5. THE FINANCE-INDUSTRY RELATIONSHIPS IN JAPAN, GERMANY AND KOREA[33]

5.1 INTRODUCTION

Financial systems are often classified between bank-based systems (sometimes referred to as German-Japan model) and market-based systems (often referred to as Anglo-Saxon or Anglo-American model).[34] Following this classification, the United States and the United Kingdom are often characterised as market-based systems, while the Continental Europe—particularly Germany—and Japan (CEJ) are characterised as bank-based systems.[35] In the Anglo-Saxon economies, securities markets are both active and a major source of finance for industrial firms, while the banking sector plays a less important role. Investors are viewed functionally as specialised outsiders to the firm: shareholders hold only equity and creditors only debt (Berglof and Perotti, 1993: 259). Banks and bondholders in Anglo-Saxon countries are discouraged from seeking control of corporate affairs. Anglo-Saxon banks have only lent short-term working capital (Davis, 1992: 23).

In contrast, the securities markets and institutional investors in the CEJ are relatively underdeveloped. In CEJ countries, banks play a much more dominant role in industrial finance and the relationships between bank and industry are closer, often cemented by formal ties, e.g. bank representatives on company boards, as well as bank holdings of equity (Davis, 1992: 23). Some related CEJ features summarised by Davis include the following:[36]

- In terms of the banks' balance sheets, CEJ banks are able to hold equity stakes.
- Firms are much more highly indebted, almost exclusively to banks rather than being bond-financed.

- There has been traditionally a greater unwillingness to extend much credit to the personal sector, i.e. corporate customers are favoured.
- Levels of competition are lower in banking, as well as between banks and other financial institutions and markets, often entailing extensive cross subsidisation of loan rates by deposit rates, or between different types of borrowers, and high levels of co-operation among banks.
- There is a virtual absence of hostile corporate takeovers.
- There are tendencies to industrial cartelisation, which effectively protect banks' holdings of equity or equity-like loans.
- Banks are more willing to rescue companies, often using their own staff to aid or replace management.
- There is a lower level of information disclosure by companies direct to the public, which is offset by private disclosure to related banks, and via institutions such as central risk offices run by the public sector, through which banks share information on large corporate borrowers.

The remarkable economic successes of Japan and Germany has generated much interest in banks as a theoretical and practical alternative model for industrial financing. Recent academic research attributes the comparative failure of the stock-market-dominated financial systems of the Anglo-Saxon countries of the United States and the United Kingdom relative to the bank-oriented financial systems of Germany and Japan, to arms-length bank-industry relations and other features of the financial systems of these countries involving corporate control, industrial investment and economic growth (see, for example, Cosh, Hughes and Singh, 1990; Dertouzos, Lester and Solow, 1990; Mayer, 1988 and Vittas, 1986).

In this section, finance-industry relationships in Japan, Korea and Germany will be reviewed, despite the scant data available. This consider the institutional environment prevailing in the three countries, viz the financial structure, the role of the state in finance and the bank relationships of industrial firms.

In these countries, banks have been and continue to be the core of the financial system. One of the common features of financial development in these countries is the predominance of indirect finance.[37] Table 3 shows the high level of financial intermediation in post-war Japan.[38] The corporate sector obtained more than 30 per cent of its external funds from financial institutions. Banks were the major source, supplying more than 70 per cent of the funds flowing to the non-financial sector, while securities and foreign loan markets contributed proportionally less (see Table 4). Although secondary securities markets have gained importance with deregulation, the role banks play in producing information about borrowers (discussed in Section 4) will remain important. Given the importance of bank-firm relations in Japan which will be discussed in Section 5.4, one should exercise caution in predicting the continued decline of indirect finance in Japan (Cargill and Royama, 1992: 339). From Table 3, it can be observed that there has not been any definite tendency for the shares of various sources of funds to change.

Table 3 Japan: Distribution of sources of funds raised by the private corporate sector (percentages)

	1970-4	1975-9	1980-4	1985-9	1980	1985	1989
Internal[a]	34.7	42.0	47.6	43.4	45.1	50.0	42.9
Equity	2.2	2.3	5.4	5.4	1.5	4.0	8.7
Debt securities[b]	1.4	2.2	1.2	1.7	1.1	7.3	4.5
Borrowings from							
Priv. financial institutions	33.2	27.6	29.1	28.2	25.3	31.3	32.3
Govt. financial institutions	3.0	4.2	3.3	5.7	3.7	2.5	5.6
Foreign sources[c]	-0.2	1.0	1.3	5.6	-1.7	4.6	11.0
Trade credits	25.7	20.7	12.1	4.5[d]	24.9	0.5	-5.0
Amount raised, in trillion yen (annual average of multiyear periods)	36,913	39,057	58,359	101,419	51,953	73,401	116,938

Note: Multi-year figures are computed by averaging the totals for the period. Excludes miscellaneous sources.
a. Internal funds are savings and gross fixed capital depreciation.
b. Bonds, commercial paper, and bills.
c. Bonds and other foreign liabilities.
d. In 1986 trade credits were -11.9%: this, combined with the negative value in 1989, contributes to the small number for 1986-89.
Source: Bank of Japan, flow-of-funds data from many different publications, cited by Teranishi (1994: 75)

Table 4 Japan: Sources of finds in the non-financial sector, 1960-84

	FY1960-4 average	FY1965-9 average	FY1970-4 average	FY1975-9 average	FY1980-4 average
Shares by sectors (%)					
Corporate business	76.3	60.4	58.4	33.1	39.9
Individual	13.5	18.4	20.1	20.5	17.3
Public	10.2	21.3	21.5	46.4	42.8
Shares by tape of liabilities (%)					
Loans from banks	72.7	76.5	79.1	61.7	63.7
Private	62.3	63.0	64.1	40.1	44.4
Public	10.3	13.5	15.0	21.6	19.3
Securities (%)	21.8	22.2	18.4	37.7	36.6
Bonds	7.9	13.7	14.1	31.2	30.0
Foreign loans (%)	5.6	1.3	2.5	0.6	-0.3
Total (A) (100 million yen)	54,652	103,256	271,808	451,838	571,822
(A)/GNP(%)	25.0	21.6	26.7	23.8	21.0

Source: Bank of Japan, 1976; 1986, cited by Kobsaka (1990: 101).

Similarly, in Korea, indirect financing still dominates, although the corporate sector has began to rely more on direct finance and capital markets have grown in size and importance. As shown in Table 5, the corporate sector obtained more than 40 per cent of its external funds from banks and non-bank financial intermediaries (NBFIs) in the early 1970s, and since then, it seems that the share of indirect finance has declined. Nevertheless, it should be noted that although short-term corporate bonds did become a significant source of external funds in the late 1980s, they were guaranteed by banks and involved negotiated placement with financial institutions rather than open market sales. The household sector held a larger share of its securities through intermediaries such as investment trust companies (ITCs) in the 1980s than before.[39] By offering fixed yields on bond investment trust certificates with high degrees of liquidity, ITCs and other NBFIs have to assume the risk of holding bonds, and hence, the ultimate lenders (household savers) no longer bear the risk totally, as when they hold securities directly. Thus, the increasing household savers' preference for indirect holdings of securities implies that 'despite the rapid growth of money and capital markets, the importance of indirect finance has not decreased as much as the flows-of-funds data indicates. Banks and NBFIs use capital market instruments in their intermediation between saver-surplus and spending-deficit sectors more than before' (Park, 1994: 141).

Table 5 Korea: Distribution of sources of funds raised by the corporate sector (percentages)

	1970-4[a]	1975-9	1980-4	1985-9	1980	1985	1989
Internal[b]	n.a..	26.6	28.2	39.7	18.3	39.8	27.1
Equity	18.6	13.4	12.5	15.5	8.9	7.8	19.2
Debt securities[c]	2.4	5.4	12.1	11.8	9.8	10.5	22.3
Borrowings from banks[d]	30.8	18.4	14.2	14.7	17.0	21.3	11.4
Borrowings from NBFI[e]	12.4	10.5	15.3	10.1	12.4	12.5	16.0
Government loans	4.1	1.3	1.7	0.2	2.2	0.1	-0.1
Foreign borrowings	20	11.8	4.1	1.3	13.6	0.4	-0.4
Trade credits	11.7	12.6	119	6.6	17.8	7.5	4.4
Amount raised (billion won) (annual average of multiyear periods)	1,519.50	6,133	16,873	31,640	14,238	21,043	31,640

n a : not available.
Note: Covers the non-financial corporate sector, which includes both private and public enterprises.
Disaggregated data are available in the sources for external financing, but not for internal funds. Excluded 'other'.
a. Internal funds data for 1970-4 are not available. Data in this column show the total and distribution of *external* funds raised and thus are not comparable to the other columns.
b. Internal funds are savings, gross fixed capital depreciation, and capital transfers (net).
c. Includes bonds, industrial papers, and debentures.
d. Includes Bank of Korea loans, which are less than 0.4% in all periods.
e. Non-bank financial institutions include investment and finance companies, as well as institutions for development, savings, securities and investment.
Sources: Park (1994: 182).

The importance of banks in Germany can be traced to the origins of German industrialisation in the 19th century.[40] The growing importance of the banking industry for the economy as a whole can be inferred from recent statistical data. While nominal GDP in Germany grew from DM300 billion in 1960 to DM2,000 billion in 1991, the total business of all German banks increased from DM253 billion in 1960 to DM5,570 billion in 1991 (Hofmann, 1992: 16). Long-term bank credit in most years amounted to between 30 and 40 per cent of total external funds (Hofmann, 1992: 16). Even if internal sources of funds are included (see Table 6), intermediated, mostly bank finance[41] was still an important part of German corporate financing as compared to direct financing, despite the fact that retained earnings were the most important source of funds.[42]

Table 6 Germany : Gross funding of non-financial corporations as a percentage of total gross financing

Sources of Finance	1970-1985	1986-90
Retentions	76	78
External Finance of which:	24	22
Intermediated debt	21	18
Securities	3	4

Note: Total gross financing exclude trade credit and some overseas financing. Intermediated debt refers to loans from financial institutions. Securities includes public equity and short and long-term bills and bonds.
Source: Adapted from Prowse (1995, Table 8: 24)

5.2 THE STATE AND FINANCE

Unlike in the US or Western Europe, Japan and Korea started with more tightly controlled financial systems, that have served both late-industrialising countries well during their rapid growth periods. The states in both countries have been deeply involved in the allocation of financial resources, both through state-owned banks (for example, the Industrial Bank of Japan and the Korea Development Bank) as well as through their regulation of private financial intermediaries and markets. Financial regulation in both countries is mainly enforced by administrative guidance and interpretation of existing law, rather than by reliance on detailed regulations and legal rulings. Both governments share common objectives in that their regulations were designed to promote industrialisation and export-led economic growth.

Japanese financial regulation has been dominated by the Ministry of Finance (MOF) and the Bank of Japan (BOJ).[43] Interest rate controls, entry restrictions and segmentation of financial services among different types of institutions were three regulatory tools used to reduce competition on the deposit side so as to enable marginal banks to capture the non-competitive rents necessary for survival and growth. Since the start of the rapid growth period, interest rates on commercial lending have been controlled to stimulate fixed capital investment in the private sector, and to prevent interest rate competition, considered detrimental to the profitability of financial institutions. The controls ensure a minimum spread for banks so that the banks can have make handsome profits by expanding their loans.

Within the banking industry, long-term and short-term banking have been separated. The separation of commercial banks from long-term lending has directly reduced competition on the deposit side. As Kitagawa and Kurosawa (1994) document:

> Market segmentation enabled banks to raise deposits from individuals despite the low interest rate. The banks (city and regional banks) were not allowed to accept long-term deposits, but at the same time, long-term and trust banks had few branches and thus could not easily take part in the short-term deposit business. In addition, the capital markets was too immature to attract household savings. Therefore, the seperation reduced competition.
>
> (Kitagawa and Kurosawa, 1994: 84)

Korea was a former Japanese colony with a strong Japanese cultural influence and its financial regulating system exhibited much of the Japanese model. The Korean banks have been heavily controlled by the MOF and the Bank of Korea (BOK). In the 1960s and 1970s, the Korean state made decisions over the allocation of financial resources, while the financial institutions mobilised savings as they were not allowed to play an active role in loan-making decisions. The Korean state determined the amount of credit to be extended by the banking as a whole. This nature of such early direct state control is illustrated by Chung:

> In the 1960s and 1970s, a commercial bank, before making most of its loans to individual customers, would first approach the BOK to ascertain whether or not it would discount or make loans against the credit documents that the commercial bank would receive from its customers in return for the loans. The BOK then consulted the government for approval of the loans. If the government agreed and the commercial bank received the necessary assurance from the BOK, the commercial bank went ahead and made the loan. In effect, the government lent directly to the customer, with the commercial bank and BOK being little more than intermediaries in the process. (Chung, 1990: 114-115)

Unlike the deposit money banks, the NBFIs—such as investment and finance companies and merchant banking corporations—were left to operate in a relatively free regulatory environment during the 1970s (Park, 1994: 135). They enjoyed considerable discretion in managing their asset portfolios and setting lending and borrowing rates at competitive market levels. This was to encourage the growth of the NBFIs so as to reduce informal finance and integrate the huge unregulated money markets into the formal financial sector.[44] Since the mid-1980s, however, the state has taken over control of their lending and borrowing rates.

Regulation and control of the German financial system are not as tight as in Japan and Korea. The German central bank, the Deutsche Bundesbank is not a lead regulator or lead supervisor comparable to the central banks in Japan and Korea. The functions of bank supervision are the responsibility of the Federal Ministry of Finance and the Federal Banking Supervisory Office which works closely with the Deutsche Bundesbank (Hofmann, 1992: 5).

The Bundesbank is involved in banking supervision insofar as its duties and functions are defined by the Deutsche Bundesbank Act 1957, which was last revised in 1984.[45] The Act granted the Bundesbank a high degree of continued independence from political bodies (Mullineux, 1991: 124). As prescribed in the Bundesbank Act achieving and maintaining price stability in Germany, is the main objective of the central bank. As Hofmann documents:

> Banking supervision in Germany is carried out in compliance with market principles: bank managers have the sole responsibility for their business decisions. Except in emergencies, banking supervision does not directly intervene in the banks' individual business transactions, but supervises the banks indirectly through the licensing procedures, regulations on the capital liquidity of banks, audit rights and the like. (Hofmann, 1992: 4)

The German banking system is dominated by universal banks, which account for more than three-quarters of the combined volume of all banking business (Hofmann, 1992: 2). German banks have operated within a fairly liberal environment. There are competing commercial, savings and cooperative bank credit networks all offering universal banking services. They are permitted not only to conduct deposit and credit business, but also dealings in all kinds of securities (shares, bonds, options, futures, etc.).[46] Although they are not permitted to conduct insurance underwriting directly, they may own insurance companies or hold shares in them and may sell insurance policies underwritten by insurance companies. In September 1989, for example, the Deutsche Bank (the largest bank in Germany) established a life-insurance subsidiary, Lebensversicherung to compete with Europe's largest insurance company, Allianz. German banks are not geographically confined and are allowed to operate in every part of Germany as well as in other countries.

5.3 LIBERALISATION OR DEREGULATION

The initial steps toward liberalisation in Japan were small and piecemeal largely due to its more stable financial and monetary environment. Unlike most developing countries, where deregulation has estensibly been introduced to achieve more efficient resource allocation, as proposed by the McKinnon model and endorsed by the World Bank and International Monetary Fund (IMF), financial reform in Japan has mainly been motivated by the desired transformation of the real economy. As Cargill and Royama (1988: 113-0114) contend, the slower growth following the impact of the first oil shock (1973-4) on the flow-of-funds patterns (on the three major non-financial sectors—the government, corporate and personal sectors) is regarded as the catalyst for reform of the Japanese financial system for the mid-1970s. For example, the economic slowdown changed the established flow-of-funds pattern as the government became the major deficit sector, and there was consequent pressure to develop a government bond market.

Despite the considerable liberalisation efforts since the mid-1970s[47], the Japanese financial system still remains regulated and administratively controlled. Financial institutions remain highly segmented, a large number of interest rates are still subject to administrative control, and barriers to capital mobility still exist (Cargill and Royama, 1988: 191). For instance: 'Although short-term Euro-yen loans to residents by commercial banks were liberalised in June 1984, long-term lending is still not yet allowed, and although commercial banks could issue Euroyen CDs with less than 6-month maturity was approved in December 1984, longer maturity CDs are still not allowed.' (Teranishi, 1994: 59). This shows that the segmentation of short-term from long-term financing in the domestic system still remains.

In Korea, liberalisation has proceeded even more slowly, and has been limited in scope and degree (Park, 1994: 147). As summarised by Park, financial liberalisation during the 1980-89 period was aimed at:

1. Relaxing interest rate controls gradually over time, including deposit and lending rates in deposit money banks (DMBs).[48]
2. Removing some barriers to entry into the financial industry.
3. Giving financial institutions—both banks and non-banks—more autonomy in their day-to-day operations and asset management, including from government control over management.
4. Moving toward universal banking and reduced institutional specialisation in the non-banking financial sector.
5. Relaxing restrictions on exchange rates and foreign exchange transactions.
6. Freeing capital movements.[49]

Even after a decade-long liberalisation, state control remains a pervasive feature of the Korean financial system. The entry requirements are restrictive as they were in the 1970s (Koo, 1994: 172). The seriousness of the state's intentions regarding interest rate deregulation is doubted. Despite a series of measures giving up control of interest rates in the organised financial sector since the 1980s, the monetary authorities still have the leverage to change interest rates if they deem the rates not reasonable, and can still interfere in the allocation of banks' loanable funds. According to Park:

> If there is any change, it is at most the degree of direct control. As before, DMBs are subject to direct quantitative ceilings on the lending levels, and their lending rates have been kept artificially low and stable. Monetary authorities have attempted to lower market yields on short-term money market instruments through moral suasion and administrative guidance, thereby giving the impression of retreating from the policy of financial liberalisation. (Park, 1994 : 154)

Even following privatisation of all the five large state-owned banks by 1983, the state still maintained de facto monitoring of bank management and credit allocation: 'The Korean state has maintained a controlling stake in many banks and still has an unchallenged authority over all of them through its control over the central bank (which has enormous leverage over the over-exposed commercial banks), its power to appoint the bank directors, and other administrative regulations' (Chang, 1995: 6). As reported in Greenwood's survey of developments in financial deregulation and innovation in seven East Asian countries:

> . . . following the collapse of the Kukje conglomerate group at the end of 1984, the five privatised banks were required by the government to step in and absorb the component companies in the group. Also, the presidents of the four largest commercial banks were reshuffled following the latest National Assembly Election in February 1985, according to the government wishes. . . the commercial banks, though privatised, are still quasi-government organisations. (Greenwood, 1985: 84)

In Germany, the talk has been of further liberalisation since the mid-1980s. Further liberalising measures were introduced in 1985 to stimulate foreign interest in German financial markets: foreign banks incorporated in Germany were permitted to lead manage D-Mark bond issues; new instruments, particularly floating rate notes, currency swaps and zero coupon bonds, were permitted to be issued and traded in Germany (Mullineux, 1991: 128). The Federal Government explicitly proclaimed its intention to enhance Germany's attractiveness as a financial centre ('Finanzplatz Deutschland'). However, the extent to which the Bundesbank has permitted further liberalisation relies on its view of the Bundesbank's ability to influence the effectiveness of its monetary policy (Mullineux, 1991: 115). In the event of a conflict between the two aims, the Bundesbank would give priority to safeguarding currency and monetary stability over promoting Germany as a financial centre (Hausler, 1994: 255).[50]

5.4 BANK-FIRM RELATIONS

This review of finance-industry relationships will not be complete without discussion of the relationship between banks and business corporations.

Most large firms in Japan have developed some affiliation with an industrial group, often referred to as *keiretsu*. The six largest industrial group are Mitsubishi, Mitsui, Sumitomo, Fuyo, Daiichi Kangyo and Sunwa. The first three originated directly from fragments of pre-war *zaibatsu* which were dissolved in 1945 during the U.S. occupation. However, in the late 1940s and early 1950s, many former zaibatsu companies began to form groups.[51] The group are both diversified and vertically integrated. For example, the Sumitomo group has member firms in various industries: finance (Sumitomo Bank, Sumitomo Trust and Banking Co, and Sumitomo Life Insurance); electronics (NEC Corp); construction (Sumitomo Construction Co.); glass and ceramics (Nippon Sheet Glass Co.).[52] Membership of a particular keiretsu is usually defined by representation in the group's Presidents' Councils (Shacha-kai), and the regular meetings of presidents of affiliated companies (Berglof and Perotti, 1994: 263). Membership in these groups have been remarkably stable over the decades (Hoshi, Kashyap and Scharfstein, 1994: 37). One of the main features of these groupings is extensive intra-group trade. An affiliated firm sells much of its output to other group firms and buys much of its inputs from other group firms. Gerlach (1987) estimates that affiliated firms are three times as likely to do business with other firms in their group than with unaffiliated firms. The intra-group trade within the six largest keiretsu in 1989 is indicated by Table 7.

Table 7 Financial and trade links in the six largest financial keiretsu, 1989

	No. of core firms[a]	Intra-group shareholdings[b] (%)	Intra-group borrowings[c] (%)	Intra-group trade[d] (%)
Sumitomo	20	27	27	38 (37)
Mitsubishi	29	35	18	26 (21)
Mitsui	24	19	24	19 (18)
Sanwa	44	16	17	6 (5)
Fuyo	29	16	19	13 (11)
DKB	47	14	12	12 (7)

[a]Number of firms represented on the group's Presidents' Council (1991).
[b]Share of group's total equity held by group members.
[c]Share of group financial institutions in total borrowings by non-financial member firms (excluding discounted notes and trade credits).
[d]Share of other member firms' purchases over total sales of manufacturing members of the group; in parentheses is the share of group's general trading company.
Source: Berglof and Perotti (1994: 265)

The most interesting feature of the keiretsu is the widespread cross-holdings of shares among member firms. The Anti-trust Law, 1947 was amended to allow industrial companies to own shares of other companies. Until 1987, banks were allowed to hold up to 10 per cent of the shares in any single company; currently, 5 per cent is the legal limit. In effect, however, Japanese banks can hold more than 10 per cent through cross-holdings. Suppose a bank holds 10 per cent in firm A and 10 per cent in firm B and firm A holds 20 per cent in firm B, then the bank effectively holds 12 per cent of firm B (10 per cent plus 10 per cent of 20 per cent).

Affiliated firms borrow significantly from banks in their own group. Table 7 illustrates the financial links within the the six largest keiretsu. In 1989, the shares of group financial institutions in total borrowings (excluding discount notes and trade credits) of group members ranged from 12 to 27 per cent. Group banks extend loans to 98 per cent of all member firms in their respective groups (Berglof and Perotti, 1994: 266).

These close ties between banks and firms in affiliated business groups are strengthened by group bank representation on the boards of group firms. For example, Sumitomo Bank has four directors on the board of Sumitomo Coal Mining, three on the board of Sumitomo Construction, and two on the board of Sumitomo Cement; main banks often place trusted employees in key managerial positions in affiliated firms. By 'main bank', Aoki, Patrick and Sheard (1994: 3) mean a firm's primary bank, both in terms of overall direct lending (i.e. a particular bank from which the firm obtains the largest share of its borrowings) and its assigned exclusive role in corporate monitoring and governance.

The main bank relationship is not exclusive in that firms also borrow from other banks while banks lend to firms that have main bank relationships with other banks. However, the *ex post* monitoring function is exclusively that of the main bank, which gives it the incentive to more intensively engage in *ex ante* and interim monitoring than other financial institutions (Aoki, Patrick and Sheard, 1994: 41). If the main bank tries to shirk its responsibility *ex post*, sanctions may be imposed by the regulatory authority. Aoki, Patrick and Sheard refer to this system—of corporate financing and governance involving an informal set of practices, institutional arrangements and conduct among industrial and commercial firms, different types of banks, other financial institutions and the regulatory authorities—as a 'main bank system'.

Hoshi, Kashyap and Scharfstein (1991) present empirical evidence suggesting that corporate groupings and the main bank system mitigate some informational and incentive problems that typically arise when debt and equity are diffused as discussed in the earlier section. They reach this conclusion by examining two sets of Japanese firms. Their results indicate that the first set of firms which have close ties to large Japanese banks is much less liquidity-constrained than the second set of firms which have weaker links to a main bank, raising their capital through more arms-length transactions. There are also numerous anecdotes to support the view that the concentration of debt and equity give the main banks the incentive to become involved in the rescue or reconstruction of group firms in financial distress.[53] The most famous case is that of Sumitomo Bank's rescue of Mazda Motors in the early 1970s, bailing out the company from the verge of bankruptcy to later become one of the industry's most successful firms. Sheard (1994: 213-26) documents several other examples of main bank rescue operations.

In Korea, state intervention in finance by allocating bank loans primarily to *chaebol* (translated as large industrial or business groups) has accelerated the concentration of economic power in chaebol hands. They are different from Japanese keiretsu in that 'a chaebol is tightly controlled by a single owner and his family, while a keiretsu is a loosely connected group of corporations in a cooperative relationship without any single controlling shareholder' (Nam and Kim, 1994: footnote 1, 450). Chaebol come in a wide range of sizes and diversity. Each chaebol usually comprises of a number of manufacturing firms and their subsidiaries and affiliates. According to Park (1994: 165), a larger number of Korea's small and medium-sized firms belong to subcontracting networks developed by or affiliated with chaebol. The four largest chaebol are Samsung, Hyundai, Lucky-Goldstar and Daewoo. Table 8 shows the number of member companies of the four largest chaebol between 1981 and 1991. They have had access not only to bank loans, but also to NBFI lending. Although the shares of the 30 largest chaebol in total bank loans has fallen due to the credit control system (discussed later), their share of GDP only declined marginally (see Table 9). Their share of total NBFI credit has increased substantially.

Table 8 Korea: Number of Member Companies of the 4 Largest Business Groups, 1981-91

	1981	1986	1987	1988	April 1989	1991
Samsung	21	31	31	41	42	48
Daewoo	25	25	28	28	30	24
Hyundai	30	43	30	36	37	42
Lucky-Goldstart	30	43	30	36	37	42

Source: Adapted from Nam and Kim (1994: 472-73).

Table 9 Korea: Share of the 30 Largest Business Groups in Total Bank Loans and GDP (percentages)

	1986	1987	1988	1989	1990	1991
Share in bank loans subject to credit control	25.3	21.6	18.6	14.7	13.5	8.8 (1)
Total loans	28.6	26.3	24.2	20.7	19.4	18.9
Share in NBFI Credit	-	37.9	36.5	42.1	43.6	-
Share in GDP	-	14.6	13.5	14.1	-	-
Equity Ratio	17.4	19.8	24.7	23.8	20.8	19.4

Note: Excludes credit to major corporations, corporations with highly dispersed ownership. loans extended by overseas bank branches and post-shipment export financing.
Source: Nam and Kim (1994: 471)

After a decade when the repressive financial regime was institutionalised, in the early 1960s, the government began to realise that a financial system dominated by commercial banking had become too rigid to meet the growing and varied financial needs of an economy whose structure had become more complex (Park and Kim, 1994: 193). Several problems associated with the rigidity of the system began to surface. One of the monetary authorities' major concerns was the weak capital structure of the chaebol. Their heavy reliance on indirect financing, particularly bank lending, raised the leverage[54] of these groups to dangerous levels, causing them to be extremely vulnerable to business downturns. Another concern was the limited access of small and medium firms to bank credit due to the concentration of bnak credit to chaebol. In 1976, the government introduced a main bank system, termed the 'principal transactions bank system' by Nam and Kim (1994), to restrain the flow of bank credit to chaebol so as to control their indebtedness at a manageable level. The main contents of the Agreement on the Operation of the Principal Transactions Bank System adopted in July 1976 were as follows (Nam and Kim, 1994: 454):

- The principal transactions bank supervise overall credit to large corporations above a certain size.

- The authority to set a credit ceiling for a client company is transfered to its principal transactions bank from the bank with whom the company had maintained its primary relationship.
- The principal transactions banks' position in the overall corporate credit management of the group and its members is strengthened as the banks are allowed to set ceilings on operating capital, provide business information and give management guidance to companies.

The principal transactions bank system is only applied to corporations subject to credit control as designated by the Office of Bank Supervision and Examination (OBSE) (Nam and Kim, 1994: 460). The objective of the credit control system has changed in response to new challenges the Korean economy was facing. The credit control system was first introduced in the mid-1970s to improve the highly leveraged capital structure of large corporations by regulating bank credit extended to large corporations. The system was later used in the early 1980s, when Korean companies suffered from a severe recession, to curb real estate acquisition and encourage R & D investments.

The credit control system has been and remains a regulatory framework ensuring state control of the corporate sector. Through the principal transactions banks, the state implements credit control measures over the corporate sector. The banks are authorised to monitor and offer advice on borrowing and liability management, and to guide business groups to improve their capital structure on the basis of the 'guided equity ratio' set by the OBSE for each industry.[55] At times, a bank may take the initiative to organise a loan consortium when large-scale loans and guarantees are to be provided to a client from its group. In organising this, it has the responsibility of monitoring overall performance of the project and corporation by handling the relevant information on behalf of other participating banks.

In reality, however, the monitoring of the chaebol by the principal transactions banks has been superficial and passive (Park and Kim, 1994: 208). Their role has been restricted to reporting to the OBSE to help it to control credit allocated to chaebol. Principal transactions banks' credit supply to their client corporations is typically insufficient due to the credit control system and the usually tight monetary policy (Nam and Kim, 1994: 461). The OBSE can use its discretion to put a ceiling on the amount of additional credit extended to any chaebol.

The principal transactions bank for the principal corporation of a business group usually becomes the principal transactions bank for all the corporations belonging to that group. Table 8 shows the four largest chaebol linked to a particular bank in the context of the credit control system. Only the five major nationwide commercial banks (Hanil, Korean First, Cho Hung, Seoul Trust and Commercial Bank) and the Korean Exchange Bank have been selected to be the principal transactions banks for the thirty largest chaebol.

As a result of the tight credit control, not a single family or business group is permitted to collectively own more than 8 per cent of the equity in any single nationwide commercial bank. Without such equity ownership restrictions, the chaebol could easily control the management of nationwide commercial banks. Nevertheless, Park and Kim (1994: 195) point out that the restriction is insufficient to prevent the chaebol from dominating the financial sector. The reason is that the holdings of life insurance companies which own many bank stocks, are not included in the 8 per cent group-ownership ceiling. Through cross-holdings, the chaebol which control the larger insurance companies can have significant control of the banks as well.

In Germany, multiple banking relationships are dominated by the 'house bank' (Vittas, 1986: 7). This house bank relationship is a long-term relationship between a bank and a firm, where the house bank has the largest share of the financial business of the firm, including credit provision, and may even be the sole financier (see Baums, 1994: 417; Benston, 1994: 129 and the references cited therein). It has a special responsibility to the firm in times of financial distress, especially for rescue and reorganisation, and is represented on the firm's management board (Baums, 1994: 417 and Vittas, 1986: 7).

The power of German banks in industrial affairs rests on two pillars: their market power over sources of finance for industry, and their legal rights to own substantial stock in corporations and to exercise proxy votes for other shareholders (Zysman, 1983: 261). Although there are no rules limiting bank holdings to some percentage of the firm's capital, there are limits with respect to the bank's capital—participation in one firm may not exceed 15 per cent and all such holdings together should not be more than 60 per cent of the bank's capital (OECD, 1995: Table 34).[56]

The voting power of German banks comes from various sources:z from their direct shareholdings,[57] from investment companies owned by banks, and from shares held by the banks as custodians.[58] Much of German bank control of voting rights derives from the exercise of proxies (Cable, 1985: 120). Under German company law, this requires written authorisation by the shareholder, which is valid for 15 months and can be cancelled at any time. If the shareholder does not give the bank special instructions, the bank is to vote according to its own recommendations.[59] A government commission reported that the proportion of voting rights controlled through direct holdings in the top 100 companies was quite small, around 5 per cent, but when proxies are added, the overall proportion of votes controlled by the banks rose to 36 per cent (Cable, 1985: 120). A recent study shows that voting rights are highly concentrated in the three largest private banks, i.e. Deutsche Bank, Dresdner Bank and Commerzbank (Baums, 1994: 427).

Besides the role as creditors, shareholders and proxy-holders, they are widely represented on many supervisory boards of industrial firms. As summarised by Baums (1994: 432), a recent empirical study shows that 'of the 100 largest firms surveyed, 92 had a supervisory board in 1986. Banks were represented on 75 of them, holding more than 10 per cent of all seats. . . On average they had more than two representatives on each board'. Cable (1985) has shown that there is a significant positive relationship between the degree of bank involvement in leading industrial companies and their financial performance.

Banks may have information advantages due to their active involvement in industrial firms. There is concern that banks might use this information advantage in ways detrimental to their customers. It has been alleged that banks may benefit from an informational lead due to their participation in securities underwriting that enables them to sell off the shares of those companies in financial distress, and to withdraw or recover credit earlier than others. But as postulated by Sharpe (1990), a bank holding shares cannot exploit them without ruining its reputation in the long run (see Section 4). From German experience, banks holding shares are rather more inclined to organise rescue operations for ailing companies (Benston, 1994: 140). Vittas (1978: 80) documents that:

> The banks as universal institutions have been able to play a major role in the financing of the reconstruction effort after the last war and of the subsequent expansion of German industry. They have also taken an active part in arranging mergers and takeovers and have occasionally used their strength to prevent the purchase of stakes in German companies by 'undesirable' elements. More recently the banks have supervised the rescue of a number of companies, saving jobs and gaining considerable goodwill in the process.

One of the well-known cases of rescues is the Deutsche Bank's refusal to allow Mercedes Benz to fall under foreign control (Zysman, 1983: 265). There are some cases on record of the government using the banks to acquire significant shareholdings ostensibly in the national interest (Charkham, 1994: :37). An other example of this was is when the government got the Deutsche Bank and Dresdner Bank to save Hapad Lloyd by acquiring a majority of the shares. A published analysis of the acquisitions of shareholdings by the top ten banks between January 1, 1987 and September 1, 1989 shows that many holdings were acquired through rescue operations of ailing firms—fourteen were made to provide financial support, nine for placement purposes, five for investment and one to stop a hostile takeover (Charkham, 1994: footnote 5).

There are a few studies suggesting that the influence of German banks may often be exaggerated (see Edwards and Fisher, 1993 and Fisher, 1990). For instance, in his study of house bank relationships, Fischer (as cited by Baum 1994: 422) found that exclusive relationships between banks and firms were the exception. Large publicly traded companies tend to maintain relations with five to ten principal or main banks and also use other banks. He only found house bank relationships to exist between small firms and banks. But it is no doubt that the German banks do play a more significant role than in the Anglo-Saxon countries because:

> First, small and medium-sized unincorporated companies are relatively important in Germany. Second, the so-called main bank ('hausebank') system implies a long-term relationship involving the exchange of information and continued surveillance. Third, in the absence of a strong market for venture capital, bank finance is extremely important for smaller firms. Fourth...banks are important share owners, holding 14 per cent of shares in 1993. Thus, finance and monitoring by banks through the 'hausbank' system of long-term implicit contracts between a firm and its (main) bank connection to some extent perform a role similar to that of venture capital firms in the Anglo-American system of enterprise governance, though not all aspects of this role may be filled. (OECD, 1995: 95)

Morevover, as pointed out by Baums (1992: 518), the study did not ask the question whether there are syndicates rather than an exclusive business relationship with one bank, and whether these syndicates correspond to the shares of syndicate members in the firm's shareholders meeting. The house bank also acts as a lead bank for syndicated loans and as lead manager in securities issues (Vittas, 1986: 7). Thus, the bank is not just a source of funds; it is also the critical means for access to capital markets.