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KOREAN UNIFICATION AND BANKING SYSTEM

- An Analysis in View of German Experiences and Korean Differences -

Ralf Müller

April 2001 No. 139

Diskussionspapiere
Discussion Papers

Department: Structural Change
Dr. Ralf Müller
Phone: 0049/(0)345/7753-851
Email: rmr@iwh-halle.de

Opinions expressed in this paper are those of the author and do not necessarily reflect views of the institute.

INSTITUTE FOR ECONOMIC RESEARCH HALLE (IWH)
Address: Kleine Märkerstraße 8, D-06108 Halle
Post: Postfach 11 03 61, D-06017 Halle

Phone: 0049/(0)345/7753-60
Fax: 0049/(0)345/7753-820
Internet: http://www.iwh-halle.de

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Abstract

One of the reforms that have to be launched in a future unification process in Korea, which seems possible after the political negotiations last year, is the transformation of the North Korean banking system. The question arises whether Korea could profit from the German experience where banking transformation was one of the rather few success stories in unification. In 1990 the East German banking transformation was achieved relatively fast and uncomplicated due to considerable direct investments of the West German banks compounded with state guarantees for bad loans resulting from the credit business with existing GDR-corporations. Unfortunately, South Korea currently lacks some major prerequesites that contributed to the German banking unification, among them – and probably the most important one – is the lack of a sound and efficient banking system that could become active in the North. Consequently, depending on the circumstances of a future Korean unification either a more gradual process is recommended or, if inner-Korean migration requires a more dynamic transition, considerable investment by foreign banks and assistance from international organisations is recommended.

JEL classifications: G 21, N 25, P 21

Keywords: Banking, East Germany, Korea, Transformation, Unification

* This study results from a research stay in October 2000 at the Bank of Korea (BOK) in Seoul. The author would like to thank the Research Department of BOK for their valuable cooperation. Moreover, various representatives of banks and research institutes in Korea contributed to this study by commenting on the topics. The Deutsche Bundesbank released data about Germany's banking unification. Nevertheless, none of them is responsible for results and opinions expressed in this study.

Contents

I. INTRODUCTION

After decades of seperation and cold war (including several bloody clashes) between North and South Korea, in the year 2000 both countries made more than a considerable progress in improving their relationship – a reunification does not seem utopian any longer, it is a real perspective now. However, when the two Koreas will be unified among the numerous problems that have to be solved one is very decisive: the creation of a joint and competitive banking system. Efficiently working banks are a critical prerequisite for a stable and dynamic economic development process (FRY 1993). The recent crisis in South Korea and other Asian countries is only one example of misdevelopments in financial intermediation with severe implications for the whole economy. Thus, the question is how to implement a process that will lead to unified and efficient Korean financial intermediation.

At present, there does not exist a North Korean banking system that could be unified with the one in the South. Consequently, it will be less a unification but rather the foundation of market-oriented financial institutions in North Korea, performed under the assistance of South Korea. This resembles the German unification in 1990 when East Germany needed a market-oriented banking system. However, in the German unification economic differences were not as striking as those between North and South Korea. Moreover, a further problem arises if the Korean unification came soon because at present even without the unification South Korea faces enough problems in its banking system.

The following analysis will deal with these topics in more detail. The first section (II) starts with a short description of Germany's banking system (East and West) prior its unification and will then analyse the unification experience. In the subsequent section (III) present conditions will be described for North and South Korea in terms of economic situation and banking system structure. This will identify main parallels and differences between German and Korean unification. Subsequently, some lessons will be drawn for a strategy of future banking unification in Korea, either by a very gradual process or by a fast process of banking unification. Altogether, the analysis cannot serve as a final instruction for policy-makers on how to perform a banking unification. Yet, the study presented here can be very useful to develop such a guide in the future.

II. GERMANY'S EXPERIENCE OF BANKING UNIFICATION

1. Banking system – A short survey

At the end of World War II Germany was seperated into four sections, which were controlled by British, French, American and Russian military. In 1949 the three western-controlled sections became the Federal Republic of Germany (West Germany), whereas the section under Russian authority became the German Democratic Republic (East Germany). Because of the affiliation with two different political and economic blocks for decades contacts between West and East Germany were rather limited. Therefore, economic development and banking system development were quite different.

a) West Germany

After the war West Germany restructured its universal banking system, a system that was traditionally predominant in Germany. This banking system prevails until today and, thus, was existent at the time of unification, too. This system is characterized by the following institutions (graphically summarized in figure 1):[1]

- a central bank (*Deutsche Bundesbank*) with a network of branches (*Landeszentralbanken*) for the province level; the *Bundesbank* is mainly responsible for monetary policy and refinancing tasks,[2] it is independent from direct government orders;
- credit banks (or commercial banks) that can be divided into the "big banks",[3] regional banks (including other credit banks) and branches of foreign banks;
- savings banks, which are non-commercial institutions, the solvency of which is guaranteed by the local community; public *land banks* serve as a central institute (*Girozentrale*) for savings banks; savings banks hold shares of *land banks*;
- credit cooperatives on the province level (e.g. *Volksbanken*, *Raiffeisenbanken*) and regional institutions of credit cooperatives (including the head institute *DG Bank*) providing subsidiary services for credit cooperatives;
- mortgage banks that have an important function for housing financing;
- banks with special functions, such as financing small and medium firms or start-ups – some of these intermediaries are in public ownership (*Kreditanstalt für Wiederaufbau* and *Deutsche Ausgleichsbank*);

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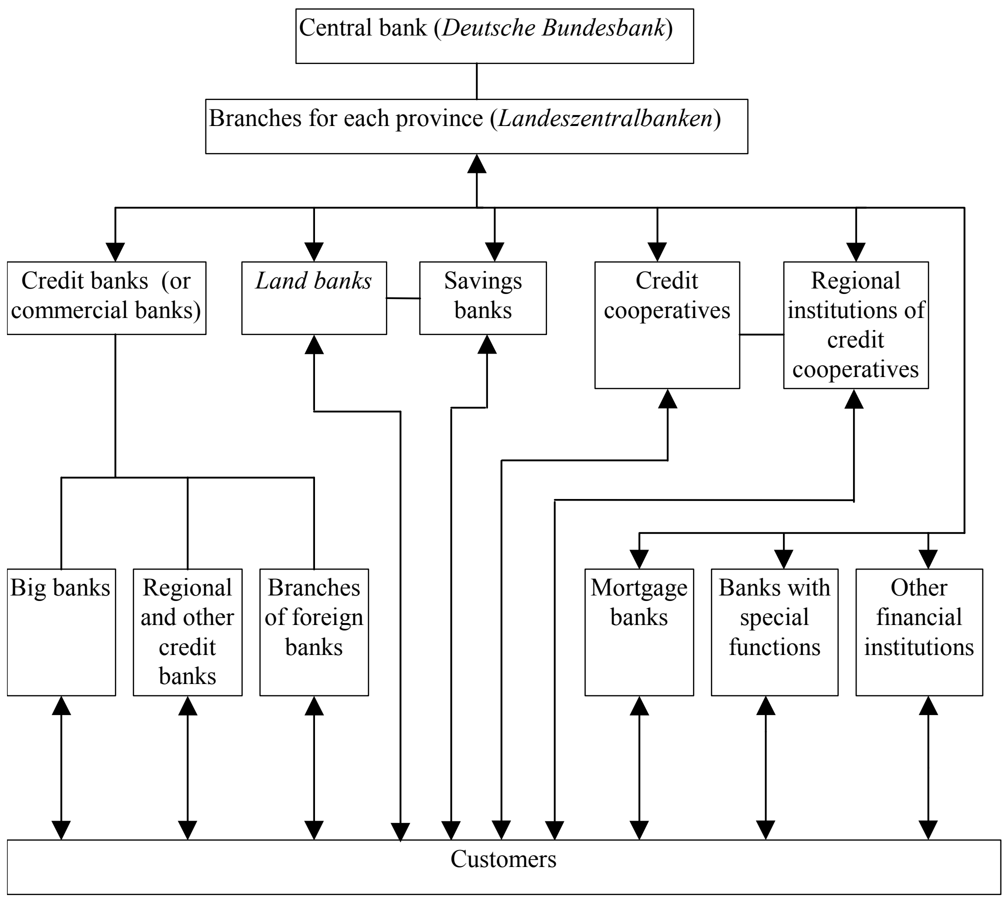
[1] This survey follows mainly the official statistics of DEUTSCHE BUNDESBANK (2000).

[2] A further institution (*Bundesaufsichtsamt für das Kreditwesen*) supervises credit business.

[3] At the time of unification the big banks were *Deutsche Bank*, *Dresdner Bank* and *Commerzbank*. Recently, *Hypo-Vereinsbank* became a further big bank.

- other financial institutions (e.g. building and loans associations).

Figure 1
Structure of the West German banking system



Altogether, at the time of unification (and also before and later on) West Germany was characterized by the classical banking system in free market economies: a two-stage-system with the central bank on the one hand and commercial banks as well as other intermediaries on the other. This system was open to foreign entrants and competitive. Yet due to a strong banking supervision this competition was not completely free – in fact, supervision was more prudential (and more regulative) than for example in the United States.

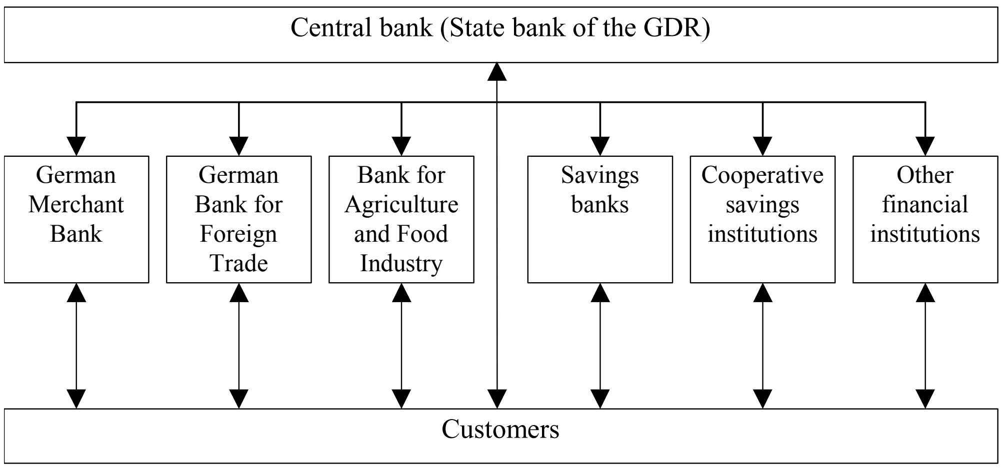
b) East Germany

Until 1945 there was no difference between banking in West and East Germany. Though after Germany had been seperated existing private banks were nationalized under the Russian occupation and only some credit cooperatives remained formally as private institutions. Several new state-run financial institutions were founded. Since that time there has not been any private banking in East Germany until unification. Interest rates, credit volumes and credit recipients were determined by a state planning system. When finally the Berlin Wall fell and the socialist rule came to its end (1989/90) the banking system in East Germany contained the following institutions (summarized in figure 2):

- State Bank of the GDR (*Staatsbank der DDR*) acted both as the central bank and a credit bank; it financed and controlled the major part of the economy and offered also insurance;
- German Merchant Bank (*Deutsche Handelsbank*) served for accounting, financing and controlling the trade of East German corporations with non-socialist countries;
- German Bank for Foreign Trade (*Deutsche Außenhandelsbank*) had a similar assignment as the German Merchant Bank but for trade and other kind of financial relations with socialist countries;
- Bank for Agriculture and Food Industry (*Bank für Landwirtschaft und Nahrungsgüterwirtschaft*) financed and controlled the agricultural sector and the food industry;
- Cooperative savings institutions serving for some different sectors;
- Savings banks that mainly offered savings accounts to private customers, but also allocated a limited amount of credits to this group (especially for young families);
- Other special institutions such as postal savings and railways savings.

Similar or even more than in western countries, financial institutions in socialist countries have a decisive position in the economy. By planning, financing and controlling corporations banks have a significant influence on business. Consequently, banks in socialist countries depend to a large extent on the government. In this context it is important to note that East Germany did not possess any two-stage-banking-system like Western market economies, but did not have a pure monopoly-banking-system (that has been taught by Marxism-Leninism), too. Instead, East Germany's banking system was characterized by different institutions, among them – and most important but not alone – the State bank of the GDR that not only controlled all other financial institutions but financed and controlled corporations as well.[4] Despite the existence of several financial institutions there did not exist any real competition in banking, neither for credits nor for savings.

Figure 2
Structure of the East German banking system prior to unification



2. Unification and banking system development

It was more than surprising when in autumn 1989 the Berlin Wall fell, the East German government collapsed, a democratization process started and finally the unification was evident. Thus, government and corporations in West Germany were not prepared to unify. Yet still, as a result of this lack of knowledge about the implementation of this process, a euphoria grew, which made decision-making in terms of economic rationality rather difficult – especially because the following year was a general election year. In this situation the unification process was implemented within a very short period, mainly by the Monetary, Economic and Social Union (MESU) established on the 1st July 1990. The rates set in the MESU for the exchange of the East German currency into the newly introduced West German currency (Deutschmark) were far from justified by the productivity of East German firms.[5] Moreover, with the MESU East Germany liberalized most

[4] Therefore, in figure 2 exists a direct arrow between the central bank and customers. In West Germany there is no any relation like this for the central bank (see figure 1).

[5] That mis-development was further increased by wage rises. Consequently, East Germany had significant cost-disadvantages and was not competitive for internationally traded products. As a consequence, even today East Germany's integration into foreign trade is still weak. Certainly, it is necessary to mention that the openess of the border between East and West Germany since the 9th November 1989 made it difficult to set a more realistic exchange rate and lower wages – due to migration of East Ger-

commodity prices and abolished various subsidies; along with the adoption of West German economic laws this was a major step for the integration of markets. In addition, with the 1st July existing East German state-owned corporations came under the control of the Treuhand, an institution responsible for the privatization process.

Concerning the banking system there did not exist any links between East and West Germany until November 1989. Financing East-West-trade had not been a business so far, nor was there any kind of physical infiltration (by branches or representative offices). Thus, similar to the industrial sector banks were not prepared for unification. In this situation it was very doubtful if existing East German banks could survive without any partnership of other banks in a unification: East German banks' staff lacked the knowledge of financial techniques essential in a market economy; banks were burdened with loans having allocated in the pre-unification period that became non-performing after unification; a further organizational problem was the adoption of the West German payment and clearing system. Therefore, for many observers the best way to implement the unification seemed to be a takeover of the existing East German financial institutions by West German intermediaries.

The following steps characterize the main events of transformation in the banking system:

- While West German commercial bank began to open first offices in East Germany (notably offices, not representative offices), West German savings banks started supporting their East German counterparts in preparing for market economy by consulting as well as financial and technical assistance (since November 1989).
- The State Bank of the GDR lost its functions and capacities as a credit bank to the newly-founded Deutsche Kreditbank (for East Germany without Berlin) and the Berliner Stadtbank (for the city of Berlin).[6] The Deutsche Kreditbank founded two joint-ventures with the two leading West German banks (Deutsche Bank and Dresdner Bank).[7] The Berliner Stadtbank was overtaken by the Berliner Bank, the leading bank in West Berlin. West German and foreign banks received permissions for representative offices in East Germany. Thus, offices could be converged into formal representative offices, notably not branches (1st of April 1990).

mans to the west that had to be stopped. Yet unrealistic exchange rates and high wages were obviously no solution because unemployment steadily grew in Germany in the early 1990s and migration continued especially for the first years of unification (and exists still today).

6 Until July 1990 the State Bank of the GDR continued fuctioning as the central bank for East Germany.

7 Later both joint-ventures merged with their West German partner banks (for the Dresdner Bank's strategy in the early years of transformation see PUCHTA 1993, p. 19-28).

- With the MESU West German financial laws were introduced in East Germany (only a few exceptions remained until the formal act of the state unification in October 1990). West German and foreign banks could now operate branches in East Germany and with the MESU the Deutsche Bundesbank became the central bank for East and West Germany (1st of July 1990).

In May 1990 the Bundesbank opened an office in West Berlin that moved some weeks later to East Berlin. Several members of the Bundesbank-staff were sent to East Germany at that time. Among other tasks, this staff was training East German personnel. The Bundesbank used the method of "godparenthood" (*Patenschaft*), meaning West German departments and sub-institutions of the Bundesbank became a sort of "godfather" for similar institutions that had been established in East Germany.

A further important task for the government was the enlargement of West Germany's banking supervision to East Germany. To guarantee a qualified banking supervision external auditors were used apart from existing staff in West German state banking supervision. Moreover, existing banks in East Germany (mainly *Deutsche Kreditbank*, including its joint venture, savings banks and credit cooperatives) had to be compensated by the government for their bad loans. This was necessary to ensure equal competition with western banks and to meet Basle-standards of capital-ratio. To secure depositors' confidence in banks a political consensus was found, according to which no existing GDR-bank would become insolvent. Yet, existing banks in East Germany had been burdened with loans to former state-owned firms that faced serious solvency problems with the start of the MESU. These firms were now under control of the Treuhand the task of which was to decide which firm could be privatized and which one had to be closed. Thus, the future of former state-owned corporations depended more on the Treuhand than on banks that mainly renewed existing credits for those firms on the risk of the Treuhand.[8] This risk-assignment to the Treuhand (instead of to banks) was not cheap for the government but favorable for banks and the East German economy insofar as banks could concentrate their own-risked credit business on new corporations (MEINECKE 1993, pp. 90-92). Thus, East Germany was provided very early with a banking system that was free from former financial burden.

[8] At the end of 1992 40 % of commercial loans from the nine largest commercial banks were allocated to Treuhand firms, among them nearly 90 % were fully guaranteed by the Treuhand (DEEG 1994 ,p. 31-32). However, banks consulted the Treuhand for their selection of surviving and non-surviving firms.

With legal restrictions widely abolished, an integration process by the market could start in July 1990. Nonetheless, of course, Germany were not immediately provided with a unified and efficient banking system, it was a process. In the commercial banking sector, West Germany's private banks went to East Germany partially by a takeover of existing GDR-banks (and their branches) and partly by creating a new network of branches in East Germany. The lack in infrastructure and human capital significantly impeded financial business at that time in East Germany (MANN 1996, pp. 48-49). Infrastructure deficits existed especially with respect to buildings and telecommunication (which was a serious problem in East Germany in the early 1990s). Thus, the opening-process of new branches occurred frequently in an improvising manner, i.e. some branches were founded as an interim solution in buses or containers as adequate buildings were not available. Especially those banks running a non-takeover-strategy in East Germany were confronted with an infrastructure problem. Yet also those banks that had decided for a takeover of East German banks faced difficulties, due to the need of transforming existent socialist-oriented bank staff into market-oriented bankers. This implied a strong need for education efforts all the more because these banks had a wide customer base (that asked for information about the various new financial products) and existing staff was not familiar with products such as bonds, shares etc.

Concerning human capital weakness, three strategies were applied: the transfer of Western bank staff to East Germany, the training of existing bank staff of former GDR-banks and the training of newly hired personnel. The two joint-venture banks of the Deutsche Kreditbank (with Deutsche Bank and Dresdner Bank) faced a significant human capital problem because of their large size compounded with the commitment to guarantee most existing jobs in these banks. For a limited time, in some branches the principle of two branch-managers was used to perform the bank transformation: one manager from the West who was responsible for bank knowledge, and another one from the East who had contacts to and knowledge about local business. West German banks that started a more limited business in East Germany and therefore did not found any joint ventures, relied rather on experienced staff in existing branches in the West that was sent into the East (or on personnel having been hired after unification). Most investing western banks used a sort of regional godparenthood to spread the burden of personnel and logistical assistance to various West German branches. In the long-run the joint-venture-strategy paid-off for Deutsche Bank and Dresdner Bank because they had received both existing bank branches and an access to a broad customer base, enabling them to get a high market share in both credit and savings business. Until today those West German credit banks that had decided against the takeover-strategy and built-up their own network of branches lag behind these two banks in terms of market shares.

In contrast to credit banks there has not been any direct investment for savings banks and credit cooperatives in East Germany. This was due to the principle of regional limitations for these kinds of financial intermediaries. Nevertheless, savings banks and credit cooperatives from West Germany supported their eastern counterparts as they had an interest in the survival of these institutions in East Germany under the newly established market economy. This assistance for their counterparts was performed – similar to the Bundesbank and credit banks – by a regional godparenthood as well.[9]

Apart from private credit banks, savings banks and credit cooperatives also public banks with special functions contributed to the banking system development in East Germany (DEEG 1994, p. 24). For example the KfW and the Deutsche Ausgleichsbank supported East German firms by providing them with various credit programs. Especially KfW's contribution was significant. KfW itself had lent 20 billion DM to the East in June 1992 (which was more than just significant when considering that at this time the nine largest banks together had lent a sum of approximately 40 billion DM to non-Treuhand-firms in East Germany).[10] The credit programs of these public banks were focussed especially on start-ups and small firms that had been neglected by the free market mechanism in banking. Even today credit programs exclusively reserved for East German firms still exist. Altogether, the state highly contributed to the dynamic development of the banking business after unification (DEEG 1994, p. 37-38).

The branch presence of banks in East Germany considerably increased after the unification (see Table 1). At the beginning of the transformation East Germany was characterized by an "under-banking" compared to West Germany; yet in the course of time this difference in branch presence decreased. A lack of bank presence prevailed in East Germany, especially for credit banks and "others" in the early 1990s, whereas various branches of savings banks and credit cooperatives had already existed in the pre-unification era. Thus, in the early 1990s especially credit banks were very busy in increasing their presence in the East. Until 1996 the overall number of branches for credit banks increased in East Germany, for savings banks it was growing until 1997 and only credit cooperatives reached their highest presentation relatively early (in 1993). Later

[9] For the transformation of the different kinds of financial institutions see also DEEG (1994), pp. 9-21.

[10] For KfW-programms see KfW (2000).

on, bank presence was decreasing in East Germany – a process that had already been a general trend in West Germany as a result of rationalization, too. Interestingly, the number of branches for cooperative banks has decreased in East Germany below its pre-unification level.

Table 1:
Banks' Branches in East and West Germany, 1990-1999

Year	East Germany[a]					West Germany[b]				
	Credit banks	Savings banks	Credit cooperatives	Others[c]	Branch-density[d]	Credit banks	Savings banks	Credit cooperatives	Others[c]	Branch-density[d]
	Number of branches				Residents per branch	Number of branches				Residents per branch
1990	464	2,131	1,849	151	3,488	5,968	17,250	15,684	858	1,603
1991	606	2,478	2,213	463	2,741	6,042	17,130	15,551	3,434	1,530
1992	854	2,655	2,204	611	2,480	6,225	16,923	15,451	4,259	1,523
1993	881	2,760	2,139	631	2,433	6,255	16,750	15,286	4,417	1,539
1994	983	2,788	2,098	705	2,362	6,149	16,483	15,109	4,406	1,566
1995	1,022	2,790	2,014	5,023	1,426	6,027	16,281	14,985	19,788	1,162
1996	1,029	2,773	1,871	4,880	1,462	6,015	16,122	14,913	19,060	1,187
1997	1,002	2,805	1,777	3,880	1,624	5,840	15,946	14,799	17,137	1,241
1998	994	2,755	1,685	3,565	1,699	5,839	15,572	14,317	15,202	1,311
1999	924	2,710	1,619	3,436	1,751	5,943	14,957	14,044	14,913	1,343

a) Without Berlin; b) including Berlin; c) since 1995 postal savings have been included in bank statistics (summarized in the category "others"); d) size of population/number of all branches.
Source: Deutsche Bundesbank

Despite the banks' efforts after the unification to increase their presence East Germany still lags behind West Germany in terms of branch-density (size of population/number of branches). Certainly, the branch presence has been accelerating since 1990, and further rationalizations in West Germany could reduce the present East-West-difference. Obviously, though, a lower branch density for East Germany continues. Nevertheless, today the financial services supply in East Germany is similar to the one in the West. All financial products offered in West Germany are supplied in East Germany, too.

Table 2 and 3 entail banks' market shares for deposit and loan business since 1992.[11] For deposits market, shares were relatively stable in the 1990s, both for East and West Germany. Obviously, savings banks defended the major part of their deposits market share in East Germany and, thus, their traditional role in the former GDR for collecting savings; even nowadays the majority of deposits and other kind of savings are still held

[11] Data for 1990 and 1991 is not included in these tables because official banking statistics is not very reliable for that time due to reporting problems of branches. Moreover, until 1991 statistics is distorted by the business of the former State Bank of the GDR.

at savings banks, compared to a market share of less than 30 per cent for savings banks in West Germany. Another interesting difference is the weak position of "other banks" in East Germany compared to a deposit market share of 31 per cent in the West.

Table 2:
Market shares of banks for deposits and other savings[a] (in %)

	East Germany[b]				West Germany[c]			
Year	Credit banks	Savings banks	Coopera-tive banks	Other banks	Credit banks	Savings banks	Coopera-tive banks	Other banks
1992	22.7	59.9	16.6	0.8	20.8	32.1	21.5	25.7
1993	22.6	59.4	16.6	1.3	21.1	32.0	21.7	25.2
1994	21.7	59.3	16.7	2.3	19.5	31.9	22.0	26.6
1995	21.0	58.9	17.4	2.7	19.0	31.5	22.0	27.5
1996	21.5	58.4	17.0	3.1	19.6	30.7	21.5	28.2
1997	20.3	59.1	16.8	3.8	19.7	30.8	21.4	28.0
1998	20.4	58.4	16.5	4.7	20.3	30.7	21.3	28.0
1999	20.1	59.7	16.6	3.6	22.9	28.4	20.1	31.3

a) Domestic non-banks deposits and other savings; b) without Berlin; c) including Berlin.
Source: Deutsche Bundesbank

In contrast to the deposit business, credit banks could defend their position as the main loan supplier in East Germany, which astonishes when considering a nearly steady decrease of credit banks in West Germany for loans in the past. Another interesting result is the rise of intermediaries summarized under the term "other banks". Only a few of these intermediaries existed in the early transformation years and still today they largely ignore the savings business. For loans, however, their market shares rose above 20 per cent. Compared to West Germany "other banks" still lack importance, though. A further outcome of the banking unification is the decreasing role of credit cooperatives in East Germany in the loan business (which today is small, even compared with West Germany). Altogether, even a decade after unification the market share structure of East and West Germany still differs.

In addition to their credit and deposit business banks became also active in the privatization of Treuhand-firms. Especially credit banks contributed to this process by using their investment banking capabilities or by arranging and financing mangement-buy-outs. Moreover, banks consulted firms regarding the internal reconstruction, export chances etc.).

Table 3:
Market shares of banks for loans[a] (in %)

	East Germany[b]				West Germany[c]			
Year	Credit banks	Savings banks	Coopera-tive banks	Other banks	Credit banks	Savings banks	Coopera-tive banks	Other banks
1992	43.2	38.3	14.5	4.0	26.9	22.2	12.8	38.1
1993	37.1	39.2	13.6	10.0	23.9	22.2	12.8	41.1
1994	34.9	37.1	12.3	15.7	24.1	22.8	13.4	39.8
1995	33.6	34.5	11.7	20.2	23.9	22.6	13.4	40.1
1996	33.2	32.5	10.8	23.4	23.8	22.3	13.3	40.6
1997	35.9	29.6	9.8	24.8	23.2	22.2	13.3	41.4
1998	35.8	28.8	9.4	26.0	22.9	22.0	13.2	41.9
1999	37.7	30.6	9.7	22.0	22.5	20.9	12.6	44.2

a) Credits to domestic non-banks; b) without Berlin; c) including Berlin.

Source: Deutsche Bundesbank

Despite various efforts and activities described so far, several problems could not be avoided:

- Due to a lack of creditworthiness for a considerable part of the East German industry during the early years of transformation, banks were facing higher credit risks. Especially private credit banks accepted these risks as they were searching for market shares that would bring about profits in the future (DEEG 1994, p. 33). Moreover, the public opinion (in both East and West) demanded and expected a generous credit policy for East Germany. However, as explained before existing staff in former GDR-banks frequently lacked the knowledge for allocating credits according to profitability aspects. Also, staff from the West had difficulties in evaluating East German firms' creditworthiness in the early 1990s (all the more because of a lack of reliable firm-balances in the beginning of the transformation). This resulted for some banks in non-performing loans that had to be compensated by the banks' more profitable business in the West; in this context it is important to note that those compensations were an advantage for the takeover-strategy, since independent East German banks could not be trusted on such reserves.
- In the course of time in particular credit banks became increasingly reluctant to allocate credits because of the lack of collateral and reputation for East German firms (THIEßEN 1998, pp. 201-204). Instead of increasing interest rates banks frequently responded to higher credit risks by reducing the credit supply to a level that was not satisfying the market demand (credit rationing).[12] Thus, firms, especially small ones, increasingly faced a credit-shortage.
- While West German banks introduced their system for conducting payments, East German savings banks and the Deutsche Kreditbank continued for some

[12] STIGLITZ/WEISS (1981) have shown that banks can decrease their profitability by setting market equilibrium interest rates because this would cause a kind of adverse risk selection.

time to use their own, formerly existing payment system. This dualism caused serious delays for payments, threatening economic transactions at the beginning of the transformation (MANN 1996, pp. 50 and PUCHTA 1993, pp. 24-25).

Nevertheless, altogether the German banking unification can be regarded as a success, especially when compared to unification in other economic sectors.[13] Western banks made considerable investments in East Germany, employment in the banking business has been growing since the unification and financial services supply has converged to the Western level. Moreover, a banking system instability did not exist, and only a moderate (and short-run) increase in inflation occurred after unification. Certainly, the banking unification was implemented by a takeover of the West. Critics may object that the development of a banking system could have been accomplished entirely by East German intermediaries and that this would have been a more valuable solution. However, two aspects arguing for the takeover strategy have to be considered. Firstly, owing to East Germany's lack of banking skills a financial development without western partners would have been a long lasting process with the risk of a severe banking crisis if East German financial intermediaries banks had failed. Secondly, the aim was a unification and not a continuing separation of East and West, neither in industrial nor in financial respects. Thus, experienced and well-funded western banks were highly qualified to found a banking system. And eventually it also has to be realized that banks normally do not pursue special regional interests, they are profit-oriented intermediaries that do not discriminate between East and West.

3. A few lessons

Altogether, the German experience is an interesting case study of major issues to be considered in banking system unification. Among the most relevant lessons are the following:

- Unification can cause a non-performing-loans-problem because existing firms in the transformation economy may become bankrupt once the transformation has started. In Germany this bad debt was taken to a large extent by the government (meaning it became state debt).
- Banking unification by an overtaking of financial institutions of the less powerful country by the banks of the other one can work quite well if one of the unifying partners has strong and competitive financial institutions. Otherwise there is the risk of a banking crisis.
- Credit rationing of banks can discriminate certain companies (especially small firms and start-ups). Thus, credit supply could be one topic of transformation policy; in Germany banking unification was supported by the public credit programs and guarantees.

[13] According to DEEG (1994, p. 22) "the banking industry itself is arguably the most successful case of a restructured sector in Eastern Germany".

- The transformation of financial institutions for a market economy is favored if institutional parallels exist for the unifying countries. In Germany for example savings banks and credit cooperatives existed both in the East and in the West before 1990. Therefore, these institutions in the East could be supported by their western counterparts.
- Banks from market economies investing in a transformation economy can not just contribute to the economic development by financial services supply, but they could also consult firms (regarding the internal reconstruction, export chances etc.), too. Moreover, banks can contribute to the privatization process by using their investment banking capabilities and, this way they can prepare the ground for industrial takeovers.

However, Germany's banking system unification was carried out under specific conditions that do not quite exist in Korea. The four main prerequisites for Germany's banking unification were: (1) a state that was financially healthy enough to compensate investing western banks for bad loans that had resulted from credits to former GDR-corporations; (2) a qualified banking supervision; (3) institutional parallels between the two unifying banking systems; (4) the West German banking systems was competitive and sound, enabling it to make huge investments in East Germany. Only if these prerequisites exist in Korea, the German way of banking transformation could be a model. Thus, before applying the lessons drawn from the German experience, one needs to summarize the main pre-conditions prevailing for a Korean unification. This implies a discussion of some basics of Korean economic and bank development.

III. BANKING IN A KOREAN UNIFICATION PROCESS

1. General set-up in Korea – economic development and banking system

At the end of the Japanese rule in 1945 Korea was divided into a northern state controlled by a socialist government and a market-oriented one in the South. Since this separation the economic development has been very different for the two Korean countries, as contacts were more than limited after the end of the Korean War (1950-53).

a) North Korea

In the decade following the Korean War it was initially North Korea that profited from a dynamic economic development. Estimations about North Korea's average growth rates vary but are high and probably above 15 %. The endowment with natural resources, some existing industrial development and high investment rates favored the economic development at that time.[14] The North Korean economic policy was characterized by a

[14] Still in the mid-1960s North Korea impressed many foreign visitors. Economist Joan Robinson (see ROBINSON 1965, cited in PARK 1994 p. 119) praised North Korea as a "miraculous success" and a "nation without poverty". From today's perspective this seems to be a naive observation. Yet in inter-

steady enhancement of the state's impact on business. Consequently, in 1990 when the reform process in Eastern Europe and the USSR started North Korea remained as the most centralized-planned economy in the world (PARK 1994, pp. 112-114). Moreover, the economic policy was determined by the ideology of self-reliance (Juche). The economy should become independent from international markets (products and technology), even the influence of other socialist countries was limited. A further important feature, mainly since the 1960s, has been the high priority for military affairs, withdrawing resources from the industrial sector.[15] As a consequence, since the 1960s North Korea's economic development has been stagnating. The country became increasingly isolated and its technological gap to other countries grew, contributing in a severe food-shortage in the 1990s.

As the entire economy of North Korea its banking system was also created to a large extent according to the model of Russia and partly China. In 1946 58 existing financial institutions were nationalized and converged to the Central Bank of the Democratic People's Republic of Korea. Since then this bank has been serving both as the central bank and a credit bank by regulating money supply, offering a nationwide payment system,[16] financing and controlling organizations and corporations, serving as a depository institution and offering insurance. Each state organization, corporation and cooperative possesses an account at the central bank that strictly depends on the government and allocates funds according to state plans and priorities.

In the course of time the North Korean banking system was complemented by specialized banks and some other financial institutions. The Foreign Trade Bank (built in 1959 as an international branch of the central bank for foreign exchange transactions) and the Industrial Bank (built in 1964) can be regarded as specialized banks. A few further banks do exist, pursuing activities that are partly dubious or unknown abroad. Interestingly, a few joint-ventures exist (under Japanese and Hongkong influence) that have

national comparison North Korea showed a significant development progress making Robinson's statement more credible. At that time North Korea profited from an important characteristic of a centralized-planned economy, meaning the state could determine the national investment rate (and, thus, could set investments higher than they would be in a market economy – this contributed already in the 1930s to high growth rates in the USSR). In the 1960s South Korea copied this policy by restrictions that reduced private consumption and favored industrial investment.

[15] The increase in military spending since the early 1960s was caused by different reasons, among them a deteriorating relationship with the USSR, the China-Soviet-rift, the Cuban missile crisis and the estabishment of a military government in South Korea. Moreover, North Korea participated in the Vietnam war (LEVIN 1982, cited in PARK 1994, p. 118). According to estimations, the North Korean forces comprise today approximately 2 million soldiers. In view of a population of approximately 22 million this means that nearly 10 % of North Korean residents belong to the army – the percentage among adults is, of course, much higher.

[16] Here it is important to note that – as in many other socialist economies – only products for private consumption (by private individuals) are transfered via financial payments while the exchange of goods between corporations is non-cash and performed financially via the central bank (KIM 1994, pp. 157).

functions such as attracting foreign exchange and technology transfer. Moreover, there is a Unification Promotion Bank and a postal savings system that was built in 1957, working independently from the central bank but not from the state (KIM 1994, p. 155). The banking system was completed by credit cooperatives controlled by the state since their nationalization in 1946.

There have not been any banking system links with South Korea so far. However, despite recent developments other kinds of economic relations with South Korea are more than just limited, too. Consequently, at present there exits only a weak basis for a cooperation and unification process. The "sunshine-policy" of Kim Dae-Jung and the reply of Kim Jong-Il could change this.

b) South Korea

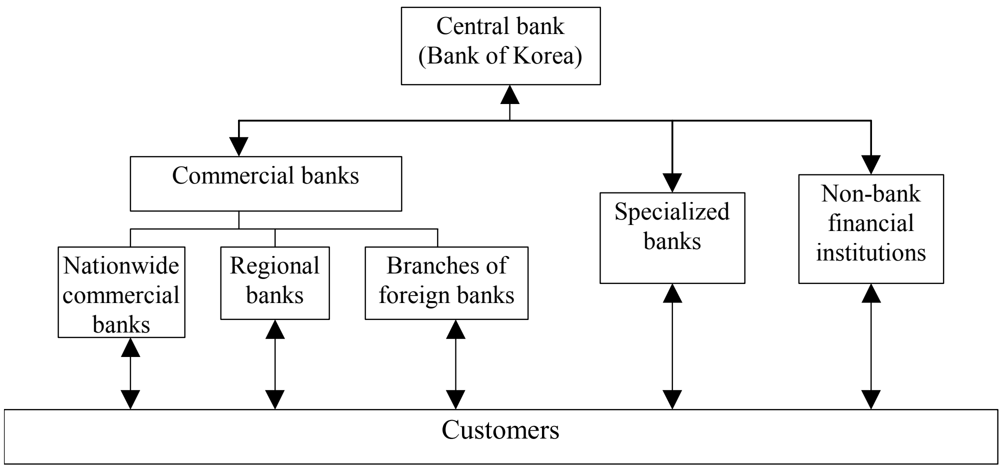
During the 1950s and still in the 1960s South Korea's economic development lagged behind the North Korean one, due to a weak economic management in the early political leadership in South Korea and, moreover, to the unfavorable pre-conditions for economic development (because of South Korea's low industrial level in the 1950s and its lack of natural resources). In 1961, though, a new military government established the system of a market economy that was containing the notion of a strong state that influenced economic developments via five-year-plans. Even today economists still discuss the controversial question of how efficiently this system of industrial policy worked. Banks frequently allocated "policy-loans" into weak and failing investments. However, government-restrictions for private consumption made industrial investments flourish. Thus, despite frequent misallocation economic development was highly dynamic and impressive even in comparison with other Asian countries. Yet this process was financed by huge investments that called for high savings. In fact, one generation being forced by the government to refrain from consumption must live in poverty to enable the following generations to profit from prosperity.[17] At present South Korea differs from other industrialized countries in the West, not really because of a much lower level of income but rather a still existing preference for state influence in the market process. Considering from this perspective South Korea resembles Japan.

For financial intermediation, South Korea possesses today a diversified system comprising various banks and non-bank financial institutions. This structure mainly developed in the early 1960s when the military government came into power. This regime assigned the financial system, and especially banks, a decisive rule for implementing industrial policy. In the early 1960s the few already existing banks were nationalized and various further banks have been founded since then, among them nationwide commercial banks,

[17] Nowadays, reminiscences of former poverty are still existent for the older generation, whereas today's wealth is considered as normal by their children or grandchildren.

several specialized banks (acting in specific economic sectors, such as export, agriculture, industry, housing etc.), regional banks and branches of foreign banks that started business in 1967. Apart from that, numerous non-bank financial institutions were founded.[18] Figure 3 summarizes this structure.

Figure 3
Banking system structure in South Korea (including non-bank intermediaries)



In the course of time the importance of these different institutions was changing, a process that was not the least influenced by a reformed regulative environment. The first liberalization measures were launched in the early 1980s with the foundation of some private nationwide commercial banks and the formal privatization of existing state-owned nationwide commercial banks (yet the government continued to influence these banks, and owing to less restrictive regulations on non-bank financial institutions the banks' market share was decreasing). In the 1990s the liberalization process was accelerated: Interest rates were liberalized and banks were given more independence for credit allocation. However, due to the structural weakness in Korean industry (especially at some large chaebol with dubious diversification in the past), the resulting weakness of banks and non-bank financial intermediaries, a current account almost continuously in deficit in the 1990s and last but not least an alarming increase of short-term debt, South Korea was involved into the Asian crisis in late-1997.[19]

A serious economic downturn in 1998 was following. Many corporations became insolvent and as a consequence various banks and especially non-bank financial institutions as well. Under the pressure and the financial assistance of the IMF the newly-elected

[18] For an overview see BANK OF KOREA (1998).

[19] For an analysis of the causes for Asian crisis see FLYNN (1999). For South Korea's debt – long-term and short term liabilities – see table A1 in appendix.

government initiated a restructuring process. A public assistance fund was founded the task of which was to rescue the banking as well as the financial system from bankruptcy. Furthermore, the Korea Asset Management Corporation (KAMCO) became responsible for selling bad loans to the market. Due to the mergers and closures the number of banks and especially non-bank financial institutions was decreasing,[20] staff was reduced and the shareholder structure of various banks changed; some banks received foreign partners.[21] The banking supervision now performed by the Financial Supervisory Commission (FSC) and the Financial Supervisory Service (FSS) was considerably improved[22] and a deposit insurance was introduced. However, despite all these efforts the process of financial restructuring is not finished yet. The ratio of non-performing loans is still high for banks and also for non-bank financial institutions (see table 4).

Table 4:
Asset quality of banks and other financial institutions in South Korea (December 2000)

	Bank	Non-Bank	Insurance	Securities	Total
Total loans (A) (trillion won)	526.1	43.2	44.5	7.6	621.4
Substandard and below loans (B) (trillion won)	42.1	14.7	3.8	4.0	64.6
B/A (per cent)	8.0	34.0	8.5	52.6	10.4
Net substandard and below loans[a] (in trillion won) (C)	17.1	8.0	1.4	1.5	28.0
C/A[b] (per cent)	3.4	21.9	3.3	29.4	4.8
Non-performing loans[c] (in trillion Won) (D)	29.5	14.2	2.5	4.0	50.2
D/A (per cent)	5.6	32.9	5.6	52.6	8.1

a) Total substandard and below loans – loan loss provisions.

b) (Total substandard and below loans – loan loss provisions) / (total loans – loan loss provisions).

c) Includes all loans overdue for more than 3 months and non-accrual loans.

Source: Financial Supervisory Service

Some further data regarding South Korean banking is shown in table 5. As one can see, the overall capital ratio of banks has improved considerably, yet some banks still do not

[20] See table A2 in appendix for institutional restructuring.

[21] For example in the case of commercial banks, two years after the crisis the number of banks (formerly 33) decreased to 23 and staff was reduced by 34 per cent. Moreover, various non-bank financial institutions – especially merchant banks (that had been highly involved in the crisis) – were closed, suspended or otherwise dissolved.

[22] For example since April 1998 all those banks failing to meet the 8%-capital adequacy ratio (according to the Bank for International Settlement) have become subject of "prompt corrective actions" (automatic suspension, merger, liquidation etc.).

meet the BIS capital ratio of 8 per cent; also, owing to still existing problems in the industrial sector (many corporations, including some chaebol, are still in trouble) a new increase of non-performing loans could be possible, which would further deteriorate the capital-ratio of banks. Moreover, due to writting off non-performing loans the overall profitability of banks is still negative, whereas the reduction of banks' staff has stagnated (after a considerable decrease in 1998 when the restructuring process started). Various banks are still burdened with excessive staff while lacking simultaneously qualified personnel. Many bank managers have not changed their attitude and continue behaving more like state officials than profit-oriented bankers. Thus, a new round of financial restructuring and reforms is on the way.

Table 5:
South Korea's domestic commercial banking system

	Capital ratio (per cent)		Return on assets (per cent)		Staff (number of persons)	
	Nationwide commercial banks	Regional banks	Nationwide commercial banks	Regional banks	Nationwide commercial banks	Regional banks
1996	8.97	10.15	0.23	0.47	83,749	20,164
1997	6.66	9.60	-0.90	-1.17	94,065	19,929
1998	8.22	8.31	-2.99	-5.83	64,830	10,847
1999	10.79	11.36	-1.42	-0.11	-	-
2000	10.75[a]	11.19[a]	-0.53	-1.07	64,759[a]	8,642[a]

a) March 2000.

Source: Financial Supervisory Service

Altogether, in banking terms South Korea is still suffering from structural and human resource problems, which would be serious obstacles if the unification process will be initiated very soon. Nevertheless, despite existing problems it has to be acknowledged that the restructuring in South Korea was executed faster than in other countries involved in the Asian crisis. Already in 1999 South Korea returned to a high growth rate (10.7 %).[23] Thus, in spite of the recent decrease of economic growth it seems that the economic distance to North Korea will further increase.

2. Strategies for unification

a) Gradualism versus shock – the general strategy for unification

As shown in section II, Germany's banking system unification can generally be considered as a success story. However, the prerequisites for the German unification in 1990

[23] See table A3 in appendix for a summary about South Korea's present economic situation.

were quite different from those in the Korean banking system at present. Out of the prerequisites identified in section II. 3 Korea's debt level (state debt) may be regarded as the most favorable requirement. Thanks to a present debt/GDP-ratio of less than 40 per cent,[24] which is low in comparison to Asian and even European countries, there is still space for government action to compensate those South Korean banks facing an increasing bad loan problem when investing in North Korea (prerequisite 1). Yet in contrast to Germany South Korea does not have a tradition of a qualified banking supervision. Certainly, as described before, as a result of the financial crisis South Korea had considerably improved its banking supervision but it is very doubtful if this step will make it already possible to meet future lending practices in a reformed North Korean banking system (prerequisite 2). Furthermore, Korea cannot really profit from some institutional parallels between the two banking systems. At present North Korea lacks much more financial institutions that could be unified or cooperating with counterparts in the South than East Germany during unification (prerequisite 3). Yet the most important difference between the German banking unification and a Korean one at present would be the absence of a sound banking system in South Korea. Despite government efforts for financial restructuring, both South Korean banks and non-bank financial institutions are still burdened with non-performing loans and structural weaknesses, such as personnel overcapacity (while suffering at the same time from a lack of professional banking capacities) (prerequisite 4).

Yet there are not only differences between the German past and the Korean future unification in terms of banking. One can mention two further, more general obstacles to a unification in Korea requiring a different overall unification-strategy compared to the German one:

- The ratio of North Korean to South Korean population is approximately 45 to 20 million at present, meaning it is much less favorable than the German one (which was 60 to 16 million in 1990); compared to the German case this implies a higher financial burden on each South Korean citizen.
- There is lack in reliable data regarding North Korea's economic output, although it can be assumed that the gap between the South and North Korean economic development is considerably higher than the German economic disparities in 1990; again this will demand further sacrifices from South Korean citizens.

In addition, there is another difference that might be the decisive one: the existence of a unification experience. Whereas the Germans have started their unification without any useful example from the past,[25] the Koreans do have the chance to learn from the German model. And because of this German example (resulting in high financial obligati-

[24] See table A4 in appendix.

[25] There was the example of the Vietnamese unification in the 1970s. However, this was not just a unification of two agricultural economies. Unlike the German unification, the Vietnamese one resulted in a transformation of a market-oriented system (in the South) into a socialist economy.

ons and a weak East German economy even a decade after unification) the Koreans are today much more realistic about unification prospects than the Germans, who had rather naive expectations in 1990. Moreover, the general solidarity between North and South Koreans might be less intense than the one among the Germans in 1990 due to civil war experience (1950-1953) and a long cold war period; in contrast to Korea, there has never been any kind of military conflict between the two German states and thanks to frequent visits of West Germans in East Germany (which became relatively easy in the 1970s) it was possible to maintain an inner-German solidarity.

Altogether, considering the high costs of the German unification and the continuing transformation deficits in East Germany (in terms of productivity, income and employment) the German model does not seem very attractive to the Koreans. That is why the people in South Korea are much less enthusiastic about a future unification. Nevertheless, most of them agree on a cooperation with the North, which might some day bring about unification, as long as this implies a very gradual process. It can be assumed that the government in Seoul will resist against any fast political, economic and social integration as it has happened in Germany – even if the government in Pyongyang would ask for it. The present economic disparities would cause unification costs exceeding probably South Korean willingness and ability to spend. However, the length of time and the course of the unification in Korea do not entirely depend on South Korean preferences. A sudden collapse of the Pyongyang government could result in a migration to the South, which may force the government in Seoul to take responsibility for North Korea and implement a relatively fast unification process. A government collapse in Pyongyang may, at present, not seem very realistic. However, what will happen if the North Korean economy will worsen yet further?[26]

Consequently, there can be different scenarios for unification, depending on the economic and the political stability in the North. In the following sections two different scenarios will be analyzed. One of them is based on the assumption that the situation in North Korea will remain stable. The other scenario assumes a soon collapse of the socialist rule in Pyongyang, which would result in a less gradual process of unification.

b) Banking cooperation in a gradual unification process – scenario 1

A gradual process of unification allowing a long-term transition for the North Korean economy could be implemented in a political confederation or a special economic zone in the North, which will be transformed gradually (ELI 1996, p. 48). Even a Chinese-like unification as in Hongkong may be a choice ("one country, two systems") for a limited period of time with a full integration of the two economic systems later on. In the

[26] In East Germany the government seemed to be very stable until summer of 1989, too, but within just a few months the climate was changing totally and eventually the government was forced to resign.

following section a gradual transition process of the North Korean banking system is sketched, and it will be shown how banks from South Korea may contribute to this process.

For the transformation of the North Korean socialist banking system into a market oriented one, a reform process with different stages is recommended. First of all, the institutional structure for a market oriented banking system has to be created (stage 1). Then, a gradual increase of domestic banking competition has to be achieved by liberalizing financial intermediaries market conduct (stage 2). In this phase foreign capital inflows should be allowed, in a regulated manner, though. Finally, financial intermediation could be opened to foreign capital inflows by liberalizing capital account restrictions (stage 3).[27] In the end a full unification between the two Korean banking systems could be implemented. The velocity of this banking system transition depends on the speed of the overall transition in the North Korean economy.

Table 6 summarizes some major reform measures necessary for the different stages of transition in North Korea (including possible South Korean contributions to this process – the complex matter of banking restructuring in South Korea is not analyzed in this section but will be of course a major prerequisite for a Korean banking unification). All reforms mentioned in this summary are important but the most critical one will be probably the creation of a strong and efficient system of banking supervision. Without this supervision the other measures of financial liberalization described in table 6 could cause practices of excessive risk taking and fraud among banks and other intermediaries, which would threaten the economic stability (including the political acceptance for the entire reform process).[28]

As learnt by the example of the German unification institutional parallels can have a favorable effect on the unification of banking systems, meaning in terms of institutional reforms that new laws and institutions introduced in the future North Korean banking system should be the same or similar to those existent in South Korea at present. This is another reason why South Korea should be involved in a North Korean banking reform process. Also, macroeconomic stability is a further "must" to implement a successful financial liberalization.[29] In general this implies a consistent macroeconomic policy,

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[27] For the sequencing of financial system reform see VILLANUEVA/MIRAKHOR (1990), BISAT/JOHNSTON/SUNDARARAJAN (1992) and FRY (1995), pp. 461-471.

[28] A special case of lack of supervision and resulting fraud on financial practices was the transformation process in Albania. However, fraud and weak credit management as a consequence of a lack of supervision was observed in various reforming countries – both in the transformation process in Eastern Europe (in the Czech Republic just recently), in the former Soviet Union and in reforming developing countries (or emerging markets), too. Frequently, these banking problems resulted in a general economic crisis.

[29] See e.g. McKINNON (1993).

especially with regard to monetary and exchange rate policy and – in this transformation context – a successful privatization process as well.

Table 6:
North Korean banking transition and South Korean assistance

	Reform measures in the North Korean banking system	Contributions of the South Korean banking system[a]
Stage 1	Reforming existing financial institutions to commercial banks (e.g. via privatization) and foundation of further commercial banks as well as other financial intermediaries to receive the structure of a competitive banking business (these institutions can be private, half private or run by local communities depending on the overall speed of economic transition)	South Korean banks can consult existing northern financial institutions with respect to commercial banking practices. Moreover, South Korean banks can invest in North Korean financial institutions
	Foundation of development banks to overcome credit shortage of special groups (because of credit market failure such as credit rationing)	Consulting assistance from South Korean specialized banks and development institutions
	The central bank hands over its functions as a credit bank to the newly arising commercial banks and other intermediaries	Assistance by the Bank of Korea
	Enabling the central bank to fulfill its monetary functions by introducing sufficient monetary instruments	Assistance by the Bank of Korea
	Establishing a system of prudential supervision with (a) a strong supervising institution and (b) regulations forcing intermediaries to act soundly and avoid excessive risk taking (e.g. by introducing single borrower limits)	Consulting services of South Korean supervision capabilities (Financial Supervisory Commission, Financial Supervisory Service)
	Introduction of a deposit insurance (yet in order to avoid moral hazard a limited deposit insurance is recommended)	South Korean consulting service
Stage 2	Liberalization of interest rates	South Korean consulting service
	Abolition of remaining government influence on banks' credit policy (without restrictions that guarantee solvency-oriented credit conduct)	South Korean consulting service
	Careful allowance of foreign capital inflows and foreign banks' activities	South Korean consulting service
Stage 3	Liberalization of remaining capital barriers and full entry for foreign banks	South Korean consulting service

a) An additional South Korean contribution – which is not part of banking system transformation – could be, similar to the German unification experience, the financing and consulting of North Korean industrial privatization by banks from the South.

The South Korean contributions to the banking transformation in North Korea in the right column of table 6 disclose some lessons that can be learnt from the German unification – despite differences in the prerequisites mentioned in the former section. One of them is the way West German banks have contributed successfully to transform existing socialist banks in East Germany into market-oriented banks via a system of "godfatherhood". South Korean banks could act as such kind of godfather for existing intermediaries in North Korea. However, due to present banking deficits in South Korea these contributions may be limited. This is a further reason why South Korean banks should be restructured and catch-up with Western banking competitiveness as soon as possible or in other words: The more competitive the South Korean banking system will be at the time of unification, the more successful the banking transformation in North Korea could be implemented.

As a preparation for the above described reform process in North Korea, it would be wise to make contacts with northern financial institutions now. The South Korean government should encourage banks to engage in the North. However, this requires an agreement from Pyongyang about this kind of external influence, making this an issue for negotiations between Seoul and Pyongyang in 2001. In fact, North Korea can improve domestic financial intermediation by allowing external assistance (not just by South Korean assistance but also by the help from other countries).[30] Therefore, it will be necessary that South Korean banks as well as foreign banks open representative offices in the North to consult local institutions. Additionally, a limited credit business for southern and foreign banks would promote the reform process and in this way contribute to an economic recovery in the North. Another improvement would be the opening of representative offices of North Korean financial institutions abroad, at least in South Korea. Also, an exchange of central bank staff between Seoul and Pyongyang should be implemented in order to increase mutual knowledge and confidence.

Altogether, if a unification can be started a gradual transition process in North Korea is both realistic (since the government in Pyongyang is rather stable at present) and recommended (because of economic disparities between North and South Korea including southern banking problems). In this section some major characteristics have been sketched to prepare for or to implement this sort of gradual transition. However, despite the present political stability in North Korea, a fundamental change cannot be precluded. If the situation in Pyongyang collapsed, there would hardly be another choice for South Korea than to contribute to a dynamic transition. A major reason for this need is migration, which has to be prevented.

[30] For possible reforms see also KIM (1994), p. 176.

c) Banking takeover in a dynamic unification process under foreign assistance – scenario 2

Seoul is located very close to the inner-Korean border, making the South Korean capital highly attractive for emigrating North Koreans. If the border was opened in the same way as the Berlin Wall in November 1989, a migration could occur, which would be much stronger than the one in Germany. And considering the high population-density already existent in South Korea, and especially in Seoul, a migration from the North could hardly be handled. Therefore, it can be assumed that the South Korean government will make an effort to keep the border closed or at least allow only a limited immigration. However, this will increase the responsibility of the South Korean government with respect to a participation in a dynamic transition process in the North that would enable the northern part to catch-up with the South Korean economic development in the long-run.

In case of a sudden North Korean collapse the necessary reform measures would not be very different from those described in table 6, though the speed might be much higher. Thus, parallels to the German banking unification would be more existent, too. South Korea would be forced to make an effort to implement a successful banking transformation to stabilize the North Korean economy. This implies a kind of takeover of the North Korean banking system by the South, which may resemble the German model from 1990. Yet this process could only be executed successfully if the present weaknesses in the South Korean banking were overcome or were be compensated by other sources. Such compensation could be foreign assistance by international institutions as the World Bank and the IMF or direct investments of foreign banks in North Korea. The latter case would mean that a reform measure proposed in the former section for the later phase of transformation should be implemented earlier.

Aid by the World Bank and the IMF could be given in both financial and technical respects (credits and for example consulting services for establishing a banking supervision or efficient development banks). These international institutions would play the role West Germany's government (including the Bundesbank) had acted in 1990. Similarly, foreign banks could ease the burden of South Korean banks in the transformation of North Korean financial institutions and, thus, would take on a part of the role West German banks played in 1990. In fact, foreign banks could significantly contribute to an efficient financial development in North Korea, as it is known by South Korean experiences that foreign banks can allocate funds more efficiently than domestic banks due to a highly educated staff that is more independent from government orders than domestic bankers (MÜLLER 2000). However, a free competition of the foreign entrants might be favorable in terms of a more competitive and efficient banking system, yet local citizens and politicians will not always agree to this foreign influence. Moreover, it is also known by South Korean experiences that foreign banks wish to focus business on just a few market segments (large corporations and foreign corporations) and neglect major business fields like small and medium corporations or private individuals.[31] Consequently, foreign banks cannot act as a substitution for strong domestic banks. In addition, the entrance of foreign banks implies serious risks for the banking stability as long as existing domestic intermediaries are burdened with bad loans, excessive staff, a lack of banking knowledge etc.[32] Thus, a symbiosis of foreign and domestic institutions in the form of joint ventures is recommended. Here different choices or combinations to found new banks or to restructure existing intermediaries are possible: joint ventures between (1) North Korean banks and foreign banks or (2) North and South Korean banks or (3) South Korean banks and foreign banks.[33]

All this could contribute to a competitive banking system in North Korea that is unified with the South Korean one. Of course, it will not be easy to attract sufficient investments and international aid but without these contributions the prospects for a North Korean financial and economic development would be even more uncertain.

IV. CONCLUSION

The successful example of German banking unification is hardly suitable to serve at present as a model for the banking unification in Korea. The situation in Korea is in several respects quite different from the German one. Especially South Korea's still remaining problems in the banking sector exemplify a serious obstacle, which demands a more gradual strategy. Nevertheless, the German experience could be used for the Korean unification – but with care.

The German banking unification has proved that a transformation could be achieved successfully if the government is able to provide financial compensations, if a strong banking supervision exists to avoid weak lending practices, if there are institutional parallels between the unifying banking systems and if finally one of these systems is financially healthy enough to execute the unification. Obviously, South Korea has to reinforce and complete its own banking restructuring to improve the prerequisites for a unification. Otherwise, if the unification already takes place before the restructuring is

[31] For a comprehensive investigation of foreign banks' performance in the South Korean banking system see MÜLLER (1999).

[32] In several Central Eastern European countries (the Czech Republic, Hungary, Poland, Slovenia, the Slovak Republic) governments were highly reluctant to allow foreign competition as long as internal problems in domestic financial institutions were not solved – however, a too strong restriction on foreign banks' entry hampers the banking system restructuring due to a lack of competitive pressure for existing intermediaries (BORISH/DING/NOËL 1997, pp. 49-77).

[33] A further possible construction could be a joint venture between North and South Korean as well as foreign banks.

completed, a comprehensive international assistance would be an unavoidable ingredient to implement banking unification. Thus, the main lesson with respect to the unification time is the following: The sooner the Korean unification occurs (or the weaker the banking system in South Korea is at the moment of the unification), the greater will be the need for an external assistance functioning in a similar way like the strong West German banks and the West German state in East Germany in 1990.

So far it has been assumed that the two Korean states would come to an agreement about a unification or a political change, which would make a soon transition process necessary. However, even if both countries will not agree on unification a banking cooperation would be suitable to promote a cooperation in the industrial sector. In fact, it is not entirely a question of unification or not to cooperate in both financial and industrial terms. As neighboring regions both Korean states have significant incentives to cooperate. And due to the shortage of financial resources in North Korea as well as significant investment risks for South Korean corporations investing in the North, an economic cooperation should be accompanied by sound banks.

Consequently, it will be a further – and major issue – for political negotiations between the two Korean administrations to involve banking (or the financial system) into economic cooperation. At present this seems to be a very difficult job, in particularly owing to the still remaining structural problems in the South Korean banking systems, but also to an overall skepticism regarding commercial banking in the North. Nevertheless, it is a job that has to be done.

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APPENDIX

Table A1:
Total external assets and liabilities (in billion US$)

Year	Total external liabilities	Long-term liabilities	Short-term liabilities	Total external assets	Net external assets
End of 1997	159	96	64	105	-54
End of 1998	149	118	31	129	-20
End of 1999	135	98	38	146	11
End of 2000	136	92	44	167	31

Source: Ministry of Finance and Economy

Table A2:
Status of institutional restructuring end of August 2000 (in number of intermediaries)

	Existing institutions in Dec. 1997 (A)	Type of resolution			Institutions newly established (C)	Operating institutions (A-B+C)
		Exit	Merger	Total (B)		
Banks	33	5	6	11	-	22
Merchant Banks	30	18	3	21	-	9
Securities Companies	36	6	-	6	13	43
Securities Investment trust Companies	31	7	1	8	4	27
Insurance companies	45	5	7	12	1	34

Source: Bank of Korea

Table A3:
Major economic indicators

Year	GDP growth rate (per cent)	Unemployment rate (per cent)	Inflation rate (per cent)	Current account (billion US$)	Foreign exchange reserves (billion US$)
1997	5.0	2.6	4.5	-8.2	8.8
1998	-5.8	6.8	7.5	40.5	48.5
1999	10.7	6.3	0.8	25.0	74.1
2000	9.0	4.1	2.3	11.0	96.2

Source: Financial Supervisory Service

Table A4:
Government debt/gross domestic product (GDP) in 2000

	Initial government debt/GDP (in per cent)
Indonesia	83.3
Korea	33.9
Malaysia	52.5
Thailand	62.6

Source: SALOMON SMITH BARNEY (2000)