THE KOREA STOCK EXCHANGE: FROM DEVELOPMENT TO INTERNATIONALIZATION

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In recent years, the South Korean government has given the Korea Stock Exchange (KSE) a key role to play in its drive to internationalize the economy and diversify its financial base. Such was not always the case, argues Steven Thompson in this survey of the history of the stock exchange and of Korean equity funds currently operating abroad. For years, the availability of government-subsidized loan capital allowed Korea's largest corporations to avoid listing themselves on the exchange, leaving the KSE weak and prone to manipulation by a few powerful speculators. Current government policy to stimulate the exchange involves a tradeoff: heavy regulations help stabilize the KSE, yet they also tend to inhibit its growth. Based on interviews with officials of the KSE and the Ministry of Finance and with Korean academics, Mr. Thompson proposes specific steps the Korean government should take to solve this dilemma.

South Korea is undergoing a financial transition of profound importance. Slowly but surely, the government is shifting the means of capital formation from traditional borrowing patterns to more sustainable modes of investment. This shift will change the structure of the Korean financial system and may affect the future direction of the economy.

The Korea Stock Exchange lies at the center of these changes. The government is trying to reduce the public and private sectors' reliance on foreign and domestic borrowing as a means of generating capital. To fill the resulting need for investment capital, it has sought to promote foreign direct investment in the South Korean economy and to encourage both domestic and foreign investment in the Korean stock market. Successful achievement of these objectives will contribute to the government's goals of internationalizing the economy and securing economic and financial competitiveness in the international arena.

These moves to restructure and ultimately internationalize Korean finance are a radical change from earlier policies. For the past twenty years, South Korea's development has been fueled by foreign and domestic bank loans and a steady stream of foreign aid, channeled to strategic firms and sectors by government-controlled banks. Such "subsidized" capital, used in concert with

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sound fiscal management and a cheap and educated labor force, brought remarkable success to the economy in the 1960s and 1970s. From 1963 to 1978, South Korea's Gross National Product (GNP) grew at an average annual rate of 8 percent. Today, its economy ranks as one of the most productive in the world.

However, this very success has rendered traditional modes of capital formation increasingly inefficient. Government regulations requiring low-interest loans and frequent extensions of credit have reduced the profitabiliy of Korean banks, forcing them into the role of development institutions rather than profit-seeking commercial banks. Easy credit terms encouraged firms to use funds inefficiently. Further, the official tendency to finance larger corporations at the expense of smaller firms has discouraged small business participation in national economic growth.

A development strategy based on loans and aid may have been appropriate for a war-torn country with a large population and limited natural resources, but the current complexity and diversity of the South Korean economy calls for extensive structural change in the modes of capital formation and its deployment.

In sum, the Korean economy is shifting in new directions in an effort to become internationally competitive. Korea's financial institutions lie at the foundation of this shift. The Korea Stock Exchange (KSE) is important not only as a vehicle of capital formation but as a guidepost to the economic policy objectives of the bureaucracy. Accordingly, a discussion of the history of the KSE and recent developments in market structure should provide a solid framework with which to view the issues that confront Korean financial planners, and will shed some light on the direction, past and future, of the Korean economy.

Japanese occupation forces established the basis for the Korea Stock Exchange during their domination of the Korean penninsula from 1910 to 1945. When the Japanese forces departed in 1945, they left behind a virtual economic vacuum and a collapsed market. The destruction caused by World War II and the Korean War left little of practical value to trade on the market. In the years following the war, the Korean stock market consisted of a set of informal committees dominated by a select few corporate leaders known as the "Securities Club."[1] Not until 1956, when the Ministry of Finance formally authorized the opening of the Korea Stock Exchange, did the market begin to achieve internal cohesion.[2]

Structural and financial difficulties plagued the exchange until the mid-1970s, including four major market crashes, chronic manipulation of stock and bond issues, and an absence of sustained growth or investment. Ironically,

1. Young Moo Shin, *Securities Regulations in Korea* (Seattle: University of Washington Press, 1983), p. 8.
2. *Financial System in Korea* (Seoul: The Bank of Korea, 1985), p. 70.

the initial difficulties of the KSE were in large part the result of the success of government economic policies in other areas of the economy.

First, the government placed primary importance on the development of heavy industry to rebuild the industrial base of the nation. The success of this strategy, however, came at the expense of the Korean securities market. To mobilize the finances required to complete a series of ambitious Five-Year Plans emphasizing heavy industry, the government placed strict control over the quantity and flow of capital within the country.[3]

Via direct control of the Bank of Korea and of the major commercial banks, Park Chung Hee's government (1961-1980) targeted loans to specific industries by granting them artificially low, officially subsidized interest rates. Consequently, the large corporations found that it was easier and more profitable to secure capital through bank loans than by issuing shares on the securities market.[4] This diversion of funds away from the KSE during the 1960s prevented any real growth in the volume of the exchange.[5] The continued allocation of credit to heavy industry also reduced the supply of capital available to small and medium-sized firms, who were forced to approach the unofficial, high interest, "curb" capital market to generate investment capital.[6] High borrowing rates and substantial interest payments left these firms in a highly leveraged position, without government backing and at the mercy of stiff repayment schedules.[7] The large interest payments gouged these small firms' profits, thereby stunting their growth and preventing them from buying or issuing shares on the KSE.

Secondly, the receipt of cheap government capital allowed Korea's large, heavy industry corporations to expand at an extremely rapid pace. The concentration of capital in a few companies led to the rise of huge business conglomerates (generally controlled by a single family), called Chaebols.[8] This accumulation of wealth by a few dominant corporations had a detrimental effect on the stock market.

Chaebol owners avoided listing shares for several reasons. Most importantly, they feared losing financial and managerial control to potentially unknown shareholders, and they were discouraged by the vast swings in the market's price index during its early years.[9] Today, less than one-third of the 250 subsidiaries of the top 15 companies in South Korea are listed on the exchange.[10] The KSE's financial disclosure requirements and tax laws allowing

3. *Evaluation of the First Five Year Plan, 1962-1967* (Seoul: Economic Planning Board, 1968), p. 70.
4. Interview with Park Seoung-Yoo, securities analyst, Ministry of Finance, Republic of Korea, July 1986.
5. *Korean Statistical Yearbook, 1986* (Seoul: Economic Planning Board, 1986), p. 275.
6. Jang Jung-Soo, "Seeking Pragmatic and Positive Support," *Business Korea*, April 1986, p. 89.
7. Interview with Yu Zu-yul, official, Ministry of Foreign Affairs, Republic of Korea, June 1986.
8. *Korean Statistical Yearbook, 1986*, p. 275.
9. Interview with Sung Oum-Bong, economic analyst, Korea Development Institute, June 1986.
10. Laxmi Nakarmi, "The Case for a Korean Big Bang," *Business Korea*, December 1986, p. 38.

a company to take tax deductions on interest payments but not on dividend payments also contributed to the reluctance of the Chaebol leaders to issue shares.[11]

Government loan strategies and Chaebol reluctance effectively denied the KSE the capital it needed to achieve growth and stability, and kept the KSE small and vulnerable to market manipulation. As a result, the exchange fell easy prey to a few powerful speculators who wielded sustantial influence in the weak market. These speculators contributed to the instability of the exchange which in turn decreased public confidence in the market as a viable financial institution. Lack of public confidence in general, and of the large corporations in particular, discouraged further equity investment and kept the market weak and vulnerable to speculation.[12]

A third factor which inhibited the growth of the KSE was the structure of the market itself. Following the Japanese model, adhered to during the establishment of the exchange, the government bureaucracy controls the market and the issuance of shares on the exchange.[13] The inconsistency inherent in direct government control of a free-market organization became particularly apparent when the National Assembly decided to issue shares of the KSE on the exchange itself. The ensuing disaster is known as the "KSE Certificate Accident" of 1959 and illustrates the problems of such a relationship. As a result of rumors that the National Assembly would pass a bill to reorganize the KSE in the form of a stock corporation or a membership institution, speculators purchased large quantities of KSE certificates in the hope of profiting by ownership of the institution. When heightened demand caused stock prices to soar, the government decided that it could no longer issue new certificates without great financial risk. Officials who would have benefited from passage of the legislation then stalled the bill in the Assembly. Rumor spread to the exchange floor that the certificates bill would not pass, thereby causing the price of KSE stock to plummet and badly hurting speculators and other KSE shareholders. This crash, and others like it, further discouraged public investment in the market and helped to keep it small and vulnerable to excessive speculation.[14]

Government discrimination against small and medium-sized companies, Chaebol dominance, and structural defects in the KSE continued into the early 1970s. In 1972, the government tried to correct the situation by enacting three new laws designed to facilitate capital formation in the private sector. First, the government issued the August 3 Emergency Decree which lowered

11. Interview with Kim Seung-Hee, Professor of Economics and Finance, Seoul National University, June 1986.
12. Young, p. 9.
13. Ibid.
14. Ibid., p. 14.

bank interest rates on loans to all firms (large and small) and extended the maturity on loans.[15] The decree was intended to encourage private industries to use official lending agencies rather than the curb market for loans. The Going Public Encouragement Act (GPEA) encouraged "closely held corporations to go public" as a means to stimulate growth in the stock market.[16] The Public Corporation Inducement Law required certain corporations to publicly offer shares on the market.[17]

These measures, however, had a only minor impact on the KSE. Many corporations avoided government orders to issue shares, or disguised those issues by placing large numbers of shares in the names of friends, relatives, and controlling shareholders of other companies in complex reciprocal arrangements.[18] Political and economic factors also limited the ability and willingness of the government to force corporate compliance with these laws. After an initial surge in investment in 1972, the market again lapsed into sluggish trading.[19]

In 1976, the government amended the Securities Exchange Act to make the KSE a viable institution for capital formation. The original act gave the Ministry of Finance supreme power to control and regulate the securities market. To ensure greater efficiency and fairness in the management of the exchange, the amendments established several administrative bodies, separate from direct governmental influence, to oversee the day-to-day and medium-term functions of the KSE.[20] The amendments also prohibited officers, employees, and major shareholders of listed corporations from realizing profits by using inside information and required many listed companies to file adequate disclosure statements.[21]

The government also amended the Corporate Income Tax Act in 1976 to reduce the concentration of share ownership. (As of December 31, 1976, only 1.6 percent of the South Korean population actively invested in the stock market.)[22] The amendment applied a tax rate which varied with the degree of equity ownership; it required a 33 percent tax rate when individual shareholdings exceeded 35 percent of the total shares outstanding, and a 27 percent rate when shareholdings fell below 35 percent.[23] In response to the sweeping

15. Ibid.
16. Ibid., p. 54.
17. Antoine van Agtmael, *Emerging Securities Markets: Investment Banking Opportunities in the Developing World* (London: Euromoney Publications, 1984), p. 77.
18. David C. Cole and Yung Chul Park, *Financial Development in Korea, 1945-1978* (Cambridge, MA: Council on East Asian Studies, Harvard University, 1983), p. 280.
19. *Korean Statistical Yearbook, 1976,* (Seoul: Economic Planning Board, 1977), p. 323.
20. Young, p. 95.
21. Ibid., pp. 102-109.
22. Ibid., p. 100.
23. Ibid., p. 104.

magnitude of these changes, both the number and value amount of listed stocks more than doubled the following year.[24] Public confidence in the KSE appeared to be rejuvenated.

Unfortunately, the gains made by the KSE were short-lived. From 1978 until early 1981, unfavorable market conditions prevailed on the stock exchange. The oil price shock of 1979 curtailed economic growth, and the general political upheaval, which culminated in the assassination of President Park in 1980, damaged investor confidence in the economy. Total market value of equities decreased by 36 percent from 1978 to the end of 1980. New issue activity for equity securites also stagnated, with only one initial public offering in 1980.[25]

Further problems arose when, in January 1980, the government devalued the South Korean won against the dollar by 16.6 percent, resulting in a sharp rise in real interest rates on foreign loans. While benefiting exporters, the devaluation adversely affected the profitability of many listed companies, which tend to be highly leveraged by international standards. The increase in interest rates also improved the status of the curb market, for the traditionally high rates it charged no longer seemed exorbitant when compared to the higher official rates. The increased curb market activity further impeded the flow of capital to the stock market.

The market continued to drift downward, despite periodic upswings. However, official measures to internationalize the KSE began to make a positive impact on the exchange. In 1981, the government declared a long-range internationalization plan for the domestic capital market as part of a plan to boost the ratio of equity financing from 40 percent in 1982 to 60 percent in 1986.[26] Also, on July 18, 1983, the government announced a series of concrete measures to foster capital market development.[27]

The ensuing four-stage liberalization program began with the creation of two open-ended funds, the Korea Trust and the Korea Investment Trust, which allowed foreigners to indirectly purchase Korean securities. The open-ended funds were established with a combined value of $30 million and helped retain stability in the market despite the world recession. Foreign brokerage houses were also allowed to establish a presence in Korea for the first time.[28]

In 1984, Korean officials launched the second stage of the program by allowing foreigners to directly buy Korean stocks. To assuage the fear of foreign take over of Korean companies, local authorities imposed strict limits

24. van Agtmael, p. 60.
25. Lehman Brothers/The First Boston Corporation, *Korea Fund Prospectus* (New York: Lehman Brothers/The First Boston Corporation, 1984), p. 16.
26. "6th Economic Plan Sets Annual Foreign Capital Need At $6.9 Billion," *Korea Herald*, 4 July 1986, p. 4.
27. Young, pp. 425-29.
28. "Internationalization Process," *Business Korea*, March 1986, p. 65.

on foreign investment. The maximum total foreign ownership in any Korean company was set at 10 percent of listed shares and maximum individual foreign ownership of those shares was capped at 5 percent.[29]

The creation of the Korea Fund highlighted this period of expansion. Established in New York and listed on the New York Stock Exchange, the fund became the first overseas closed-ended investment fund capable of selling and purchasing stocks on the KSE. The fund has added some $60 million worth of foreign capital to the Korean stock market and the government is considering allowing another $40 million to be invested. The fund has been remarkably successful on the US market and its success has contributed both to the growth of the KSE and to the internationalization of the Korean stock market.[30]

To curtail potential foreign domination of the market, Korean authorities have recently placed investment limits as well as a series of restrictions on the types of activities Fund managers can conduct. The Fund's financial objective is to seek long-term capital appreciation and, as a result, it will not concentrate on trade in securities for short-term gains. Accordingly, the annual portfolio rate of turnover should not exceed 50 percent.[31]

Fund managers must also be aware of two factors unique to this type of arrangement. First, since the Fund's assets are invested primarily in Korean securities with income denominated in won, while distributions are made in dollars, the net assets of the Korea Fund decrease if the value of the won declines relative to the dollar.[32] Second, the sheer size of the Korea Fund relative to the market means that Fund investment decisions could have a substantial impact on the price of listed shares.[33] In other words, unless the government adheres to the restrictions mentioned above, the Korea Fund could create its own investment opportunities by significantly altering the demand for a particular stock or by shifting the flow of capital into and out of the exchange.

The third and fourth stages of the exchange liberalization program, yet to be enacted, will determine the future course of the KSE. By the end of this decade the third stage of the program will allow foreign investment in domestic securities and encourage Korean firms to issue securities on the overseas capital markets.[34] The fourth stage, which may culminate by the early 1990s, will grant individual foreign investors full access to the market as well as the complete remittance of foreign exchange earnings.[35]

29. Ibid.
30. Ibid.
31. Lehman Brothers/First Boston Corporation, p. 4.
32. Ibid., p. 5.
33. Interview with securities analyst, Korea Stock Exchange, July 1986.
34. "Nation's Security Mart Aims to go International," *Korea Herald*, 25 May 1986, Supplement Section, p. 2.
35. Ibid.

A recent landmark decision by the Ministry of Finance gave the market a sustained boost. In a move that was probably the most significant step to date toward liberalizing the stock exchange, the ministry announced on November 11, 1984, that financially solid Korean companies could issue convertible bonds and depository receipts on international securities markets.[36]

This policy allows foreign residents to directly own Korean stock as soon as their previously purchased convertible bonds can be converted to common stock. Within two days of the announcement, the Samsung Electronics Company was permitted to offer the public $20 million in convertible bonds (CBs).[37] The government promised more CB offerings for the following year. The KSE responded to this measure with an immediate uspurge in trade volume and in the Capital Stock Price Index (CSPI). In less than two months, as the market closed for the New Year holidays, the CSPI rose by 20 points and trade volume by more than 100 percent.

By February 1986, renewed confidence in the KSE combined with the so-called "Three Lows" — declining oil prices, falling international interest rates, and the depreciation of the won against the Japanese yen — gave further impetus to the market's growth.[38] Additionally, new government restrictions on the curb market and real estate investment increased the relative attractiveness of the KSE.[39] From February through June, the CSPI grew by almost 100 points and the average daily trade volume jumped by more than 50 percent.[40]

Fearing a new phase of instability in the stock market, the Korean government has recently taken several measures to restrain the growth of the CSPI. The Ministry of Finance has argued that tighter government control of the market is necessary to prevent inflation.[41] Without increased control, government officials stated, consumer prices may spiral upward as a result of rising stock prices and the expansion of the money supply (M2 rose by more than 19 percent in 1986).[42] The government sees inflation as a serious threat to economic development, particularly through its impact on domestic savings.[43]

Secondly, and perhaps more realistically according to some scholars, the government fears a major market crash if the exchange becomes overheated.[44] The unstable early years of the KSE have instilled a lack of confidence in the ability of the exchange to withstand large price and volume fluctuations. A major market crash could doom the KSE as a viable institution for capital

36. "Firms Soon to Float Int'l CBs, DRs, " *Korea Herald*, 12 November 1985, p. 4.
37. "CB, DR Issuance to Lure Foreign Investors," *Korea Herald*, 14 November 1985, p. 3.
38. "Liquidity+Expectation=Bull," *Business Korea*, May 1986, p. 136.
39. Yu Zu-Yul.
40. Statistics compiled from Stock Exchange section, *Korea Herald*, November 1985-November 1986.
41. Oum and Kim.
42. "Double Digit Economic Growth Forecast this Year," *Korea Herald*, 24 July 1986, p. 4.
43. "CB, DR Issuance to Lure Foreign Investors," p. 4.
44. Ibid., and Yu Zu-Yul.

formation and anger influential securities houses and corporate leaders. Consequently, the government believes that the imposition of certain market restrictions is necessary to prevent inflation and market volatility.

In the spring of 1986, the government introduced measures to slow the growth of the KSE. Authorities raised margin requirements for securities companies and froze the extension of securities-related credit by the Korea Securities Finance Corporation.[45] When these steps failed to constrict market growth, the government issued a new set of regulations on July 8. These regulations included an order to 25 securities firms to purchase 110 billion won (about $126 million) in monetary stabilization bonds by the end of the month and to drastically curtail their stock holdings and purchases.[46] These measures have been remarkably successful in restraining the growth of stock prices on the exchange. From the July 8 proclamation to the end of 1986, stock prices have remained stable and the daily trade volume declined by more than 50 percent.[47]

There are, however, broader implications to these bureaucratic attempts at securities market regulation. By placing restrictions on market growth, the government has signalled its intent to impose a greater degree of stability on the stock exchange. Officials believe greater market stability is a prerequisite for making the KSE a more integral part of the nation's economic growth. Consequently, the government has had to regulate and at times slow some of its own KSE initiatives. This retrenchment has extended to the internationalization of the KSE as well.

The bureaucracy has delayed the establishment of a second Korea Fund in Europe for fear that an additional $30 million influx of foreign capital would have a destabilizing impact on the stock exchange.[48] Korean officials also postponed CB issues on the international market by allowing only one private business to float foreign currency-denominated convertible bonds on overseas money markets in 1986 and by limiting the ceiling of such bonds.[49] (Samsung Electronics Co., Daewoo Heavy Industries Co., and Yukong Ltd. are now allowed to issue CBs on foreign capital markets.)[50] Because prior issues of Korean CBs on the foreign market had attracted more than $100 million to the KSE, officials feared a further inflow of foreign exchange would endanger the stability of the KSE.

Such steps do not imply that the government is retreating from its policy of "internationalization," but rather express genuine concerns that an influx of foreign capital could overheat the market. An overheated market could lead

45. "Share Prices Nosedive in Mini Market Crash," *Korea Herald*, 25 April 1986, p. 4.
46. "KSE Plunges by 8.56 Points in Slack Trading," *Korea Times*, 9 July 1986, p. 2.
47. Statistics compiled from Stock Exchange section.
48. "Capital Market Opening Delayed for Time Being," *Korea Herald*, 8 June 1986, p. 4.
49. Ibid.
50. Ibid.

to inflation or another market crash. Moreover, officials fear that foreign investors might try to buy equity control of Korean companies and, as foreign capital grows in proportion to the size of the exchange, subject the KSE to fluctuations in the international money market which are beyond the control of the national government. Again, it should be noted that the government recognizes the long-term benefits of an economy more fully integrated into the international market. Its policies therefore constitute a moderation rather than an abandonment of its commitment to the liberalization of the KSE.

The government's general policy toward the KSE, at the domestic and international level, is to promote both stability and growth. While it has placed a series of financial restrictions on the rapid growth in the price and trade volume of KSE shares, the government has continued efforts to encourage closely held Korean corporations to publicly issue shares. Internationally, the administration has continued to promote market liberalization. Such measures indicate a concerted effort to maintain control over the market and promote stability while at the same time ensuring sustained expansion of the exchange. Fear of KSE instability is justified when placed in a historical perspective, for another large fluctuation in the market could have serious financial consequences. Nevertheless, the disruption of rapid market liberalization plans could also raise political and economic problems for the Korean government.

The fundamental question remains: how can the government achieve this balance between market stability and growth? Today's basic problems are still those that have plagued the exchange for years. At root is the small size of the market, which reduces the overall stability of the KSE by subjecting it to large price fluctuations, foreign domination, and manipulation at the hands of a few large local investors. The Korean equity market has a total capitalization of only 7.9 percent of GNP which is small even by East Asian standards. Investors number less than 700,000 in a country of over 40 million and despite the small share of institutional investors in the market, nearly 90 percent of the total listed stocks are held by less than 10 percent of the shareholders.[51] The KSE is also only 7.7 percent of the size of the banking market, reflecting its relatively minor role in the capital formation process.[52]

The government has responded to these problems with essentially negative incentive programs as illustrated by the recent government restrictions on CSPI growth. These restrictions, however, do not address the real issues. First, they seek to control price fluctuations when the basic problems of the exchange are size and volume. Second, the restrictions, by their nature, are a negative form of control which serve to discourage public investment and inhibit corporations from issuing shares. The government has attempted to force 59 blue chip companies to issue new equity shares in 1986, or face official restrictions on bank loans and the floating of convertible debentures, as a

51. Laxmi Nakarmi, "Investor Interest Pushes for Innovation," *Business Korea*, March 1986, p. 62.
52. Ibid.

means to impose greater corporate involvement on the exchange.[53] The KSE Securities Supervisory Board has also "strongly urged" 129 listed firms, whose shares are traded at least 1.3 times as much as their face value but whose equity to capital ratio remains below 50 percent of their total assets, to issue new shares.[54] Here too the measures are essentially negative and will not promote the long-term growth of the stock exchange. "It's shameful," says one government official, that "we have to whip [the corporations] publicly for not seeking investment funds from the capital market."[55]

The government should instead promote positive incentives to encourage large companies to issue stock. An excellent first step would be to reform the tax system. Presently, income from dividends is subject to comprehensive tax laws that can result in a tax rate as high as 70 percent, while the tax rate on income from interest on bank deposits is a flat 16.5 percent. This "forces investors to invest only for short-term capital gains, instead of as a long-term investment, which is normally the basic goal of the stock market."[56] Meanwhile, the government has rescinded tax incentives granted in the 1976 Amendments to the Corporate Income Tax Act which gave tax breaks to listed companies with a high concentration of individual shareholders. Pension funds, which are powerful investors in most stock markets, are barred from investing in the Korean market. Insurance companies, investment trust companies and mutual saving and finance companies should also be allowed greater roles in the stock exchange.

The government recently implemented legislation that exemplifies the often conflicting nature of the search for KSE growth and stability. In 1984, the legislature passed the Korean Commercial Code, which governs institutional investment in the stock market and stipulates that all listed companies must raise the face value of their shares from 500 or 1,000 won to 5,000 won by August 1987. The stipulation was made, according to a senior executive of a brokerage house, by "arm chair bureaucrats who believed naively that by increasing and unifying the par value of listed shares to 5000 won, a company will be able to reduce the number of shares listed and subsequently save" on printing costs of stock certificates![57] According to many analysts, the stipulations will have a negative impact on the KSE. Small investors, who normally invest in a portfolio of stocks, will be unable to afford the larger share blocks and may thus be forced to "move away from the market."[58]

The conversion process could also reduce the total number of listed stocks tenfold. Also, as the price of each share block increases, Korean companies may have difficulty listing their stocks on foreign stock exchanges.[59] These

53. "59 Blue-Chip Firms Urged to Issue Additional Shares," *Korea Herald*, 19 April 1986, p. 4.
54. "129 Blue Chip Firms Urged to Issue Additional Shares," *Korea Herald*, 13 April 1986, p. 4.
55. Nakarmi, "The Case for A Korean Big Bang."
56. Ibid.
57. "Legal Provision Adds Confusion," *Business Korea*, December 1986, p. 43.
58. Ibid.
59. Ibid.

developments could both curtail small investor participation in the stock market and impede the internationalization of the KSE.

Unfortunately, the sum effect of these penalties and restrictions is to saddle a free-market institution with excessive bureaucracy. History makes clear the motivations for such control. To curtail the manipulation of a small market, the government found it necessary to supervise the KSE with strict legal measures. Almost two decades have passed, however, since the last market crash, and the exchange appears on the verge of reaching relative internal stability.

The government should therefore relax some, although certainly not all, KSE regulations and offer instead more positive incentives to induce public participation in this market. The government could provide tax incentives by reintroducing the benefits given to publicly held corporations under the 1976 amendments to the Corporate Income Tax Act. The government could also loosen some of the artificial restrictions placed on securities companies in 1986 to curb KSE growth. Finally, the role of institutional investors should be encouraged. Market planners may, for example, want to resurrect a plan devised several years ago to establish a long-term pension investment trust fund of $176 million as one way to integrate pension funds into the KSE.[60]

In short, by providing tax benefits, encouraging the facilitating role of securities houses and promoting institutional investment, the government may be able to achieve its goal of sustained growth in the stock market; growth that has seemed illusory in the wake of a number of negative incentive programs.

Government regulations concerning the stock market are very much a part of a broad, long-term economic goal of growth and stability. However, political elites' desire for stability sometimes clashes with the government's strong drive toward a modern and fully developed economy. The KSE has the potential to become an integral part of the Korean financial system, but the government must formulate a consistent policy regarding the exchange, as well as a long-term positive incentive program to induce local companies to invest in and issue shares on the KSE. The modern history of the Korean securities market, and of the economy as a whole, can be viewed as a continuous search for compromise between the often conflicting policy goals of sustained expansion and the financial stability required by the business community and investors.

CONCLUSION

South Korea's government in the 1980s faces a financial dilemma as it attempts to restructure the financial system. To reduce the size of its foreign

60. Nakarmi, "The Case for a Korean Big Bang," p. 39.

debt and to foster financial self-sufficiency in the business sector, the government hopes to reduce the traditional dependence on borrowing as a means of capital formation. On the other hand, the country continues to need capital for economic expansion. To fill this potential "capital vacuum," the government has encouraged direct foreign investment, with national and foreign banks as financial intermediaries. It has enacted measures to integrate the Korean financial network into the international arena. Lastly, the central bureaucracy has designed a series of programs to foster domestic and foreign investment in the securities market.

Despite recent financial setbacks, and concern over the pace of the nation's internationalization policies, the government is slowly redirecting the monetary foundations of the economy. However, there are social and economic implications to these policies. Reliance on private capital markets to generate investment capital may reduce central control over the flow and direction of that capital. Foreign investment in Korean securities will influence the trading volume and prices of listed stocks. Additionally, corporate leaders are wary of the potential for foreign control and ownership of listed Korean companies.

How will these issues affect local businessmen and bankers who form the bedrock of Korean economic growth? How will these same individuals, as well as opposition party and student groups, react to the perceived threat of foreign domination over Korean finances? The long-term benefits of internationalizing the Korean capital market are sound and indeed necessary in an expanding economy. However, the short-term effects are of more immediate concern to businessmen and government officials.

Korean business and political leaders' response to these questions will guide the course of the nation's financial development. In many respects, the banking industry represents the traditional mechanism for the generation of capital in Korea. The government would like the Korea Stock Exchange to become a primary source of capital in the future. The pace and mode of this transition will depend on the ability of government and business leaders to reach a compromise in the nation's dual search for stability and growth.