, the government ordered banks to grant cheap export credits which, given the inflation of the time, carried negative interest rates (Banker, January 1984, p. 32). In those days, the government has allocated from 50% to 70% of domestic credit (Cole and Chul Park, 1983, p. 173). Even though in theory the remaining credit was allocated at the discretion of the Deposits Money Banks, in reality, they exercised little control over the residual funds (ibid).

As regards control of interest rates, the Bank of Korea (supervised by the MOF) has had the power to set rates on deposits and lending for all banks and non-banking institutions as well as determine ceilings on credit expansion.

Interest rates have been regulated heavily because import substitution objectives called for long-term credit at low interest rates. The Bank of Korea supplied credit to the banking sector in two ways: by rediscounting commercial bills and by granting loans on the collateral of selected bank assets of the DMBs. However, rediscounts of bills for export promotion and other selected areas were preferential loans that were automatically rediscounted and thus outside the central bank's control (Cole and Chul Park, 1983, p. 242). Rates did not matter much since they were controlled and maintained at lower levels than those which would have prevailed in a free market. DMBs have always faced an insatiable demand for loans and have always borrowed from the Bank of Korea. What mattered was not the cost of borrowing, but the availability of credit.

Government's control over the banking sector may appear to have been substantially reduced when city banks were privatized in 1982-1983. However, the government still appoints the presidents of these banks to ensure control of the sector. Usually, retired government officials have been selected to occupy these positions. The banking sector would benefit more if presidents came from the banking industry or more specifically, from every bank's executive structure. As well, the traditional practice of having the central bank's governor appointed by the Ministry of Finance reinforces the government's control and severely restrains any plans to give the Bank of Korea more freedom in its operations. It is a clear sign that the Ministry of Finance does intend to be the sole responsible organization for monetary and credit policies, as implemented by the Monetary Board and the OBSE. The Bank of Korea will merely carry out the day-to-day operations.

Monetary policy is considered in Korea to be another important tool to accomplish the nation's economic goals. As stated by Minister of Finance Lee, monetary policy should be implemented in harmony with the government's other policy tools (Korea Business World, August 1988, p. 35). The Minister also said that the ultimate responsibility for all policies belongs to the government ministries. Therefore, the Ministry of Finance is responsible for monetary policy. The concept of an autonomous central bank is still very far from being realized. Furthermore, the Ministry has shown willingness to strenghten the functions of the Monetary Board of the central bank (which it indirectly controls).

Regulations that affect the Bank of Korea directly affect the DMBs, since they are subject to controls via the instruments available to the Bank for monetary policy (reserve requirements, direct credit controls, interest rate controls, etc.) The banks have become extremely dependent on the central bank because the government has used them extensively as tools for industrial policy. Strong requirements to grant "policy loans" have put the DMBs' accounts in deficit and they have had to turn to the central bank to get discount loans. The Bank of Korea has also provided low interest on these discount loans and interest on reserves.

In short, the Korean banking sector has been highly regulated in order to accomodate governmental priorities. Banks have thus been serving the industrial sector which has sought special treatment supported by bureaucratic direction. Banks have traditionally followed a list of instructions, drawn up each year, on how much to lend to each type of borrower. Rates on loans were set by the government, differing according to how the money was to be used (Economist, August 14, 1982, p. 17). Rates were not determined according to risk status; rather there were special loans for exporters, investors in equipment, etc.

5. Legacy of the Policy-Making Process on the Domestic Banking Sector

The purpose of this work is not to assess whether or not government policy was truly successful in attaining the growth objectives. What we will try to demonstrate is that the present situation of the Korean domestic banking sector is the result of such policy. Indirectly, foreign banking activities are affected by the present state of the banking system. The major legacy of the policy-making process in the financial sector is a weak banking system and a weak central bank.

a. A Weak and Outdated Banking Sector

Generally speaking, financial policies, which were part of development strategies, have been used mainly as a means of mobilizing and allocating domestic and foreign resources. As a result, a weakened financial system has developed, which is outdated, and lacking in independence. Government deficits (financed by the Bank of Korea), government loans through the commercial banks, and control of interest rates, all reflect the growth objective of financial policy, and have all contributed to hampering the development of the banking sector.

The major legacy of the Korean policy-making process on the domestic banks has been the huge amounts of bad loans on their books, resulting from the policy loans they had to grant. This partly explain why the banking sector has been the weakest sector of the Korean economy. Efforts made to increase the banks' autonomy have been seriously limited by these huge non-performing assets in their portfolios. Until they are disposed of, modernization and deepening of the banking sector is jeopardized.

Government policy requiring that banks grant long-term loans for investment into heavy industries have thus made the banks' assets very illiquid. This illiquidity has made it difficult for DMBs to adjust their asset portfolios according to changes in financial market conditions (Cole and Chul Park, 1983, p. 254). The second oil crisis is a good example. The severe consequences of the oil shock (high inflation and current account deficits) were truly the result of practices that were far from those of a market economy. Korean companies at the time relied heavily on borrowing for their expansion. The government's main objective being growth, these companies were able to borrow sums which were considered immense by Western standards. However, when further expansion was undertaken, there was little cash available. As we have seen, the country witnessed its first economic downturn. It is ironic that the slowing of the economy was the result of policies intended to give growth first priority.

These bad loans have significantly weakened the ability of the banks to adjust and react to the changing economic and financial developments. As a result, the authorities have felt that they are not yet able to face increased competition from foreign banks and have restricted the latters' efforts to gain access to a sound base of won funds.

As well, the practice of policy loans has led to the very weak financial structure of Korean enterprises, which are plagued with huge debts. These debts have been a strong obstacle to change. In mid-1982, companies' debts were 4.5 times their net worth in 1981 (Economist, August 14 1982, p. 17). Interest rate liberalization was said to be proceeding as fast as these companies were mending their balance sheets, which was not very fast. Interest rate liberalization could therefore not be undertaken because these vulnerable companies would have had to pay higher interest rates.

Regulated interest rates, which were kept at artificially low levels, partly explain the low profitability of domestic banks. Control over interest rates has also created fragmented and artificially segmented markets for many financial assets, as well as an uneven flow of funds among these markets (Cole and Chul Park, 1983, p. 254). This would suggest that the concept of adopting a universal banking system is non-feasible. Being categorized as commercial banks, foreign banks will thus continue to be restricted in the type of businesses they can perform.

Because government control and intervention has dominated the banking sector for so long, bank management seriously lacks autonomy and skills. Credit pricing and allocation decisions were made for many years by bureaucrats based on national priorities, not financial and economic soundness (Iqbal, 1988, p. 145). As a result, the skills required for credit and risk analysis, supervision and control are not widespread among bank managers (ibid). Bank managers have lacked the motivation (and the need) to acquire sound managerial skills and responsibility. Cole and Chul Park (1983, p. 256) argue that the passivity and lack of self-discipline of banking institutions in loan management, may have in turn given justification for the government's tighter control over these institutions and their credit allocation. But, the tighter the control, the less motivated and responsible the bank officials became; thus the vicious circle continued. As long as the government maintains this control over the banking sector and keeps a prime role in corporate policy-making, this situation will not change.

Another factor helping authorities' intervention in bank management is found in the law. According to the General Banking Act, stockholders of the banks do not have voting rights related to the number of shares they hold (Korea Business World, March 1987, p. 49). They are therefore subject to restrictions and this allows the government to intervene in the management of the banks (ibid). Banks' autonomy is jeopardized unless the government reduces its interventionist habits.

b. A Weak Central Bank

The Bank of Korea is at the head of the banking system, but it is not an independent central bank; its operations are directed by the Monetary Board appointed by the Ministry of Finance. The problem with the official structure is that the government has been responsible for policies ranging from overall macro-economic policy to monetary policy, and the Bank of Korea has only been in charge of implementing monetary policy. By having control over the Monetary Board of the central bank, the Ministry of Finance can practically regulate every aspect of Korea's financial sector. But now, with changes occurring in the economic environment calling for more market forces and less government control and intervention, this type of structure is inadequate and out of date. Monetary control should shift completely to the central bank.

Nonetheless, the Ministry of Finance seems willing to increase its control. In August 1988, the Ministry announced that the Monetary Board would be increased to 12 members. Members would still be civil servants. Meanwhile, the OBSE of the Bank of Korea was to be separated from the central bank in order to be under government control. The OBSE would be authorized to supervise banking and non-banking institutions (Korea Business World, August 1988, p. 35). As the government prepares for liberalization of the banking sector, it does so in a way to ensure strenghtening of its power: financial liberalization will not occur freely but rather it will be under control of the government which will set the pace.

Accordingly, the government still wants to keep the Bank of Korea "within the government". The Minister of Finance clearly stated: "In our case, a closer coordination and harmony between monetary and fiscal policy is very important. We would like to give the central bank more independence, relatively speaking, within the government. Not really independence from the government" (Asian Finance, July 15 1988, p. 42). The use of government intervention and control has created a dependent central bank, lacking the necessary freedom and power required to operate using market-oriented mechanisms.

6. Legacy of the Policy-Making Process on Financial Deregulation

The government's policy-making process and its related propensity to regulate and intervene, has seriously hampered financial liberalization in Korea. The highly-centralized policy-making process, performed by top economic policy-makers committed to achieving high growth, is outdated in view of the new economic and political environment. The practice of having a few men decide policy orientation is slowing down financial liberalization. Since the late 1970s, the Korean economy has been too large and too complex for the government to control in an efficient way. This monolithic style of policy-making has to change, otherwise the banking sector will retain its status as the weakest sector of the whole Korean economy.

Government intervention is still practiced today, although the methods used are more sophisticated. What the government cannot or does not wish to control directly it influences through regulation (Steinberg, 1988, p. 27). Kihwan Kim (1988, p. 14) argues that the Korean public still does not "fully appreciate the ethical and legal foundations of the free market nor does it fully understand the basic rules of the game under capitalism". It is therefore relatively easy for the government to justify intervention. Although many observers have identified the need for decentralization, especially in the financial sector, the results have not been very promising. In fact, in 1989, when the banks were given some newly-earned freedom, they formed a collusion and unified their lending rates to avoid the risks (Korea Herald, March 1989, p. 2). Liberalization and market opening measures in the banking sector are likely to be a failure in the short-term because of lack of competition and proper managerial skills.

But the use of controls and intervention in the banking sector should not be totally associated with deliberate actions made by the government. Many government officials have acknowledged the fact that the economy would be run more efficiently if a free, competitive financial system were in place. However, the problem with organizational processes (such as highly centralized policy-making) that have been used for so long is that they are quite resistant to change. Korean policy-makers acquired their knowledge when Korea was an emerging industrial nation and continue to use tools they are familiar with. industrial nation. The use of government controls in the banking sector, even when this sector was becoming more sophisticated and called for more market-oriented mechanisms, is explained because the officials did not have anything else to rely on. Given the limitations of their traditional policy instruments in such a context, authorities relied upon direct control of domestic credit and interest rates.

The use of the Organizational Process Model would thus suggest that the slow pace of financial liberalization in Korea is not caused by a rational government decision to protect the domestic banking sector until it is strenghtened. Rather, our model suggests that the poorly developed banking sector and the slow pace of financial liberalization are the results of the government's policy-making process. Therefore, the highly regulated activities of the foreign banks are also the result of this policy-making process.

7. Legacy on Foreign Bank Regulation

In Korea, when financial liberalization is jeopardized, national treatment for foreign banks is equally out of reach. The above description has illustrated the government's propensity to intervene in, and regulate the banking sector. This propensity is reflected in some regulatory measures facing foreign banks, some of which we have provided as examples.

The following episodes demonstrate that, even when the government introduces some easing in its regulation, the propensity to intervene and regulate in other related areas actually neutralizes deregulatory attempts. In Korea, it seems that every liberalizing measure is undertaken on the basis of "two steps forward, one back" (Banker, January 1984, p. 34).

a. The Money Market Episode

The government has taken steps many times to liberalize the call money market. In 1982, this market was deregulated somewhat when interest rates in the call money market, which were previously set by the Bank of Korea, were determined by the rates for commercial paper quoted by the Commercial Paper Market Dealers' Association. The government had then anticipated that this market would attract funds from the unofficial money market since non-bank financial institutions were permitted to participate for the first time. However, these institutions were required to put up 110 percent in government securities or bonds as collateral to cover these borrowings in the market (Banker, July 1982, p. 82).

In later years, the Korean Foreign Bankers Group issued an indepth report on the domestic money market. The recommendations were, at least, formulated taking into account the Korean government' policies, that is, they did not ask for a totally unregulated market, as was the case in previous years. As Houtekier of Societe Generale said: "People in this country who advocate total freedom don't get very far. They can't allow a free demonstration in the streets, so there's no reason to think they would allow a totally free money market. It must be regulated" (Korea Business World, April 1987, p. 36).

b. Certificates of Deposit and Commercial Bills

As of August 1986, foreign banks were allowed access to the Bank of Korea's rediscount window for financing commercial bills. Also, as of September of the same year, they were permitted to issue negotiable CDs. But, as a result of government intervention, these measures have been described as unfruitful, and far from having the advantages that swap mechanisms provided. As of last year, no foreign bank has had commercial bills rediscounted at the Bank of Korea since the use of the facility would trigger an increase in the obligatory extension of loans to small and medium-sized enterprises from 25% to 35% of new lending. (Korea Business World, May 1988, p. 17).

Regulated interest rates have made it difficult for foreign banks to issue CDs. Furthermore, issues are limited to 7% of a foreign bank's branch capital, so they do not constitute much of an enlarged source of funds. Yet another inhibiting factor is that foreign banks which do issue negotiable CDs must give up an equivalent amount of swap rights on a permanent basis.

c. Futures

In October 1987, "class A" foreign exchange banks were allowed by the Ministry of Finance to deal in futures, in such forms as futures, options and swaps on foreign currency and interest rates (Korea Business World, May 1988, p. 17). However, since financial futures only involved currencies other than the won, the move was criticized by many, including Mathran of Chase Manhattan. In his words: "Until the government changes the regulation and allows true won forward and won futures markets to develop, the value of regulatory change will not mean much" (ibid).

d. Expansion of Foreign Banks

A study by the Bank of Korea made in the summer of 1981, recommended that foreign banks' total assets should not be allowed to exceed 10% of all banks' assets (Far Eastern Economic Review, March 26 1982, p. 68). Another recommendation was that foreign banks in place would be able to expand their business in step with the growth of the domestic banks and the general economy. Officials said the 10% figure was a psychological barrier, with no scientific or economic basis, and could be at the discretion of every new administration or set of circumstances (ibid). As we can see in Figure 4.1, foreign banks' assets have never totalled significantly beyond 10%.

e. Extension of loans to small and medium-sized firms

The restriction that foreign banks extend 25, sometimes 35, percent of their loans to small and medium-sized enterprises has been criticized by many foreign bankers. This regulation would be judged as totally inappropriate in any other market economy. Most foreign banks have only one branch in Korea. Lending money to small businesses with which foreign banks lack actual physical contact is very difficult and very risky.

In our opinion, this requirement can be seen as a "disguised tax". Foreign banks have realized relatively higher profits in Korea and that has created some resentment in the industry. This regulatory measure can be described as a scheme to ensure that profits are reinjected into the Korean business sector.

f. Reduction in Privileges

Several years ago, some foreign banks began demanding national treatment to compete on an equal footing with domestic banks. However, their actions failed to take into consideration the authorities' decision-making process. They made the mistake of giving a very long list of demands, allowing the Korean authorities to choose which items fit the Korean agenda (Euromoney, May 1988, p. S31).

The net result was that authorities gradually withdrew some privileges enjoyed by foreign banks, such as swap limits and profit margins, in return for access to business which foreign banks consider marginal or inadequate (ibid).

C. THE POLITICAL MODEL

1. Introduction

To an exceptional degree, Korea's economic development seems to depend on its politics. Korean politics have also played a very important role in the developement of the Korean financial sector.

The policy-making process of the Korean government is not sufficient by itself to explain the poorly developed state of the banking sector and the implementation of regulatory measures governing foreign banking activities. The Political Model will analyze financial events as the result of bargaining, pulling and hauling between the different interest groups within the Korean financial industry. The following analysis will focus on the power struggles among these groups, that is, the government, the Ministry of Finance, the Bank of Korea, the financial institutions in general, and the foreign banks.

The model provides alternative answers to the questions raised using the Rational Model. The following discussion will demonstrate that the degree of financial liberalization, the status of the Korean domestic banking sector and foreign bank regulation are often the result of measures that evolve as power groups bargain.

2. Politics and Policy Orientation

Korea has had a presidential system headed by ex-military men for the last quarter of a century. The country has been ruled by strongmen, not by a truly democratic constitutional system. The political opposition has been fractional, without any unity. Without proper opposition, Korean presidents have had authority covering many aspects of South Korean life. Political parties were merely the means by which to present a democratic front to the outside (Steinberg, 1988, p. 24).

For many years, the biggest and most powerful interest group in Korea was the military, which surpassed any other pressure group in terms of influence. The fear of an invasion by North Korea has shaped the political life of South Korea. Many claim that the great economic growth of the Park regime would not have been possible without authoritarian rule. Furthermore, the military has argued that an invasion would be easier if the country had many different institutions free to express their political differences. Thus, the army has never been willing to have more pluralistic institutions, fearing that democracy would be dangerously unstable (Economist, August 14 1982, p. 6). President Chun, also a former general of the army, found it easy to have "economic autonomy". It was said that his only power base was the army (ibid).

Formulation of economic policies has traditionally been the responsibility of the President and the technocrats. Park's export-promotion policy was partly based on political factors: he had overthrown a popular government and he had to secure political legitimacy. His policy had to please some interest groups in order for his leadership to be recognized and stability to be maintained. Chun's leadership also had to secure political legitimacy because following Park's assassination, there were widespread expectations of greater political freedom.

Steinberg (1988, p. 19) argues that the relative consistency of authoritarian rule since Park's coup in 1961 has contributed to the to the "natural tendency to de-emphasize the role of poltical and sociocultural factors in Korean decision-making; notwithstanding the persistent reaffirmation that political and social stability have been necessary prerequisites for economic growth". According to Steinberg, politics have played a major role in Korean economic policy formulation and implementation. He goes on by stating: "The forces that influenced the adoption or rejection of such policies, one could postulate, were a result of non-economic forces rather than economic ignorance. Political pressures can, and often do, force erroneous policy decisions to be made by otherwise talented administrations"(ibid, p. 20).

3. The Power Struggles

a. The Monetary Authorities vs the Bank of Korea

The Ministry of Finance is at the center of Korea's economic policy and has control over all areas of the financial system. It will not give up power very easily.

Originally, in 1950, when the Bank of Korea was established, the decisions and implementation of monetary policy were intended to be the responsibility of the central bank, in line with the concept of financial autonomy and neutrality (Cole and Chul Park, 1983, p. 239). The 1950s witnessed a battle between the Ministry of Finance and the Bank of Korea over the control of monetary policy. With a new government in place following the military revolution of 1961, the Bank saw its power being transferred to the government. Officials claimed that this would provide better coordination between monetary and fiscal, exchange rate and other related policies (ibid). The Ministry then became the institution mostly responsible for monetary policy.

Government announcements of financial liberalization in later years have given new grounds for the battle between these two players. The central bank has always demanded "independence from the government", while the Ministry of Finance has been the proponent of its "independence within the government" (Korea Business World, August 1988, p. 35). The government-appointed Monetary Board of the central bank has supported the concept of keeping full control in the Ministry. The Bank of Korea staff, in response, have called for the resignation of Monetary Board members. Senior Bank of Korea officials have demanded independence and autonomy for the Bank and have surprisingly made their views known to the press.

During the country's transition from dictatorship to democracy (1988), the central bank was "at the hub" of one of the fiercest political campaigns (Banker, February 1989, p. 69). The Bank even consulted delegations of central bankers from the West to strenghten its case for independent control of monetary policy as in Western countries. As a pressure tactic, Bank of Korea staff issued a leaflet showing Presidents Park and Chun using the Bank's reserves as a private reservoir of cash. It also stated that the Bank had been expected to print money to finance corrupt elections, save insolvent businesses, and give cash favours to friends of the military (ibid).

Such outspokenness used to be (and may still be) very dangerous in Korea. In 1987, in face of the significant changes occurring in the economy, Park Sung-Sang, the governor of the Bank of Korea, asked for ministry and government support for greater independence. Unfortunately, the response was quite severe: he was immediately asked to resign (Triple A, 1988, p. 82). The Bank's negotiating power was weakened with the departure of the independent-minded governor. Establishing an independent central bank is far from being achieved because it would undermine the Ministry's dominance of all economic developments.

Because the commercial banking sector has been underdeveloped, the Bank of Korea has not had any need to build a strong supervisory role, and hence it has little influence. By keeping a tight control over the banking sector, the government and the Ministry make sure that power remains with them. The position of the domestic banks is hard to determine precisely. Certainly, some of them would prefer the status-quo for the near future. Banks have needed frequent support from the Bank of Korea since they have been so burduned by bad debts. Without this support, many believe that several of them would have gone bankrupt.

b. Technocrats vs Bureaucrats

Government officials have traditionally been split into two camps: the technocrats (economists at the EPB), some of whom were proponents of more market-oriented mechanisms, and the bureaucrats who favoured the continuation of a policy of high growth and centralization of economic decision-making (Institutional Investor, May 1981, p. 254). Many measures implemented were compromises between these two camps.

It was felt that the technocrats had lost the battle to restructure the economy toward more market-oriented lines. Under Park, the technocrats had little influence. In the 1970s, when they were pushing for allowing free market forces rather than the government to allocate resources, President Park and his advisers and bureaucrats often "ignored" their recommendations. We should note that Park had the habit of appointing people in his administration who automatically agreed with him. During Park's regime, the No. 1 policy-maker was Park himself, especially in determining investment priorities. In the view of one Western economist, his policies were "guided more by his political philosophy than by world economic realities" (Institutional Investor, May 1981, p. 254). After Park's priorities were well identified, it seemed senseless for technocrats to submit contrary proposals.

Following Park's assassination, the economic measures implemented by the newly-formed government were also compromises resulting from the bargaining between the technocrats and the bureaucrats. The former wanted more devaluation of the won and higher interest rates than their opponents. However, Korean businesses lobbied strongly for cheap credit and other government assistance. Their pressure succeeded and partly explains why interest rate liberalization failed and why the flexible exchange rate policy was abandoned. As well, the strong liberalization measures, which had been previously promised, actually turned out to be minor structural changes.

c. The Government vs the Large Conglomerates

In the 1970s, large conglomerates (chaebols) emerged with government support. Park's administration relied on the large conglomerates to lead the export promotion policy. These conglomerates have grown bigger and bigger as their leaders showed unquestioning loyalty to government plans which often enough ran counter to economic principles. In return, the government ensured that they were granted low-interest loans and other favours.

Analysts estimate that the country's top 30 conglomerates account for 16% of gross national product (Globe and Mail, March 27 1989, p. B23). Conglomerates have had near monopoly control over a wide range of manufacturing, finance, and service sectors and are seen as the foundation of the country's economic success. Mr. Chung Ju-yung, founder of the giant Hyundai Group, told a National Assembly panel that he and other chaebol chiefs had to donate money , to avoid reprisals, to a multi-million-dollar political institute Mr Chun is alleged to have planned to use to maintain political influence after he retired (ibid).

When city banks were denationalized, subsidiaries of big businesses like

Hyundai, Daewoo, and Samsung became the owners of the commercial banks. In that sense, government interference in the banking sector was politically more desirable. A very large proportion of bank loans was granted to Korea's business conglomerates as they led the country's industrial development. The concentration of economic power in a small number of Korean business leaders like Chung Ju-yung of Hyundai and Lee Byung-Chull of Samsung has become a political pill that has been difficult for the government to swallow (Euromoney, July 1987, p. 112). The Korean government did not intend to lose control of the commercial banking sector, its prime instrument through which policy is implemented.

Despite regulations limiting bank equity holdings by any individual or firm, privatization of the commercial banks has resulted in very concentrated bank ownership and insufficient independence in bank lending decisions. The conglomerates' share of the common stock of city banks ranges from 22% to over 56% (Business Korea cited in Leipziger, 1988, p. 129). Conglomerates want to gain tight control over the banks in order to maintain access to a large supply of funds. They have been dependent on state protection and subsidy for a long period of time and are therefore determined to block interest rate liberalization because they need cheap credit for their operations. In addition, since credit allocation has not been based on risk-return criteria, conglomerates' control over the banks has slowed down the pace of financial liberalization.

While the government supported the development of these large conglomerates in the 1970s, recent years have witnessed a different scene. With the enormous wealth and increasing economic and financial power the conglomerates have accumulated, they can exert greater influence in government policy. The government has felt it has to keep them under control, and it has exercised its power over the conglomerates by keeping control over the financial institutions that still supplied a significant share of their domestic credit needs (Cole and Chul Park, 1983, p. 275). It was judged impossible for the government to maintain its hold on the conglomerates and at the same time to liberalize previously controlled markets.

As opposed to the explanation provided by the Organizational Process Model, government intervention, such as appointing presidents, can be explained as a strategic action to retain power over the industry against the large conglomerates. Since the latter are the largest shareholders of the banks, there is a great possibility that they would control the management of commercial banks if selection of presidents were made through general shareholders' meetings. The government values power above all, and hence it does not want the conglomerates to control both the manufacturing sector and the financial sector. Says Lee of the Finance Ministry: "There is a general feeling that chaebols' control over the finance sector would be far worse than the government's" (Korea Business World, August 1988, p. 35).

Nowadays, Koreans are beginning to question the powerful conglomerates and their practices. In light of the new political climate, President Roh replaced the top economic manager by a Seoul National University professor, Cho Soon (Economist, May 21 1988, p. 3). The new appointee is clearly more committed to reducing income gaps in Korea than to helping the big chaebols. Roh has promised "clean government" and an end to "collusion between politics and economics" (Globe and Mail, March 27 1989, p. B23). Reforms are to be introduced to reduce economic reliance on these chaebols. Roh's government has pledged to end the practice of saving financially troubled conglomerates from bankruptcy (ibid, p. B24). In addition, the government has announced that, in the future, the substantial financing needs of these conglomerates should be met through the capital markets, not through government-allocated loans from commercial banks (Banker, February 1989, p. 67).

Given that the government does not want to increase the power of the conglomerates by reducing its own control over the commercial banks and widening their range of permissible activities, it is not surprising that financial institutions other than commercial banks have witnessed an increase in their business and power. The non-bank financial institutions have been able to offer liberalized interest rates, two to three percentage points higher than those paid by the banks, and attract more money, much to the detriment of the commercial banks. At the end of 1986, Deposit Money Banks had 54.4% of the outstanding total deposits, down 3.6% from the previous year. Non-banking institutions saw their share increase from 42% to 45.6% during the same period (Korea Business World, March 1987, p. 48).

In brief, the power struggle between the government and conglomerates would explain why the domestic banking sector is still very segmented and regulated, and why commercial banks lack autonomy.

4. Using the Banking Sector for Political Purposes

The existence of an illegal, or kerb, market has worked to the benefit of unscrupulous people with good connections. Borrowing from banks at official rates and then lending in the unofficial market at higher rates is a very profitable business. Many major players in Korea's financial system have been involved in extremely profitable operations in the kerb market. A number of officials of two major Korean commercial banks, Cho-Heung Bank, and Commercial Bank of Korea, were charged with extending credit to two firms in return for bribes. Earlier, the Korean financial sector was the scene of a multi-million dollar kerb market scandal. In 1982, Chang Young-Ja, a relative of President Chun's wife, put pressure on the banks to lend her US$ 1 billion which she lent in the kerb market. The whole thing was exposed because the amount involved was too large, and eventually some major corporations, which had lost hundreds of millions of dollars, nearly went bankrupt (Kim Dae-Jung, 1985, p. 65).

Following this scandal, President Chun saw his image badly tarnished and thus attempted to put the blame on the banks' executives. As part of this, the government-owned commercial banks were to be sold at an auction and privately managed. In prearranged bidding, the government sold its bank shares to a small number of large conglomerates. Thus, theoretically, commercial banks are privately managed. In practice, however, bank managers follow the needs of the owner-conglomerates and the government's wishes (Kim Dae-Jung, 1985, p. 66).

In the section using the Rational Model, denationalization of commercial banks was described as a rational move toward greater financial liberalization. However, it is at least equally explained as a measure to avoid political damage. The last thing the Korean government wanted politically was the bankruptcy of any of the financial institutions, especially not the nationwide city banks.

When looking at the reasons explaining the underdevelopment of the banking sector, the Political Model suggests that the inadequacy of the sector is the result of the "command" economy and the close links established between business and government. The government has forced the private sector to move into new areas. The underdevelopment of the banking system is due to a policy of politically oriented commercial bank lending, i.e., policy loans. Commercial banks are in bad shape today because of these poltically preferential loans.

Unfortunately, if Korean banks were to have suddenly lent money according to sound banking practices, few major companies would have qualified for loans and politically unacceptable bankruptcies and unemployment would have resulted.

Generally speaking, if the government had given more independence to the banks, it would have drawn some political criticism, particularly from the left-leaning political groups (Euromoney, July 1987, p. 112). This was something many observers felt the government wanted to avoid.

5. Politics and Foreign Bank Regulation

The above discussion has illustrated that the Korean banking sector is still heavily regulated as a result of several power struggles that have taken place over the years and from which the government has mostly come out victorious. Government authorities have thus been able not only to maintain their control over the banking sector, but also to use this power to further consolidate their hold on the banking sector.

One of the major reasons given to explain why foreign banking activities are governed by such a strict set of regulatory measures is that the banking sector is too weak to compete on equal footing with foreign banks. In that sense, since politics has played a major role in the development of the banking sector, foreign bank regulation is indirectly the result of the power games played between the interest groups in the banking sector. Politics also affect foreign bank regulation directly, as the following analysis illustrates.

a. Strong Lobbies Against Foreign Bank Expansion

The high profits (relative to domestic banks) enjoyed by foreign banks have given ammunition for a substantial lobby, both within the government and outside it, which has opposed any further expansion of their role in the market (Euromoney, October 1985, p. S21). So when foreign banks, especially the large American ones (which were supported by the US government) asked for equal treatment with domestic banks, strong opposition arose. This caused a great dilemma for Korea's technocrats, who, as a matter of principle, favoured greater competition and internationalization of the financial sector (ibid). Once again, we had a situation of dual objectives. The use of foreign banks' high profits as an excuse to limit their expansion occurred again when the Foreign Bankers Group submitted a lenghty report to the Korean authorities to recommend procedures for the development of a sound domestic money market

As well, foreign banks' profitability has drawn the attention of the Office of National Tax Administration (ONTA), which will emphasize exposing cases of tax evasion in its inspection of foreign banks. According to the ONTA, foreign banks have earned a net profit four times as large as their Korean counterparts, and it is likely that there has been much room for them to evade taxes (Korea Economic Journal, March 20 1989, p. 6).

As for Korean policy-makers, they still fear that financial liberalization could result in a loss of domestic control over the Korean economy. They feel they have worked hard over the last quarter of a century to develop a strong economy, and they are quite reluctant to let foreign bankers (among others) "buy up their fruits of the domestic labour".

It is hard for foreign banks to win strong support for their case in such a situation. Their lack of contacts, added to a certain resentment toward foreigners (especially when they enjoy large profits) as part of rising nationalism, have made it very difficult to find a sympathetic ear for their problems. Foreign banks are also perceived as deal-oriented (e.g. short-term) institutions. Without the proper close relationships with customers and close contacts with government agencies, winning some customers' support is thus difficult. Many feel that foreign banking activities may have reached a plateau: facing an uncertain future, foreign banks have a hard time convincing some clients that they intend to maintain a long-term presence in Korea.

If any interest group supports foreign banks, it would have to be the large conglomerates. The government has been clamping down on conglomerates' borrowing activities in order to limit the supply of credit and reduce their control over the banking sector and the manufacturing sector. In that context, conglomerates are quite supportive of the idea of allowing foreign banks to engage in more activities related to won lending. The power struggle between Korean businesses and the government will be important in determining foreign bank regulation in the coming years.

b. Regulatory measures as compromises

Many regulatory measures governing foreign banking activities take the form of compromises. It would appear that allowing foreign banks to cash in on profitable activities was given as compensation for the strict restrictions preventing them from entering certain business areas. Minister of Finance Seung Yun Lee (1980) acknowledged that the regulation was of mutual benefit. As he stated: "I want them to make profits here and also contribute to the development of Korea" (Euromoney, December 1980, p. 11). He added that introducing new banking technology and foreign exchange was also an objective.

Swap arrangements were also explained by officials as an agreement offered to foreign banks as compensation to their difficulties in raising won funds for their lending practices. Swaps are safe and provide a high spread margin. However, many bankers felt that they could not rely on Bank of Korea swap arrangements forever. They argued that the system was partly a public relations effort to "cultivate" its country risk rating (Euromoney, July 1986, p. 64). As Korea reduced its debt considerably, swaps were losing their appeal to the authorities.

In the mid 1980s, equal treatment for foreign banks only went as far as giving access to the rediscount window for export finance and to the trust business. But increasing business for export financing was not much of a giveaway by the government: Korean firms are extremely dependent on exports. It served the authorities' interests at least as well as it served those of the foreign banks.

The regulation of foreign banks can be viewed as compromises to reach a balance between meeting government objectives, pleasing concerned interest groups, and providing foreign banks with incentives to operate in Korea. The Korean government has always provided foreign banks with incentives to make loans in a way that minimizes interest paid and business surrendered.

c. No concensus on the concept of national treatment

National treatment has not been sought by all foreign banks in Korea. There are two groups within the foreign bank community with respect to national treatment. The large banks, mostly American, which have big operations in Korea, have been demanding national treatment to gain increased access to local deposits. In order to secure their long-term future in Korea, they want to compete on an equal footing with the Korean banks. However, the newcomers, from countries in Europe for example, are smaller banks which know they would face tough competition if the banking sector was further liberalized (Euromoney, July 1986, p. 64). One observer explained that many newcomers were just entering the Korean banking sector to take advantage of the privileges and had no intention of staying forever (ibid). Some of these smaller banks, afraid of losing their "artificially privileged situation", do not want to interfere in the politics of the liberalization process.

As well, from some foreign banks' point of view, government intervention in the banking sector has its advantages. It is very safe to lend money to a business that is receiving 95 percent of its financing from a Korean bank that is making such loans under government orders (Korea Business World, April 1987, p. 36).

National treatment has thus not been the major priority of all foreign banks in Korea, which is what most published documentation tends to suggest. Although the impact of this is hard to assess, it certainly has helped reduce pressure on authorities to provide national treatment for foreign banks.

6. The New Political Climate

President Roh is the first ruler of Korea to have come to power the democratic way. Now it is believed that the parliament, which will no longer be used as a rubber stamp, should move the government away from authoritarian rule. Ideas of financial liberalization should be more easily acccepted and their implementation less retarded. But Roh does not have a strong power base as President. Koreans only gave him 36% of the vote, a sign that he has to live up to his promises (Economist, May 21 1988, p. 3). Now, political parties should have a more active role in policy formulation that could better enable them to compete with the bureaucracy. It is now felt that decisions will be debated and more compromises reached.

President Roh needed a new "face" for his administration. Many analysts agreed that one of Roh's most important priorities was to remove himself and his administration, from any association with the Fifth Republic of former President Chun (Business Korea, March 1989, p. 33). To do this, the President reserved some of the most influential posts for academics, a clear departure from Chun's tradition of appointing only experienced technocrats to cabinet-level posts (ibid). With policy-makers having greater macroeconomics theory background, financial reforms should gradually be introduced in the near future. In fact, in order to reduce US trade pressure, Roh has announced a grand liberalization of Korea's financial markets (Business Week, December 19 1988, p. 46).

A more liberalized political system should pave the way for increased liberalization of the banking system. However, because of rising nationalism, the liberalization process may be required to be independent of US pressures, especially those to liberalize the country's internal markets (Steinberg, 1988, p. 32). It might prove to be more difficult to further open the economy than originally expected. Also, some feel that Korean officials, in order to have internal harmony, will implement reforms that try to satisfy too many interest groups, and thus implement suboptimal solutions (Bourdeau, 1988, p. 2).

7. Conclusions

The traditional role of the commercial banks in the 1960s and 1970s was perhaps adequate in the environment of the time. But in 1986, with Korea being a financially self-reliant nation (as opposed to being a US$ 46 billion debtor) and generating savings representing 35-36% of GNP, the old role of the commercial banks should have been abolished (Asian Finance, July 15 1988, p. 41).

The banks are still not free from their quasi-governmental role, and many feel that their emancipation was never seriously considered a viable option. Greater freedom for the banks could upset the authorities or privileged customers. Also, it could expose "politically explosive information" about the internal mechanism of bank lending (ibid).

In our opinion, the most important factor explaining the slow pace of financial liberalization and the status of the domestic banking sector, is the power struggle between the government and the conglomerates. The second model suggested that, although some government officials were in favour of liberalizing the domestic banking sector, the type of policy-making process used by the authorities constitutes a major obstacle to change. The Political Model takes a different approach by suggesting that because of the government's involvement in several power struggles, measures to liberalize the banking sector have never truly been implemented. Liberalization would result in giving away substantial control over the sector and ultimately over the implementation of future policy. As for foreign banks, they are merely spectators, witnessing the several power struggles and living with their consequences.

Korea's finance minister has summarized the situation quite well when he stated: "There are political reasons for a departure from economic rationality" (Institutional Investor, December 1987, p. 227).

CHAPTER VI. CONCLUSIONS

A. SUMMING UP: DIFFERENCES AND SIMILARITIES

The following discussion consists of a comparison of the Japanese and Korean case studies, highlighting the main similarities and differences.

Foreign banks have played a marginal role in both Japan and Korea in terms of their collective share of the loans and deposits markets. The Rational Model, applied to the two countries, provided similar explanations regarding the evolution of foreign bank regulation. Both Japan and Korea viewed the entry of foreign banks as a means of introducing much needed foreign capital (especially Korea) and modern banking technology. In Japan, the liberalization process and the evolution of foreign bank regulation is explained by the country's mature domestic economy, high trade surpluses, expansion of its financial industries abroad, and foreign government pressures. In Korea, the explanation is more simple: the restrictive measures governing foreign banking activities can be directly attributed to the poorly developed state of the domestic banking sector.

Nonetheless, the Rational Model fails to provide answers to some important questions concerning both countries. Relatively speaking, Japan and Korea have undergone a slower pace of financial liberalization and the retention of more government intervention than the Rational Model would have predicted. Using the Rational Model, one would have predicted that since Japan is a major developed economy and a major IFC, its financial sector would be less regulated and foreign banks would be granted national treatment. However, activities in the financial sector are still very segmented, commercial banking activities continue to be separated from securities activities by law, and government intervention by the MOF is frequent. Rationally, Japan should have followed the world trend of liberalizing its financial sector and providing national treatment for foreign banks.

The rational actor analysis draws very similar conclusions for Korea. As the Korean economy grows stronger and more sophisticated, the Rational Model fails to answer why government intervention in the banking sector has remained so strong. As a result of strong government control, the banking sector has become the weakest of all Korean economic sectors. The banking system is weak, outdated, plagued with huge amounts of non-performing assets, and exhibits a serious lack of managerial skills and autonomy. The Rational Model predicts that, in light of the country's economic environment, financial liberalization and strenghtening of the domestic banks would be achieved. In fact, everyone including many government officials, seemed to agree that managing the economy in an efficient manner was becoming increasingly difficult without the introduction of a more freely competitive banking sector. However, financial liberalization has been extremely slow to occur and one has to wonder why the authorities have not taken any serious steps to achieve liberalization and modernization of the banking sector. Authorities explain the imposition of restrictive regulations on foreign banks as necessary given the poorly-developed state of the domestic banks. The government has repeatedly stated that until the domestic banks are strenghtened, foreign banks will not be given a wider range of business. This argument has been used for so long that it has lost its credibility since without greater competitive pressures the infant industry will never mature.

In the case of Japan, the Rational Model failed to explain why it did not fully liberalize its financial sector and provide national treatment to foreign banks. The Organizational Process Model provides a partial answer, however. Westerners think that the policy-making process in Japan attempts to pursue a high degree of harmony and consensus. The reality is more complex. The strong tendency of the Ministry of Finance to resist change in the regulatory system and policies is the result of 1) the strong parochial objectives of each ministerial bureau - which mainly consist of achieving the stability of its sector and controlling the process of policy-making that deals with its own jurisdiction, 2) the growth and protection-oriented priorities that reflect entrenched values acquired by regulators during the early post-World War II rebuilding period, and 3) the use of informal Standard Operating Procedures, which consist of administrative guidance and a propensity to regulate excessively. The government may announce the introduction of significant regulatory changes, but once policy is formulated and implemented through this process, actual action is often incremental. This would explain why financial liberalization was slower to occur than predicted and why Japan does not seem to make a move unless facing the risk of severe international sanctions.

The Organizational Process Model offers two major explanations why the process of liberalization of the banking sector in Korea has failed. Korea's policy-making is much more centralized and autonomous than Japan's. First, policy-makers consider the banking sector as a tool through which government policy is implemented at all costs. As a result, the banking sector has worked by governmnent fiat, not market forces. While the government has announced plans for increased liberalization, the use of a "command style" of policy-making has resulted in effectively neutralizing any deregulatory measure introduced. Second, the government's propensity to control and intervene in the banking sector is so entrenched in its Standard Operating Procedures that it severely hampers the process of liberalization. The government announces plans to liberalize the banking sector, but it imposes constraints and issues directives to it that are in contradiction to the market concept articulated in the legislation.

The Political Model applied to both countries illustrated that the pulling, bargaining, and the hauling among major players have been significant factors explaining the development of the financial sector and the regulation of foreign banks. What differs between Japan and Korea is the nature of players involved in the power struggles.

Japan's private sector has many powerful interest groups which are supported by the relevant bureaus within the ministries of the Japanese government. In fact, Japanese ministers have a role of supporting the departmental interests and their ministry's client industries, rather than implementing the political will of an elected government. Therefore, the strong lobbies exercised by the domestic banks and the securities industry have created a segmented financial sector, where commercial banking business is separated from the securities business. Furthermore, the power struggles between the MOF and the BOK have been significant factors in slowing the pace of financial liberalization, as the former has tried to retain its dominant role in policy-making. For these reasons, and the fact that they lack the proper relationships and governemnt contacts, foreign banks have had a difficult time becoming players of significance.

Applied to Korea, the Political Model also illustrated some significant power struggles, although the main player involved has always been the Korean government. This shows that in light of the political system, not many other institutions or actors have been free to express their political differences. The Political Model, in contradiction to the assumptions of the Organizational Process Model, suggests that liberalization of the banking sector was never seriously considered a viable option. The analysis under this model demonstrated that because of the government's involvement in several power struggles, measures to liberalize the banking sector have never been implemented. The process of financial liberalization has been slow for the following reasons: 1) the Ministry of Finance has been successful in its power struggle to keep the central bank under its direct control, 2) the bureaucrats have traditionally won their battle against the technocrats who favoured the introduction of more market forces to allocate resources, 3) it was impossible for the government to maintain its hold on the conglomerates and at the same time liberalize previously controlled markets. The strictness of foreign banking regulations is explained as the result of strong lobbying of domestic banks against the further expansion of foreign banks. The fact that regulations provide for protected niches to the foreign banks reflects the Korean government's strategy of providing these banks with incentives to continue to operate in Korea but in a way that minimizes interest paid and domestic business surrendered.

B. CONTRIBUTION OF EACH MODEL

As mentioned in Chapter I, the models applied in this thesis can be seen to complement each other. Each model consists of a different conceptual lens through which we have analyzed the regulation of foreign banks. Therefore, they may provide different answers to the same questions, or raise new questions. Although the purpose of this thesis is not to select the "best model", some broad observations can be made as to the contribution each model has made to explaining the topic under study.

Although in both case studies we had to go beyond the Rational Model, its contribution is very important. It simplifies the analysis by considering all the different organizations and players as forming one single group, i.e., the Japanese government or the Korean government. With this simplification, it is possible to see the general context (the bigger picture), and to single out the important issues of foreign bank regulation and financial liberalization in both countries. As well, using the Rational Model enables us to identify the key elements and problems which deserve further explanation. Therefore, in explaining the regulation of foreign banks, the Rational Model has provided the best "first cut".

The "fit" of the Rational Model with observations is highest for the rebuilding periods of both countries. In these periods, the consensus on national objectives is high since economic growth issues dominate all aspects of policy-making. Rebuilding (and building up) periods are also characterized by a high degree of centralization and simple (newly-established) institutional structures. When economic growth reaches a certain level, a centralized decision process tends to experience rising transaction costs. The organizational and institutional infrastructures of the economy become more complex. A more sophisticated economy gives also rise to a larger number of powerful stakeholders. In the epoch of economic growth the Rational Model fails to provide adequate explanation for some significant developments. The Rational Model, which views the Japanese government and the Korean government as single, unitary decision-units, does not consider the critical characteristics of organizational behavior and strategic interaction among individuals and interest groups which became the dominant factors in molding the regulatory process.

Nonetheless, it is very useful to start our analysis using the Rational Model for this epoch since it provides insights into the fundamental long-term path of the system. Over the four periods analyzed, Japan has substantially liberalized its financial sector and eventually, will probably fully liberalize it and provide effective national treatment to foreign banks. Korea has pushed forward with liberalization of its financial sector and should have a stronger, more autonomous domestic banking sector in the near future, reflecting more its buoyant economy. But the Rational Model's major weakness in both case studies is that it fails to consider the general process, or mechanism, of implementing policy in the financial sector and thus to explain the inertia in the regulatory system.

The Organizational Process Model's contribution to the Japanese case study is very important. The model addresses many of the questions left unanswered by the analysis using the Rational Model. The Ministry of Finance is a classic example of a large organization the decision-making process of which can significantly influence governmental action. The Ministry's policy-making process is complex and involves many different factions (bureaus). The analysis illustrates the conflicts which arise as one tries to coordinate the complex and decentralized functions of the Ministry's component parts. In terms of additional and alternative explanations to the Rational Model, the Organizational Process Model provides extremely useful and pertinent insights.

In Korea's case, the Organizational Process Model is far less important due to the government's highly centralized and autonomous policy-making process. With only a small group of people responsible for policy formulation and implementation, the characteristics of the internal process of policy-making and the organizational features described in the Organizational Process Model were not important in the Korean case. As a result, we focus the analysis on explaining the contradiction inherent in using a centralized system of policy-making while at the same time pursuing liberalization of the banking sector. While the Organizational Process Model provides some additional insights, its contribution to explaining foreign bank regulation and the process of financial liberalization is less important than its contribution in the Japanese case.

The contributions of the Political Model to both case studies are significant. In Japan, it provides explanations which are complementary to the ones offered by the Organizational Process Model. The analysis focuses on two levels of strategic interaction: 1) territorial struggles of the financial community (supported by the relevant bureaus within the Ministry of Finance) to protect or gain business, and 2) international struggles (foreign pressure) against Japan's apparent unwillingness to assume its full role as a major International Financial Centre. Foreign banks, in many cases, have been used by domestic stakeholders in their territorial fights. Their positions also assumed importance in the larger international "trade liberalization" game between Japan and its Western trading partners. The "wins" in these games rarely benefited the foreign banking community.

The Political Model also provides significant insights in the case study of Korea. Its contribution is particularly helpful in explaining why the banking sector is so poorly developed and why foreign banking activities are governed by such a strict set of regulatory measures. The strong and long-lasting power struggles between government officials, and between the government and the emerging private interest groups provide many explanations which extend or offer alternatives to those suggested by the Rational Model.

C. THE BROADER LESSONS

The methodology used in this thesis has demonstrated that we can gain additional insights in the subject of financial liberalization and foreign bank regulation by applying more than one framework of explanation. Each analytic framework emphasized different elements and focused on distinctive logical patterns. Separating our analysis into three alternative frameworks of explanation has facilitated the generation of hypotheses and has highlighted features that might have been otherwise overlooked (Allison, 1971, p. 255).

What are the broad lessons we have learned from the study of two countries with such different features, i.e., different political systems (constitutional democracy vs presidential system) and different financial sectors (major IFC vs a financial sector in a NIC)?

First, the problems of bureaucracy (inertia) are inevitable even though policy formulation and implementation is very particular to each country. In Japan, policy-making is decentralized and very complex, while in Korea, it is very centralized and autonomous. Japanese authorities' control over the banking sector is much more subtle (use of administrative guidance) than in Korea, where control is overt. Nonetheless, in both case studies, the problems of bureaucracy are significant. Governments and large organizations must function according to a set of programmes and repertoires. In Japan, the complex decision-making process of the Ministry of Finance can influence significantly governmental action. In Korea, while policy-making is more centralized, problems arise because the bureaucracy is extremely stability-oriented and has a propensity to regulate and intervene in the banking sector. As Korea moves toward greater liberalization of its financial sector and decentralization of its policy-making process, the problems of bureaucracy should become similar to those experienced in the Japanese case.

Secondly, political "games" are also inevitable. The strategic interactions in Japan among several private interest groups and government factions reflect the higher degree of political freedom. In Korea, as private interest groups are starting to emerge, the government's involvement in power struggles is stronger than ever. As Korea moves toward greater financial liberalization, and political freedom, political games among private interest groups will increase in importance.

While both countries under study have distinctive features, the use of the three analytic frameworks has highlighted similar patterns explaining the evolution of foreign bank regulation and financial liberalization. The most important difference between Japan and Korea is the type of organizations and players involved. Therefore, the models we have applied can be useful to improve predictions of future financial policy.

Making predictions using the Rational Model is a good starting point, but attempts to make predictions based on the Organizational Process Model and the Political Model should permit improvements. Therefore, foreign bankers can improve their understanding of the environment in which they compete by better understanding the decision-making process of the regulatory organizations they deal with, and by better identifying the power games that will emerge once important financial issues are introduced. As well, this exercise should improve their chances of success when negotiating for further relaxation of regulatory measures governing their activities.

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