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Financial constraints on investments and credit policy in Korea

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Abstract

The Korean financial system has been characterised by government interference and a chronic shortage of funds. Since the 1960s the government has promoted the financing of large, chaebol-affiliated firms. Towards the end of the 1980s, the government changed its focus from large firms to small- and medium-sized enterprises (SMEs). This study assesses the impact of this change in government policy on the financing constraints of different types of Korean firms. Using data on 198 Korean firms for the period 1991–1997, we estimate several specifications of a dynamic investment model to assess the financing constraints of Korean firms. We find that Korean firms suffered from informational asymmetries and severe financing constraints during this period, and that these imperfections differ across firms. Our findings suggest that the government's change in focus towards SMEs has been successful in the sense that it has reduced financing constraints for these type of firms. We also find some evidence that firms with concentrated ownership are more financially constrained than firms with dispersed ownership.

JEL classification: E22; E44; G31; O16

Keywords: Korean financial system; Investment; Credit policy; Financing constraints

1. Introduction

The Korean financial system has long been characterised by numerous imperfections due to a chronic shortage of funds and government interference. The shortage of funds for investment has been caused by a negative saving–investment gap. Until 1980 real interest

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rates of bank loans were negative, and capital markets did not become active until 1986. The government has continuously interfered the allocation of credit through the promotion of policy loans, through exercising its power to change bank management, and through regulation of interest rates.

Initially, the government favoured policy loans to large firms, mostly operating in the heavy and chemical industries. This led to serious sectoral imbalances and a concentration of economic power among large business groups, so-called chaebols, in the 1970s (Nam, 1994; Park & Kim, 1994). However, in the 1980s the government changed its focus towards small- and medium-sized enterprises (SMEs) that had been severely constrained by a limited access to funds. In 1987, in an effort to reduce the dominance of the chaebols in bank borrowing, the government introduced a credit control criteria for large and chaebol-affiliated firms, and imposed minimum credit targets for SMEs on banks. These measures directed to support SMEs seem to have been successful (Nam, 1994; Cho & Kim, 1995). While the credit control system seems to have been rather successful in reducing the share of chaebols in total bank loans, chaebols have used trust accounts and non-bank financial institutions (NBFIs) to circumvent restrictions on bank lending (Nam, 1996; Balino & Ubide, 1999).

In the 1990s, financial liberalisation has led to improved efficiency in the allocation of credit (Cho, 1988). Interest rates on most types of deposits and loans were deregulated in 1993, while most policy-based lending was phased out by 1997. At the same time, the availability of credit has grown with the emergence of NBFIs and direct credit instruments (Kim & Suh, 1998). This paper will address whether financial liberalisation in Korea has been effective in the sense that it has reduced financing constraints of firms, in particular for SMEs.

The paper continues as follows. Section 2 summarises the related literature. Section 3 develops a model of firm investment. Section 4 describes the methodology we use to estimate a firm's financing constraints. Section 5 describes the data. Section 6 presents the empirical results. Section 7 concludes.

2. Literature

Investment spending of firms is thought to be sensitive to the availability of internal funds such as retained earnings, or more generally to financing constraints. Following the work of Fazzari, Hubbard and Petersen (1988), a large body of literature has emerged to provide evidence of such financing constraints. Empirical work has found that cash-flow is an important explanatory variable for investment. These findings are attributed to capital market imperfections that arise from informational asymmetries, costly monitoring, contract enforcement and incentive problems (see the surveys by Schiantarelli, 1995; Blundell, Bond & Meghir, 1996; Hubbard, 1998).

One model that incorporates a relationship between investment and financial decisions is the hierarchy of finance model. This model assumes that internally generated finance for investment is available at a lower cost than external finance. In contrast to the standard neo-classical model of investment in which firms have access to unlimited sources of investment finance at an exogenously given cost, the hierarchy of finance model implies that investment and financial decisions are not generally independent. This has testable implications in the