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A Case Study of Illicit Foreign-Currency Finance at Korean Firms in the Development Era (1962-96)*

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Korea's economic growth in the Development Era (1962~1996) was phenomenal. However, the growth was largely financed by debt capital: net capital inflow from abroad for the whole economy and bank loans for industrial firms. Overall demand for loans was so huge that various abnormal techniques, legal or not, had to be utilized to circumvent the tight government regulations and to take the maximum amount of loans from commercial banks. In most cases, the techniques were jointly developed by general trading companies and their prime banks. This study illustrates various techniques of illicit foreign-currency finance including advanced negotiation of L/Cs, intra-corporate D/A, intra-corporate red-clause L/Cs, loans with a forward contract, loans from written currency options, and others in the grey area. This case study is prepared on the basis of the author's first-hand experience and additional research, for the purpose of shedding some light on financial stringency in Korea as a fast-growing economy and ingenuity of firms to overcome it. The author does not intend to denounce or criticize any party referred to in the study.

Key Words: Illicit finance, loans in disguise, financial engineering, regulated financial market, Development Era in Korea

Ⅰ. Introduction

The World Bank once praised fast-growing Asian countries including South Korea with the name HPAEs (high performing Asian economies) and called such a performance "miracle" (1993). As for Korea, the average growth rate was more than 8% per annum (PA) over the Development Era (1962~1996). Korea's performance in those years may deserve the name miracle in general and "the Han-River Miracle" in particular.

One limitation was that like other HPAEs Korea's economic growth had largely been through input increases rather than productivity enhancement. Somewhat ironically, only one year after the World Bank report, Paul Krugman rejected the HAPE idea by calling Asia's growth strategy a "myth" (1994). Unfortunately, Krugman's evaluation turned out to be closer to the reality than the World

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Bank's: some of the once-praised Asian economies hit a wall in 1997. Korea also experienced a serious economic setback and had to come through the so-called "IMF *satay*" (IMF calamities).

There are two ultimate inputs in the modern economy, i.e. labor and capital. Korea, a populous country, did not have any problem in increasing the labor input. However, all through her agrarian history until the beginning of 1960s, Korea had accumulated virtually no capital. Like it or not, the government had to rely on borrowed capital from abroad, sometimes called "foreign savings," in order to achieve its challenging growth goals. The government, in a sense, chose to take the shortcut skipping the steady-but-lengthy process of accumulation of domestic capital. Intended or not, this approach resulted in promotion of big firms called *chaebol*: the government gave them the privilege to borrow money from commercial banks (e.g. Tcha et al. 2003). In this regard the government could not wait until small firms grew so as to help develop the economy or until big firms created internally-generated capital, namely, profits, so as to be used as their expansion capital. In such a case, the theme "Big is beautiful" naturally became a national paradigm and chaebol firms put themselves in borrowing binge in order to become big fastest (*cf.* Korean government 1997).

More specifically about the capital mobilization from abroad, state agencies mobilized foreign currencies through syndicated loans from international financial markets or financial packages from international institutes. Such funds were relayed to commercial banks so as for the latter to make loans to industrial firms (*chondaychaguan* 전대차관). (See Glossary of Teaching Note for key Korean terms.) In addition, some large firms could borrow long-term capital directly from abroad with a payment guarantee of the Korean government (*cf.* BOK 1981, Ch. 5). At the firm level, individual chaebol companies almost solely relied on debt capital from outside in supporting their excessively-speedy expansion, which was also the national agenda. That was even more so because the government and the firms paid little regard to profitability of targeted businesses and because, as a result, few firms made meaningful *profits* which might be retained inside the firm and used as the expansion capital (e.g. H. Lee 2004 for episodes; Y. Lee 2005 for statistics).

As a natural consequence of over-expansion, most chaebol firms were desperate for funds not only as the working capital but also as the investment capital (e.g. Korean government 1997; Tcha et al. 2003). Most funds were for the short-term because the long-term capital market was not active in the Development Era. In essence, the competition in the financial markets was for short-term loans ("money" hereafter) from banks or other financial institutions. Firms paid little attention to the duration or the rate of loans as the saying "*changdan-pulmun, komli-pulmun*" (장단불문, 금리불문) went.

This author had an opportunity to closely watch foreign-exchange operations at the Foreign Exchange Department (FX Dept.) of DW Corp., one of the big general trading companies (GTC), for 15 tumultuous years from 1977 to 1992. The role of FX Dept. was largely two-fold: collection of foreign currencies originated from exports, also called *negotiation* of export bills of exchange, and; creating *de-facto* foreign-currency loans. In terms of *overall* contribution to money that the firm needed, the department was much smaller than the local-currency department (*Chagom-bu* 자금부). In terms of *marginal* contribution, however, the department was no less critical to the firm's CFO. That was because the local-currency loans were very conventional and their availability was largely a matter of power game among the firm, the commercial bank, and the government, while the foreign-currency loans were hidden and required ingenuity for their creation. I come back to the power-game nature of the local-currency funding.

This essay is a case study about "innovative" short-term foreign-currency loans at large Korean firms which is prepared on the basis of my first-hand experience and further research where needed. I describe various techniques of foreign-currency finance, which were *mostly illicit*. Some were popular among large exporting firms while others were unique to DW Corp. Some were initiated by foreign banks in Korea, notably CT Bank. Others were invented at DW. One commonality is that all the illicit finance was denominated in a foreign currency and accordingly the foreign-currency appreciation rate should be a part of the financial cost.

Here, I do never intend to denounce any party or criticize government policies. I would like to let readers know something hidden in Korea's economic history. As a matter of fact, deceptive finance is not a uniquely-Korean phenomenon. Financial frauds of some type are everyday news all over the world. The Enron scandal was one and the Ponzi scheme by Bernie Madoff was another. The history of illicit finance is as far back as that of finance itself. Adam Smith describes cases of drawing and redrawing on a fictitious receivable (1776, pp.337-41). Charles Kindleberger also shows the case of salad oil tanks filled with water (1996, p. 54, 66). Stories of Smith and Kindleberger are especially amazing in their similarity to what I describe in this study.

In the next section, I explain financial markets in the Development Era. In the ensuing five sections, I describe most notable illicit financial methods, one after another. In Section VIII, I add some minor techniques. Section IX is to close this study. All names of industrial firms and commercial banks are disguised.

II. Financial Markets in Korea

I make a quick review of the financial markets of Korea. I focus on interest rates and

exchange rates which help understand why chaebol firms in general and DW in particular were so deeply indulged in illicit foreign-currency finance (*cf.* Ahn 1991; Ahn and Chiang 1985).

2.1 The Money Market

The Development Era is identified with the seven consecutive Five-Year Economic Development Plans from 1962 to 1996. By definition, a national economic plan is all about resource allocation by the government. The Korean government played the role of allocator particularly through a firm grip over the commercial banks. As an unintended consequence of the government intervention, the financial markets became multi-tiered and largely opaque (e.g. Korean government 1997; see also H. Lee 2004 for various episodes).

2.1.1 Official loans

Eligible (*chockyok* 적격) firms, especially chaebols, could borrow money from banks at specified rates under several programs. There was the general loan (*ilbanday* 일반대) in the Korean *won*, to a very limited extent, to be used as the general-purpose working capital. There were the export-promotion loans (*suchul-komyung* 수출금융) in the *won* but at a more favorable rate than the general loan. This was automatically available to letters of credit received by exporters for their working capital requirements in the whole process until shipping goods on board. There were facilities for *negotiation* of export bills of exchange (see Section III). The discount rate at negotiation was set at 1% point or so over the bankers' acceptance (B/A) rate (*cf.* BOK 1981, p.146). Some foreign-currency loans (*wayhua-daychul* 외화대출) were available to strictly limited uses such as imports of capital goods to be used in production of export goods (*cf.* BOK 1981, p. 277). In this last case the interest rate was about 1% point over the LIBOR. Some key rates in those years are shown in Table 1.

2.1.2 The curb market

The average households and marginal firms did not have access to the official money market. They had to rely on private lenders, mostly wealthy individuals or companies of such people. This informal and unofficial loan market was also called the "curb market." There were no regulations for the market, inasmuch as it is unofficial, and the interest rate was determined by the *market force* so to speak. The loan demand was so high during most of the Development Era that the interest rate was usually kept at 2~3 *% per month*, or 27%~43% PA. The interest was to be paid literally *monthly*. In some extreme cases, the interest was paid daily (*yilsu* 일수) at an astronomical annual rate.

2.1.3 Compensating balance

Because of the big gap in rate between the

〈Table 1〉 Interest and Exchange Rates

(All rates per annum)

Year	₩ interest rate (range)		U$ interest rate (year-end)		Exchange rate (year-end)			
	General Loan	Internal Benchmark①	Bankers' Acceptance (3 months)②	LIBOR (3 months)	₩/$ ③	% Δ ④	¥/$	% Δ ④
1977	(19.6)*	Unavailable	6.81	7.19.	484	--	240.02	--
1978	(20.5)*	Unavailable	10.24	11.82	484	0.0	193.05	-19.6
1979	(25.5)*	Unavailable	13.09	14.81	484	0.0	239.50	24.1
1980	19.5~24.5	20.0~21.0	16.62	17.19	659.90	36.3	202.87	-15.3
1981	16.5~19.5	20.0~21.0	13.06	12.13	700.50	6.2	219.62	8.3
1982	10.0~13.5	Unavailable	8.19	9.31	748.80	6.9	233.85	6.5
1983	10.0	Unavailable	9.23	9.40	795.50	6.2	231.50	-1.0
1984	10.5~11.5	Unavailable	8.01	8.97	827.40	4.0	250.30	8.3
1985	10.0~11.5	15.0~16.0	7.62	8.06	890.20	7.6	200.65	-19.8
1986	10.0~11.5	15.0~16.0	5.74	6.44	861.40	-3.2	160.00	-20.3
1987	10.0~11.5	15.0~16.0	6.77	7.44	792.30	-8.0	123.35	-22.9
1988	10.0~13.0	14.0~16.0	8.93	9.31	684.10	-13.7	124.90	1.3
1989	(15.5)**	14.0~16.0	7.97	8.38	679.60	-0.7	143.97	15.3
1990	(18.5)**	14.0~20.0	6.96	7.58	716.40	5.4	134.55	-6.5
1991	(19.0)**	16.0~19.0	3.97	4.25	760.80	6.2	123.50	-8.2.

* CP discount rate (year-end) **Corporate-bond yield (year-end)

Note ① Internal benchmark rate: According to DW's CFO

② Export-bill discount rate: Bankers' acceptance (B/A) rate + 1.0%, as the rule of thumb

③ The *won*-dollar exchange rate

1945. 10 ~ 1964. 5. The fixed rate system

1964. 5~1980. 2. The unitary fluctuating rate system (BOK: "practically fixed")

1980. 2 ~ 1990. 2. The dual currency-basket system

1990. 3 ~ 1997. 11. The market-average rate system

1997. 12 ~ Present. The floating rate system

④ The annual appreciation rate of $ against ₩ and ¥ respectively

Sources: The Bank of Korea, FRB of St. Louis, and DW Corp.

official loans and the private loans, there was fierce competition for the privileged bank loans. Often, the lending bank required a compensating balance (*koki* 꺾기) in time deposits of the borrowing firm. The combination of the loan and the forced deposits made the effective rate substantially higher and the loan amount much smaller than those explicit in the loan agreement.

2.1.4 Emergency loans

Of the three types listed above, chaebol firms seldom went to the curb market not because of the high rate but because of the stigma of going there. When all else was not enough to honor its daily liabilities, a chaebol firm must beg its prime bank for emergency loans. These were special but not quite unusual as banking practices in difficult times.

One solution was paying a check returned to an empty account with a check drawn on another bank. Not to mention, there was no cash balance at the second bank. It was *empty for empty*, as it were, a practice called *tahipday* (타입대). Honoring the second check is a job

for tomorrow, not today. In the corporate life of "treading on the thin ice," tomorrow was future. In this process, the firm has to pay the overnight interest to the first bank at an extremely high penalty rate. Of course, there were ordinary overdraft facilities (*tangjuachawol* 당좌차월) at the banks but their size was too small and their effects on the financial condition were like "pissing on a frozen foot," a popular cliché around those days.

Another vehicle was a temporary loan called *ilsiday* (일시대) dated backward. The CFO or other high executive of a firm visited the residence of the branch manager of the bank (to which checks had returned) late in the night or early in the next morning to beg for a two-day loan to go over the "night" solvent. Counting both end-dates as the loan period was one of the popular banking practices around that time. Then, a 50% PA rate was literally possible, interest for *two* days at a penalty rate for an *overnight* loan.

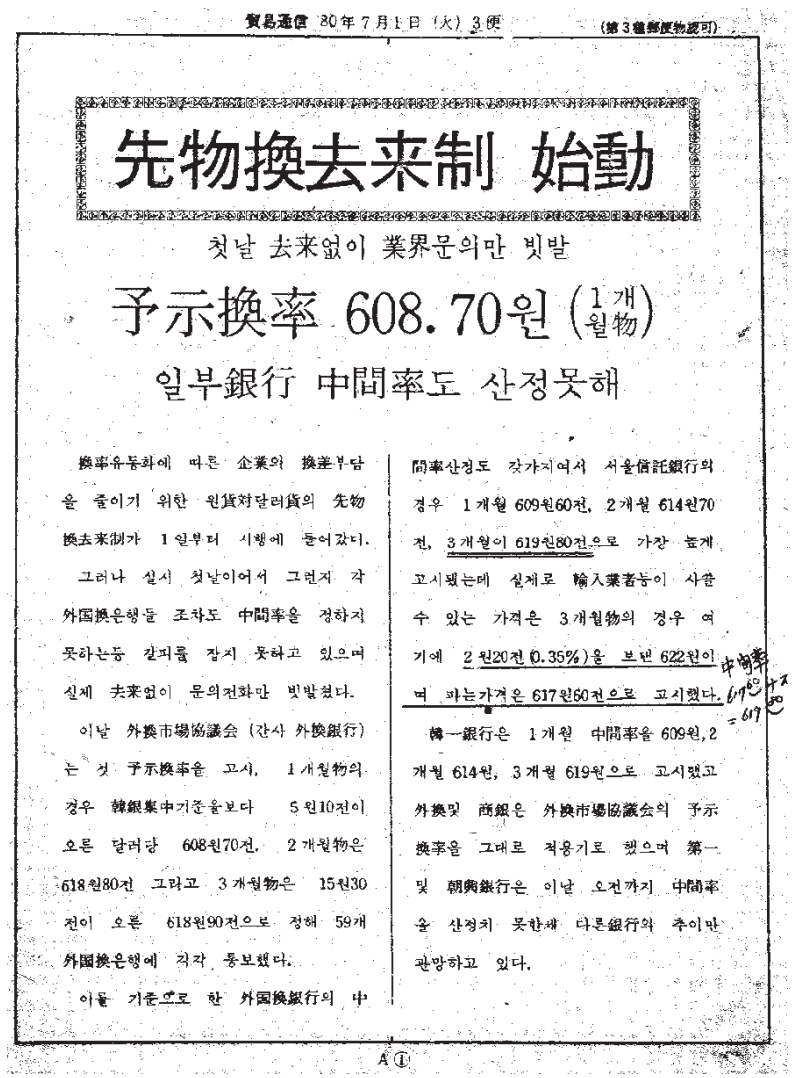
The bank supervisory board pretended not to know anything about those irregularities. The reason was that all, the government, the banks, and the firms, were on the same boat: if a big firm was to go under, so would its prime bank, and; the whole economy would follow suit. Incidentally, slowing-down of the economic growth, not to mention a national bankruptcy, was a thing that the whole Korea had to avoid at all costs.

2.2 The Foreign Exchange Market

All through the Development Era but for a few years up to the 1988 Olympics, the US dollar was the single scarcest resource in Korea because almost all the international trade, including the absolutely-required foreign capital for growth (the trade deficit), was in the US dollar. The *won*-to-dollar exchange rate was fixed or otherwise determined by the government. All the foreign exchange was to be centralized to the Bank of Korea: exporters to sell the dollar (against the Korean *won*) to a commercial bank to the central bank, and; importers to buy the dollar form a commercial bank from the central bank. In other words, the central bank was to clear the foreign exchange market at the designated price (*wayhuan chipchung-je* 외환집중제).

Up to the end of 1970s, the exchange rate was fixed at a par value, subject to a change once in a long while. Since January of 1980, the rate *varied* once every morning according to the "dual currency-basket system." Regardless of the name, the rate was determined more or less discretionally by the government until February 1990. Then, the Bank of Korea started to announce, early every morning, the daily exchange rate which was calculated as to be the market average of the previous day. It was not until December 1997 that the government made the exchange rate really "floating." The rate was *moving in a trend* from 1980 to 1997 rather than floating, as compared to the volatile yen-to-dollar, for instance, movement.

The Korean *won* is *not* a convertible currency yet. Therefore, dollar-*won* forward contracts are not theoretically viable because forward trade presupposes free convertibility of funds form one currency to another. Undeterred, the Korean government announced a plan to "establish" a market for such forward contracts in April of 1980. In preparation for the



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이날 外換市場協議会 (간사 外換銀行)는 첫 予示換率을 고시, 1개월物의 경우 韓銀集中기준율보다 5원10전이 오른 달러당 608원70전, 2개월物은 618원80전 그리고 3개월物은 15원30전이 오른 618원90전으로 정해 59개 外国換은행에 각각 통보했다.

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Source: Photo copy of KITA Daily Newsletter (Korea International Trade Association)

Main contents: The dollar-*won* forward system went into effect as of today (July 1st, 1980). Commercial banks, the supposed market makers, do not seem to have clear ideas what to do. There were many phone calls from firms querying about the new system, but no deal was made in this first day of trading.

〈Figure 1〉 A News Service Reporting the Forward System

new initiative, Ministry of Finance conducted simulations of the dollar-*won* forward trade utilizing the existing network of Korea Exchange Bank in June of the same year. (This author took part in the simulations in person.)

The dollar-*won* forward system was officially launched in July 1980 but the plan went to nowhere (Figure 1). The idea of a forward market for the inconvertible *won* was still-born as it should have been. Even today there is no dollar-*won* forward market for everyone's reach. I come back to the forward trade mechanism in Section VI.

2.3 Comparative Financial Costs

As to be discussed in detail in Section VI, the accounting currency of Korean firms is the Korean *won*. As a result, any loan in a foreign currency, say, the US dollar, entails exchange-rate risk, that is, the *uncertainty* in the financial cost due to fluctuation in the exchange rate. The effective total cost from a dollar loan is the sum of the nominal interest rate and the dollar appreciation rate against the *won* ("% Δ"), and is not predictable beforehand. The total cost could be very high when the dollar appreciated rapidly against the *won* as in the early 1980s (Table 1).

III. Advanced Negotiation of L/Cs

In addition to the overall shortage of money as explained earlier, there were a couple of additional reasons for the popularity of illicit *foreign-currency* loans. On the one hand, general-purpose foreign-currency loans were prohibited only because the Korean government was wary of short-term foreign debts or "hot money" (e.g. BOK 1981, p.25). On the other hand, the financing cost in the dollar was much lower, without any exchange risk, than in the *won* until the beginning of 1980 when the exchange rate first started to vary.

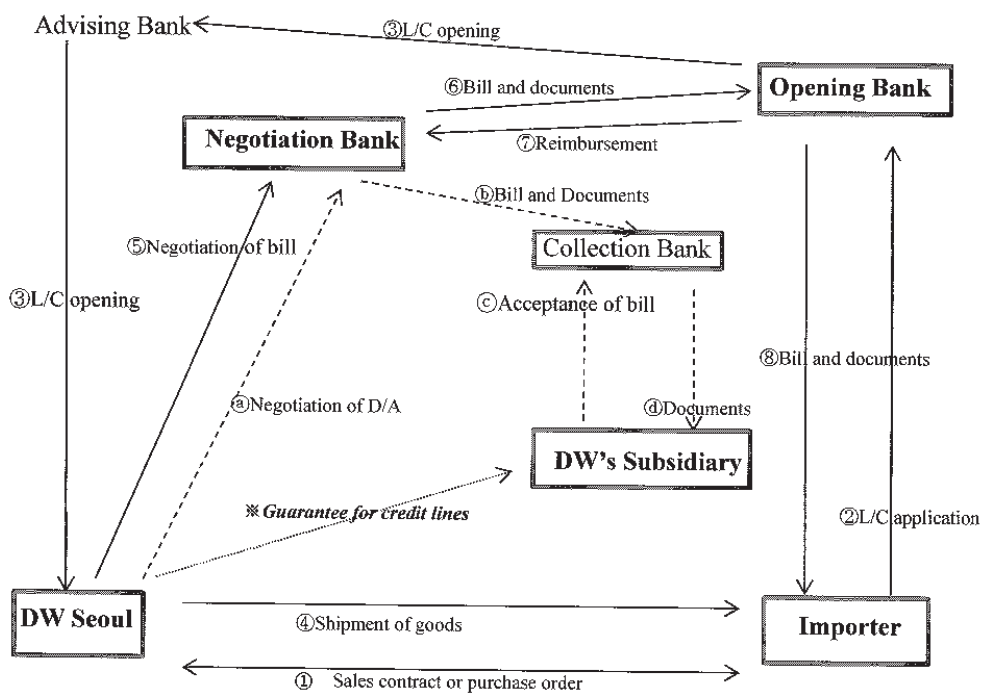
Of all types of illicit foreign-exchange finance, advanced negotiation of L/Cs was the single most popular method and was practiced by most export firms and with almost all Korean commercial banks. The fraud was so prevalent that the government should come up with two extraordinary measures in order to discourage it along the way.

3.1 Letter of Credit and Its "Negotiation"

The international trade payment is often guaranteed with a ***letter of credit*** (L/C) from the importer's bank. After shipment, the exporter issues a bill of exchange accompanied by shipping documents as stipulated in the L/C. As long as the documents are "clean," the opening bank is *obliged to honor* the bill (a process called reimbursement). Then, there is no reason why an exporter's bank may decline to discount such a guaranteed bill. The discounting process of the export bill by an exporter's bank is called "negotiation" (or NEGO for short in Korea). The process of in-

ternational payment through a L/C is sketched in Figure 2 (in solid lines). By nature of the whole process, negotiation is possible only when the shipment has been made and all documents have "cleanly" prepared. This is what keeps the L/C scheme sustainable.

One of Korea's growth strategies was export promotion, as in every other HPAE. In that regard, a letter of credit received by an exporting firm was a financial free-pass: automatic export-promotion loans, privileged licenses to import raw materials and other related goods, and negotiation of export bills of exchange. Such negotiation is equivalent to foreign-currency finance for a month or so to the exporter: two weeks for mailing the bill of exchange to the opening bank and another two weeks for recognition by the NEGO bank of the reimbursement from the opening bank. It was quite natural that the Korean government



1) ***Typical L/C process***: ① ~ ⑧, where ⑦Reimbursement is guaranteed by the opening bank for a clean bill of exchange. The role of the advising is limited to notification of the L/C.

2) ***Intra-corporate D/A***: ⓐ ~ ⓓ, without any commitment or guarantee of a bank. The payment totally depends on the two parties of the trade. The role of the collection bank is very passive.

3) ***Intra-corporate red-clause L/C***: The foreign subsidiary opens a red-clause L/C within a credit line rendered by a local bank. The credit line becomes available on the basis of a back-to-back ***guarantee*** (※) from the head office in Seoul. Under a red-clause L/C, the exporter may negotiate a bill for the full L/C amount before shipment. This in effect is a short-term loan facility.

〈Figure 2〉 Payment Process in International Trade

make it mandatory of commercial banks to negotiate export bills of exchange. Consequently there was fierce competition among commercial bank for "negotiation performance" record (NEGO *siljok* 네고실적).

3.2 Advent of the A/D NEGO

I started watching the FX Dept. of DW Corp. a GTC in January 1977. The prime job of the department was collection of export proceeds through negotiation of bills of exchange. The first surprise I came across was with the term *powan soryu* (보완서류 "complementary documents") for already negotiated bills. Initially, I thought the term might mean documents *resubmitted* after correction of errors and mistakes which were found *ex post*. The term was not limited to such cases; it also included some missing documents. This time around, I thought some documents such as an inspection certificate were in the mailing process after due issuance. The term did not stop there, either: some documents had not even been issued at all. Then, the related bills *should not* have been negotiated because late-dated documents cannot be "clean."

Not long after, I could get a broader picture what was really happening between DW and Korea F Bank, its prime bank. That was *negotiation in advance*, before shipping documents were ready or even before shipping of goods on board. There came the advanced negotiation of L/Cs or "A/D NEGO" as it used to be called. The practice was so popular and prevalent that firms and banks did not even need a pseudonym for such apparently fraudulent transactions. The benefit to the firm of A/D NEGO was straight forward: an extra short-term loan for a few days or more, sometimes a lot more. That for the bank was two-fold: an additional business opportunity of "international finance," so to speak, and one-time uplift in the negotiation performance record. After all, the A/D NEGO was mutually beneficial as the popular saying "What is good for my sister happens to be good for my brother-in-law" went.

3.2.1 Financial conditions of the firm

DW Corp. was the flagship and export window of the DW group. Its export volume grew rapidly to five billion dollars around 1990. The annual sales were several trillion *won* (7 billion dollars or so). On the one hand, by the nature of its business, the gross margin was very slim and smaller than one percent in many cases (*cf.* Ahn and Chiang 1985) and consequently the firm could hardly make a profit. On the other hand, it created and expanded all types of businesses, home and abroad (e.g. *Monthly Chosun* 2001). As a result, DW had to borrow money from all possible sources. Its debt was half the annual sales and the average funding cost was one of the highest of all major firms: a few percentage points higher than the general-loan rate (Table 1).

3.3 In-house Printing of Shipping Documents

People break rules for their own benefit. And, rule breaking is habitual, contagious and addictive.

I suspect that the A/D NEGO had been invented for the first time in Korea around the middle of 1970s jointly by DW and Korea F Bank. First, the founder chairman of DW had been famous for his financial ingenuity (*cf.* Kraar 1992). Second, the DW Group had been in the most desperate need of money primarily due to its expansion, more precisely over-expansion from hubris (e.g. *Monthly Chosun* 2001). At any rate, once the A/D got started, it was next to impossible to stop. So, the *habitualness*.

Around 1977, the A/D NEGO was already popular covering most GTCs and some smaller exporters. Almost all nation-scale commercial banks and some smaller regional banks took A/D NEGO as an implicit-nonetheless-official policy. In a word, the A/D NEGO had become a general banking practice since the late 1970s (e.g. H. Lee 2004. p.351). This is the part of *contagion*: as someone does something unlawful, so does everyone else.

The *addiction* stage: on the one hand, the A/D period, the gap between the negotiation and the preparation of a clean set of documents, got ever longer at DW; on the other hand, DW limited the A/D NEGO to Korea F Bank at first but extended it to many other banks later on.

The reliance of Korea F Bank on DW was so heavy that the former could not help pandering to the latter's wish through the process. As of early 1977, the A/D period was relatively short. The goods were shipped but documents were not completely ready yet. As time went by, un-shipped L/Cs were negotiated one after another. Finally, there came the "list NEGO" around the turn of 1980s. DW simply gave a list of shipping schedules with the *expected* amount of bills of exchange and relevant L/C numbers. The total amount of negotiation on the list was determined by the firm CFO on the basis of his daily funding plan. In the beginning the list covered soon-to-be shipped lots of goods, but it gradually became more or less arbitrary.

How did the firm prepare copies of shipping documents for the record-keeping files at the negotiating bank? That might be easy once you start a fraud and you have a typewriter. For the bank file of each negotiation entry, the FX Dept. of DW, together with the shipping department, prepared a copy each of the following four types of documents: L/C, invoice, packing list and bill of lading (B/L). There was no problem at all for the first three: DW had received and held numerous L/Cs, and; invoices and packing lists were DW's documents from the beginning. Securing copies of B/Ls was not a big issue, either, because DW had gotten large inventory of blank forms of B/Ls from various shipping companies in Seoul. On certain Sundays, managers of the two departments called in female typing clerks, all high-school graduates, to make up neces-

sary documents according to directions of male workers, all college graduates, who were also called in. All they needed to do was filling in blanks of the three types of forms, that is, invoices, packing lists and B/Ls.

3.3.1 Ballooning A/D balance

The A/D NEGO was effectively short-term US dollar finance. DW later on had to present the real bill of exchange to the bank with a similar amount with the negotiation entry. The bank got paid back by the opening bank when the latter received the bill of exchange accompanied by clean shipping documents. Needless to say, there used to be a gap between the negotiation amount and the final settlement. DW and the negotiation bank reconciled the difference, whether "over" (a surplus) or "short" (a deficit), afterwards. The gap between the "due" date according to the official record and the actual reimbursement by the opening bank was covered with a "delay charge" from the firm at a rate slightly higher than the negotiation rate.

The average "A/D balance," which is equivalent to the loan outstanding, of DW Corp. grew speedily over the years and reached the 100 million-dollar benchmark in the middle of 1980s. The balance represented negotiation of some 30 days in advance in average when the yearly export total on the L/C basis was a little over one billion dollars.

From time to time, Korea F Bank complained the outstanding balance was too large. In a particular occasion in the late 1970s, DW had to arrange a special "renegotiation" facility with Korea E bank so that this second bank might overtake from Korea F Bank more than 10 million dollars of A/D balance. The renegotiation consisted of tens of individual shipments. The book entries at Korea E Bank were so arbitrary and messy that it took a couple of years for the two parties (DW and E bank) to reconcile all the differences between the A/D entries and the real shipments (and subsequent reimbursements by the opening banks).

3.4 Blind Eyes of Bank Inspectors

Like everywhere else, Korean banks are subject to periodic inspection by the bank supervisory board. And, the negotiation files were one of the most regular targets for inspection inasmuch as the A/D NEGO was an open secret. How did banks and firms cope with inspections? First strategy of all was for a corporate executive to entertain the inspection team, for instance, in a whiskey-drinking party with young hostesses partnering at a "room salon." Sometimes including the case of DW, the entertaining executive was an ex-member of the supervisory agency. Often the inspectors were former subordinates of such an executive.

On the part of the negotiating bank, there were two technical problems: one was the negotiation record files and the other settlement reconciliation or managing the gaps in date and amount between the negotiation entries

and the actual reimbursements.

A negotiation file was to consist of copies of the L/C and key shipping documents (form DW), and a correspondence letter and a mailing receipt from the post office (on the bank side). DW's documents were prepared as explained earlier. On top of that, members from the FX Dept. double-checked all the negation files at the bank days before the *planned* inspection. (Without exception, DW got the information in advance when the inspection team was arriving at its bank.)

The correspondent letter was to be written by the negotiating bank and could easily be prepared. How could the bank secure the mailing evidence? Where there is a will, there is a way: the bank mailed a short note to the opening bank advising that goods would soon be shipped and thereby secured the required receipt. Incidentally, some opening banks appreciated the unusual service while others were intrigued what was happening. Still others were perplexed as the gap between the prior advice and the shipment got longer and as this strange practice repeated.

Finally, there was no way to change the reconciliation records. Fortunately, however, the reconciliation job was done at another department of the negotiating bank. Inspectors almost never checked the reconciliation side.

At any rate, if any inspector had been serious, he (never she) could have found a mountain of irregularities in both the negotiation files and the reconciliation records. Never mind: firms had entertained the inspectors and the latter turned blind eyes to the fraud. If the inspectors were to return to their office empty-handed, their boss might suspect they were negligent in doing their job. Here again, there was a handy trick: the inspected, the bank and the firm, prepared *in advance* a few negotiation entries with minor violations such as a wrong shipping mark on the invoice or late-dated inspection certificate, for example, and led the inspectors to those files. Then, the inspectors could proudly return to their office with some spoils in their hands.

The government did not fall completely asleep at the switch. In one case in the beginning of 1980s, the government created a new rule that the shipping company should issue an "original copy *for negotiation*" of the B/L and the bank should keep it in the file. (For each individual shipment, the bill of lading is issued by the shipping company in three negotiable copies and many non-negotiable ones.) In another case shortly thereafter, the government required that the bank keep the "original copy *for negotiation*" of the export permit (*suchul myonjang* 수출면장) from the customs office. Ironically, these *uniquely*-Korean practices evidence how prevalent A/D NEGO was in the Development Era.

These times again, finding the way out was not difficult. One was multiple negotiations of a shipment across different banks, one genuine the others fake (A/D). Another tactic was partial shipments from the same export permit. In both cases, the inspected could have enough time to prepare clean files because one set of

documents at one of the banks was clean and because the inspected knew when the inspectors were coming. At the time of inspection, DW had already switched clean sets of documents for sham ones in the bank files.

3.5 Bankers' Acceptance

Commercial banks relied on bankers' acceptances (B/A) to refinance their loans in the form of A/D NEGO to firms just like regular negotiation. And, the B/A is the very basic and popular inter-bank trade finance for 90 days or so. It was almost automatically available to Korean negotiating banks in the international financial markets. In substance, the B/A finance on the basis of fake bills of exchange was nothing other than hot money that the Korean government wanted to tightly control.

Ⅳ. Intra-Corporate D/A and F-D/A

Exporters may accept the payment method of ***D/A, documents against acceptance***, and D/P, documents against payment, when the importing party is particularly trustworthy. These are contracts without a bank guarantee. Because the international settlement can be made only through the banking channel, all types of bills of exchange should be presented to the importer through banks. In case of D/A, the importer's bank (collection bank) may release the accompanied shipping documents when the importer *accepts* the bill of exchange, a process of acknowledging the obligation and promising on a particular day in the future to pay for the bill (Figure 2, dashed lines). In D/P, the collection bank can deliver documents to the importer only against payment of the bill.

The exporter's bank may or may not negotiate a bill of exchange on the D/A or D/P basis depending on the exporter's credit. Nonetheless, negotiation of D/A or D/P by a commercial bank was a sure thing in Korea where the NEGO *siljok* was critical.

4.1 Intra-corporate D/A

DW was *the* frontrunner in incorporating a local subsidiary in major business centers in the world including Singapore, London, New York, LA, Frankfurt, and Paris under such a name as DW (America) Corp. or DW Handels GmbH. There were few limitations to making an intra-corporate D/A contract and DW made quite a lot of them. The payment term was minimum 180 days and often extended many times over.

As the baseline, an intra-corporate D/A facility for longer than 90 days is itself a foreign-currency loan from the negotiation bank. In light that the credit term in *commercial* trade is rarely longer than 90 days, DW in theory can enjoy free cash for 90 days, for instance, if the payment term is 180 days after acceptance.

DW's reliance on the intra-corporate D/A was much more intensive as well as extensive

than in ordinary commercial trade or at other Korean chaebols. First, the sum total of D/A NEGO outstanding, which effectively is a loan balance, from DW's banks reached tens of millions of dollar around the year 1980. Second, almost no D/A bill was paid on time by a foreign subsidiary. Some subsidiaries including DW Panama or DW Lagos had never paid for the bills. Too old negotiation entries at the banks were "refunded" by DW Corp. itself or paid by another subsidiary in the major financial center, such as London or New York, in lieu of the indebted subsidiaries. In the latter case, the money was mobilized through local borrowings (*hyonji komyung* 현지금융) under the guarantee of DW Seoul the parent company.

In the late 1970s, there was a rumor that some desperate firms shipped rocks instead of cement, for example, on the ocean vessel. And, there were other rumors similar to that (e.g. BOK 1981, p.443). Personally, I do not know that was applicable to DW. Instead, I strongly suspect that some goods were shipped, especially to developing countries in 1980s and transition economies in the early 1990s, with little regard to the market condition of the importing country. Put it differently, some goods stayed in the warehouse until they became obsolete. From such so-called "push-out" exports (*mironayghi suchul* 밀어내기 수출), DW got at least two benefits: one was the critical export performance record as for a GTC and the other additional foreign-currency loan opportunities.

4.2 Forged D/A Documents

If DW had to rely on A/D NEGO at any rate, why did the company not try to avoid unnecessary hassles? An idea in that regard occurred to the FX Dept. in the middle of 1980s and was immediately accepted by the executives in charge. Then and there invented was the F-D/A, which was a code name, as it were, for negotiation of completely forged D/A documents. The process was something like this. (1) DW negotiates a set of shipping documents on the intra-corporate D/A basis with Korea E Bank. DW submits the B/L copy and the export permit for negotiation to E Bank. (2) A few days later, DW negotiates the same shipment with Korea F Bank with all fake documents, everything being a copy of what submitted to E Bank. (3) Some 360 days afterwards, or even later in some cases, DW pays back its liability to F Bank with money from itself or a subsidiary in London or New York.

The F-D/A had several merits over the A/D NEGO in general. First, the size of the shipment was relatively big, usually millions of dollars or occasionally even more than 10 million dollars apiece. Accordingly, one D/A shipment was equivalent in amount to tens of smaller L/C shipments. The number of items to manage was incomparably smaller: so was the workload. Second, many things were under the control of DW including full discretion in making the D/A contract, favorable timing and size of the fake negotiation, and longer

terms of credit. The long D/A terms were especially beneficial. For example, one loan for 12 months is equivalent to 12 loans for one month each. Third, types of documents under the intra-corporate D/A were the fewest, not requiring inspection certificate, marine insurance policy, country of origin certificate, and the like. Last, coping with the bank inspection was easy: simply to borrow the original copies of B/L and export permit from E Bank and make the negotiation files at F Bank look perfect.

In May of 1991, the branch manager of F bank visited DW's CFO and expressed his concerns about the snowballing D/A balance which had just surpassed the 200 million-dollar "credit line for D/A negotiation." Around that time, DW's D/A balance at all its banks was more than 300 million dollars, out of which F-D/A amounted to 90 million dollars.

4.3 Funds at Foreign Subsidiaries

It might not be surprising that none of DW's foreign subsidiaries made a substantial profit if they were often used as the warehouse of pushed-out exports (*cf. Monthly Chosun* 2001). Anyway the two subsidiaries in London and New York played the role of DW's global financing centers. They could borrow money only on the basis of a payment guarantee from DW Seoul, often backed up by a standby L/C from Korea F Bank or Korea E. Bank. A large percentage of the borrowed money was sent back to Seoul in the form of payments of D/A, F-D/A, red-clause L/Cs (Section V below), and Exim loans (§8.2 below) (*cf. Chosunilbo* 1999; *Monthly Chosun* 2001; *Chosunilbo* 2005; WSJ 2006). As a matter of fact, abuse in various types of intra-corporate finance called *hyonji komyung* was prevalent nation-wide and the government was well aware of it (BOK 1981, pp. 439, 443-4; see also H. Lee 2004 for specific episodes). The single purpose of all types of abuse was to bring foreign-currency borrowings of subsidiaries back to Korea.

V. Intra-Corporate Red-Cause L/Cs

DW's financial ingenuity did not let the red-clause L/C framework unutilized. A ***red-clause L/C*** allows the exporter to issue the bill of exchange before shipment. Documents the exporter is to present to the bank together with the bill are a receipt of the full L/C amount and an invoice describing goods to be shipped. After the negotiation, the exporter pays back the advance with shipping documents. Shipment of goods can be partial and the final balance may be paid back in cash. Not to mention, this arrangement is so favorable to the exporter that it appears too good to be true.

DW was DW, and fully utilized red-clause L/Cs when needed and possible. The L/C was for five to ten million dollars in general—a big foreign-currency loan at very favorable interest rate. One notable point was that, as

anyone can imagine, in DW's case the importer and L/C opener was one of its foreign subsidiaries. Not to mention, the L/C opening facilities of the subsidiaries were available only with a guarantee from the head office (Figure 2, the dotted line tagged with ※). In every regard, it was an intra-office loan in the US dollar. At any rate, a few months after negotiation, DW started shipping to the subsidiary until the expiry of the L/C, which was usually six months after receipt of the "loan."

The Korean government knew the red-clause was effectively a short-term foreign- currency loan, which it would not like to see swell. There was a penalty for cash repayment as a way of discouraging red-clause L/Cs. The fine depended upon the size of the cash repayment. In a certain occasion in 1977, the FX Dept. received a notice from the Seoul District Court telling DW to pay three million *won* as fine for the cash payment under a certain red-clause L/C. The department spotted a miscalculation of the fine: the court took the repayment in kind (about two thirds of the five-million-dollar advance) for the cash repayment. Acknowledging the error, the court reduced the fine to one million *won* later on.

DW did not use the red-clause L/C from the early 1980s largely because of tighter regulation by the government that had been alarmed by abrupt increases in the nation-wide receipts of such L/Cs (*cf.* BOK 1981, pp.331~4).

Ⅵ. Loans with a Forward Contract

The Korean *won* is not yet a convertible currency. No matter what the stipulation in the Foreign Exchange Act is, even today not to mention in the 1980s, no Korean firm will dare to borrow in a foreign currency from abroad without a nod from Ministry of Finance. In practice, this inconvertibility means that commercial banks have been prohibited from making commercial loans in a foreign currency. By definition, a commercial loan is for a year or less and to be used as the general-purpose working capital. Nonetheless, DW borrowed *de-facto* foreign-currency loans on a consistent basis from foreign banks in Seoul.

The ***forward contract*** is the most traditional and the most basic management tool for price risks including the exchange-rate risk. For example, you can fix *today* in your accounting currency the value of a future receivable denominated in a foreign currency by selling the foreign currency at the forward rate. The FX forward contract is a phone-call away from any foreign bank in Seoul for any pair of major currencies. And, the forward rate is determined by the interest-rate differential between the two currencies exchanged. However, the dollar-*won* forward market is not active as explained in Section II.

6.1 The Loan Structure

There was the Seoul branch of CT Bank, an important overseas operation from the perspective of its head office in New York. CT Seoul had a pool of funds in the dollar supplied from NY, either in type A ("*kap kigom*" 갑기금) for the long-term or in type B ("*ol kigom*" 을기금) for the short (*cf.* BOK 1981, pp. 213-4), in addition to self-generated retained earnings. Quite naturally, CT, both the branch and the HQ, wanted to make loans in the dollar. This is primarily because where possible conducting business in one's own accounting currency, the US dollar in case of CT, is the very basic in the exchange-risk management. Moreover, the Korean *won* was all but certainly to depreciate against the dollar (*cf.* Table 1). Accordingly, loaning in the Korean *won* would be a sure thing to lose money from CT's perspective.

Fortunately or unfortunately, circumvention of the FX Act, which prohibits loans in the US dollar, was not difficult for CT. First, CT has globally been known to be extraordinarily innovative in finance. Second, the bank was very powerful vis-à-vis the Korean government and could get an easy excuse for an exploitation of loopholes in the regulatory framework or even for minor violations of rules.

Incidentally, DW Corp had been one of CT's largest customers, both in Korea and globally. First, both the firm and the bank were famous for their "aggressiveness," which is a Korean-English term for conducting ethically questionable, if not outright illegal, things (e.g. Kraar 1992; *WSJ* 2004). Second, DW was the most ready of all chaebols to accept high-rate loans. It may not have been a sheer coincidence that the chairman of CT Corp. wrote a "personal message" to the DW founder in the opening page of the latter's autobiographic book (*cf.* Kraar 1992).

Early in the year of 1980, CT approached DW Corp. with a loan for ₩5 billion (5,000,000,000 *won*) in a special scheme. DW gladly accepted it and the total volume quickly increased to ₩15 billion in four tranches. The loans were in general for three months, and renewable at the preset rate of a foreign currency of DW's choice: 22% PA in the US dollar, 15.875% the Deutsche mark, 12% the Swiss franc (*Sfr*), or 11% for the Japanese yen, as of the middle of 1980 for instance. (The first such loan was made in March when the Korean *won* had just started varying daily in value, for the first time in history, against the US dollar.)

Each loan consisted of two separate agreements. One was an ordinary loan agreement in the Korean *won* at around 19.5% PA, in the case of loans in 1981. The other was a shadow forward-exchange contract where DW was to sell a foreign currency for the *won*. The notional amount of the foreign currency for the forward contract was equivalent to the *won* loan. The forward rate was determined, by CT not by the market, so as to adjust to the currency-specific interest rate offered by CT. The following is an illustration of a loan for three billion *won* for three months:

① The loan agreement:
₩3,000,000,000 at 19.5% PA
② The forward contract:
DW to sell *Sfr*9.030.000 at ₩338.63/ *Sfr*
where
*Sfr*9,030,000 ≒3,000,000,000/332.40
- Spot rate: ₩332.40/ *Sfr,*
- To sell *Sfr* three moths *forward*: 338.63
=332.40 × {1 + (0.195 - 0.12) × 3/12}
③ The effective interest rate:
12% PA in *Sfr*

The loan agreement is nothing special, but the forward contract requires some supporting documents according to the FX Act. At any rate, the two, the loan and the forward, jointly represents a foreign currency loan to the firm and brings in the foreign-exchange risk and may increase the financing cost. I address these issues in order.

6.2 Hedge or Speculation

Korea's FX Act has been super-restrictive under the so-called positive system (*cf.* Ahn and Chiang 1985; Ahn 1991). Even today, a firm has to show evidence of a *real demand* (*silsuyo* 실수요), such as an export contract, for a foreign-exchange trade with a commercial bank (§10 of the FX Act 외국환관리법 in 1980 and §11 외국환거래법 in 2017). In the 1980s, a firm should submit a copy of E/L (export license), I/L (import license) or something similar to them before making a forward contract. The purpose of such tight control by the government was two-fold: to prevent capital flight and to discourage speculations in the FX. Both rationales were understandable in the 1980s, if not now, because Korea had long been in chronic deficiency of the US dollar and because financial derivatives were very new to the whole Korea.

According to the text-book principles of FX management, a party is to *hedge* a FX position (exposure) with a forward contract or another type of derivative. For example, when DW has a receivable (a long position, +) in the Swiss franc (*Sfr*), it is to sell the franc forward (a short position, -). With the two combined the effect of any movement in the franc washes out. This is what the real demand principle in the FX Act is all about: only when DW has a long position in the franc from its international trade, it can sell the franc forward. That is what the government *intends* in the Act or the "spirit" of the Act.

DW Corp. was one of the largest GTCs and had lots of E/Ls and I/Ls, most of which were in the US dollar. However, those in a third currency were as rare in 1980 as an endangered species. As such, DW did not have E/Ls in the range of million *francs* which is required as in the above illustration case. Never mind, CT found a convenient way out: DW to submit I/Ls in the dollar (short in the dollar) in lieu of E/Ls in the franc (long in the franc). CT's logic was that a firm could buy the US dollar forward (long in the dollar) with such a third currency as the Swiss franc (short in the franc) in preparation for payment of import bills in

the dollar (short in the dollar). In other words, a firm might transform the U$-to-₩ foreign-exchange risk into the *Sfr*-to-₩ risk.

Was CT's logic legitimate? The answer is yes and no. It is *yes* according to the "letters" of the FX Act: DW was covering a short position in the dollar through buying the dollar forward in return for a currency of its choice, *Sfr* for example. (CT should sell *Sfr* from DW forward for U$ to hedge their own risk. CT might possibly have combined this U$-*Sfr* forward with the *Sfr*-*won* forward in order to make DW's I/Ls perfectly justifiable.)

However, in the spirit of the Act, presenting I/Ls in the US dollar is far from legitimate. The reason is because the US dollar has been the *de-facto* accounting currency for Korean firms as long as international transactions are concerned (*cf.* Ahn and Chiang 1985, p.11, 16). First, the US dollar exchange rate had been fixed until the early 1980. After that, it has been *moving in a trend* and that somewhat predictably, rather than *fluctuating*. On the contrary, the exchange rate between the US dollar and another major currency is notoriously volatile. Accordingly, the vast majority of the exchange risk comes from the fluctuation between the dollar and the other major currencies such as the Swiss franc (*cf.* Table 1). All in all, CT's suggestion was equivalent to choosing to face a tiger in order to avoid a cat.

Second, about 95% of either exports ("long position) or imports ("short" position) of Korea were denominated in the dollar. As for the Korean economy as a whole and especially for DW a trading firm, denomination of exports and imports in the dollar was a kind of automatic hedge. Third, as explained earlier, there is no effective way to cover the dollar-*won* exchange risk and firms are to regard it as a destiny. On the contrary, the risk between the dollar and other major currencies can easily be covered through a forward-exchange contract.

After all, the US dollar has been the currency in which Korean firms *are* to conduct international trade. Simply put the dollar is the *de-facto* accounting currency. Therefore, transforming a US dollar position (vis-à-vis the *won*) into a franc, Deutsche mark, or the Japanese yen position is, in substance, not a hedge at all. To tell the truth, such a forward contract to buy the dollar against any other currency than the Korean *won* is sheer speculation. What a Korean firm should and can avoid through a forward contact, if anything, is the U$-to-*Sfr* risk in the above case: DW simply did the polar opposite, that is, intentional creation of a new risk through a forward contract.

Korea is a civil-law country and the FX Act does *not* define what the accounting currency should be. Then, a firm *can* transform a position in one currency into another of its choice. CT was CT in finding this tiny a loophole out of the complex regulatory framework. (I figured out that the Indian-American treasurer of CT Seoul dispatched from New York was extremely smart. Only a genius might come up with this counter-intuitive idea!)

6.3 Financing Costs

Side by side with loans on the basis of a forward contract in 1980, DW took outright *won* loans from CT for a total of ₩5 billion and another ₩3 billion loan in a repurchase agreement pegged to a foreign currency ("repo"). The local-currency department was in charge of these two programs. The first group of loans was at 19.5% PA, the general-loan rate, on the surface. However, DW had to make deposits for a total of ₩800 million as the compensating balance, which made the effective loan rate as high as 24% PA. Around this time DW's internal interest-rate benchmark was 20~21% PA.

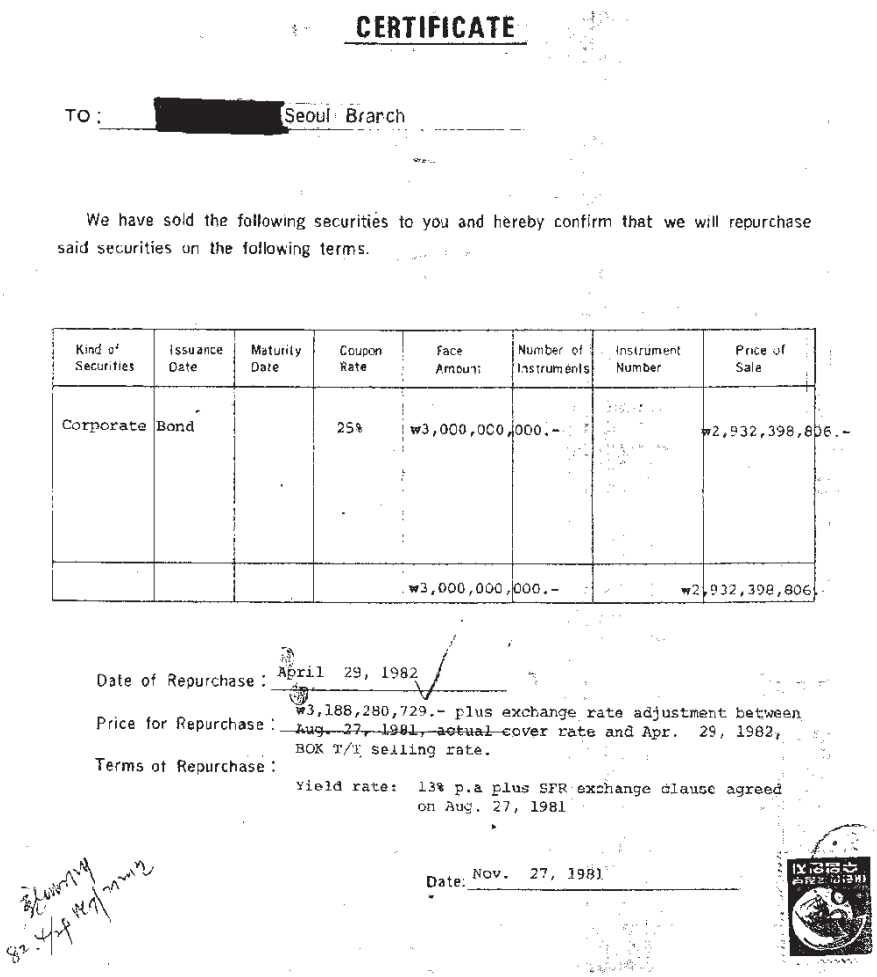
The repo linked to a foreign currency was the same in substance as the loan with a forward. However, in form, the repo was not easy to justify, that is, *appear legal*, and accordingly was discontinued after a couple of years afterwards. The effective financing cost of the repo was rollercoaster from 3% PA to 106%. In the most unfortunate case, the Swiss franc moved from ₩319.80 to 390.50 over three months. DW should postpone paying the foreign exchange loss for five months by abnormally "adjusting" the exchange rate in the renewal agreement as illustrated in Figure 3. If normal, the exchange rate adjustment of *Sfr* would have been from November 1981, the date of signing the contract, to April 1982, the loan maturity, instead of August to April.

The particular practice as above of postponing the payment of an exchange loss through hiding it in an artificial rate of the renewal contract, often called historic-rate rollover, was very popular in conjunction with foreign-currency speculation of various Korean firms (*cf.* Korea Times 1989). At last, MOF had to intervene and introduced a new rule that commercial banks shall report to the government such deals at an out-of-the-market rate as above (§7-40 of MOF Regulations of FX Trade 2017).

6.3.1 Performance in loans cum a forward

Worldwide, the early 1980s was a time of extremely high interest rates. That was due to the hawkish monetary policy by the Fed chairman Paul Volcker in his historic taming of the super-inflation in 1970s. Take the 3-month LIBOR of major currencies in the early 1982, for example: the dollar at $15^{6/8}$%, mark $10^{1/8}$, Swiss franc $8^{5/8}$ and yen $6^{5/8}$. There were substantial gaps between CT's offers to DW in the *de-facto* foreign-currency loans and the LIBOR. At any rate, DW did not have any alternatives, and the thrust of the FX Dept. was, taking CT's offers as given, to beat the internal benchmark rate around 21% in the effective interest rate.

The interest rate of 12% PA in the Swiss franc in the previous illustration is extremely high, but still cheaper than the general-loan rate in the *won* as long as *Sfr* does not appreciate more than 7.5% PA. For example, if the franc stays the same vis-à-vis the Korean *won* over the loan period, the effective interest rate becomes 12% PA, a bargain rate. However,



CERTIFICATE

TO : [redacted] Seoul Branch

We have sold the following securities to you and hereby confirm that we will repurchase said securities on the following terms.

Kind of Securities	Issuance Date	Maturity Date	Coupon Rate	Face Amount	Number of Instruments	Instrument Number	Price of Sale
Corporate	Bond		25%	₩3,000,000,000.-			₩2,932,398,806.-
				₩3,000,000,000.-			₩2,932,398,806

Date of Repurchase : April 29, 1982

Price for Repurchase : ₩3,188,280,729.- plus exchange rate adjustment between ~~Aug. 27, 1981, actual~~ cover rate and Apr. 29, 1982, BOK T/T selling rate.

Terms of Repurchase :

Yield rate: 13% p.a plus SFR exchange clause agreed on Aug. 27, 1981

Date: Nov. 27, 1981

Note: This shows a repo-loan renewal backdated from November 1981 to August 1981.

- The principal as of Aug. 27, 1981: ₩2,932,398,806; The interest rate: 13% PA (the *Sfr* rate); Loan period: 245 days (Aug. 27, 1981 to April 29, 1981); Repo amount: ₩2,932,398,806 x (1 + 0.13 × 245/365) = ₩3,188,280,729
- The repo contract requires a compensation for the appreciation of the Swiss franc from August 27, 1981 ("history") to April 27, 1982 instead of November ("present") to April. This practice is called a *rollover at the historic rate*.

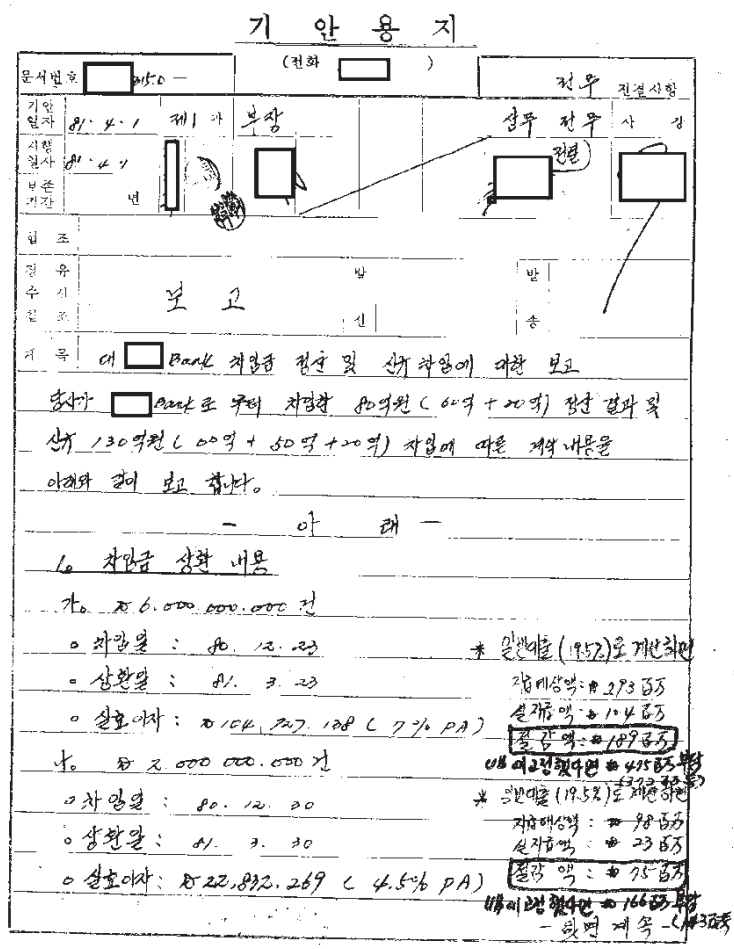
Source: Personal file

〈Figure 3〉 A Repurchase Agreement

that is nothing other than *creation* of a foreign-currency exposure which an industrial firm *should not* do discretionally.

In theory, the FX Dept. should choose the US dollar as the loan currency of the forward contract. However, more or less predictable appreciation of the dollar against the *won* by several percentage points on top of the nominal

rate of 22% PA was not to be comfortably accepted by the FX managers, self-claimed professionals. The loans were usually in one of the Swiss franc, the mark or the yen whose nominal interest rates were substantially lower than the dollar's. (In a sense, DW bit CT's bate of lower nominal rates of third currencies.) In some cases, the short position in one of the


기 안 용 지

보 고

대 Bank 차입금 절선 및 신규 차입에 대한 보고

아래와 같이 보고 합니다.

- 아 래 -

1. 차입금 상환 내용

가. ₩ 6,000,000,000 건

○ 차입일 : 80. 12. 23

○ 상환일 : 81. 3. 23

○ 실효이자 : ₩ 104,727,128 (7% PA)

나. ₩ 2,000,000,000 건

○ 차입일 : 80. 12. 30

○ 상환일 : 81. 3. 30

○ 실효이자 : ₩ 22,832,269 (4.5% PA)

Main contents:

- Tranche 1 for ₩6,000,000,000 at the effective rate 7% PA, saving ₩189,000,000 in comparison to the general loan rate 19.5% PA (Dec. 23, 1980~March 23, 1981)
- Tranche 2 for ₩2,000,000,000 at the effective rate 4.5% PA, saving ₩75,000,000 in comparison to the general loan rate 19.5% PA (Dec. 30, 1980~ March 30, 1981)
- The document was prepared by the dealer in charge and approved by the department manager (the additional comments maker), the deputy CFO, and the CFO of DW Corp.

Source: Personal file

〈Figure 4〉 Two Fortunate Cases of the Loan cum Forward

currencies was offset by buying the currency forward against the dollar along the way before the maturity. The performance in terms of the total cost of the FX Dept. was an average of 19% PA, ranging from 4% to 34%, over the two years from 1981 to 1982. Two especially fortunate cases are illustrated in Figure 4.

To repeat, both the first choice of a non-dollar currency and the midway reversal of such an intentional position are *speculative*. If anything, an industrial firm should take the dollar as the denomination currency. In practice as well, DW chose only the US dollar since 1983. As in the case of A/D NEGO and others, the additional cost from the dollar appreciation was something unavoidable to Korean firms. With few alternatives, DW extended such loans to *other* foreign banks and continued the practice well into the 1990s. Here again, we see habitualness, contagion, and addictiveness of illicit finance.

Ⅷ. Loans from Written Options

DW's needs for money never receded because of its failure to internally generate capital and because of its undaunted ambition of super-fast expansion (e.g. *Monthly Chosun* 2001). In the meantime, fortunes of the Korean economy notably turned around somewhat "miraculously" in the middle of 1980s.

Partly because of the improving economic situation, the Korean government (MOF) newly allowed such sophisticated financial transactions as options, futures, swaps and combination of those in 1987. Now, new finance opportunities dawned to DW and other firms.

7.1 Changing National Fortunes

Virtually for the first time ever all through her history, Korea recorded a trade surplus in 1986. Quite as a natural consequence, the Korean *won* appreciated against the dollar, which was Korea's first experience as well. The two new events continued into 1988, the year of the "highly-successful 88 Olympic Games" and the most proud year of all to the Korean people. There was a paradigm shift in international trade at both the Korean and the US governments.

The US suddenly recognized Korea as a maturing economy. The US government together with multilateral institutions pushed the Korean government to deregulate the economy, to open the market, and to normalize the exchange rate (e.g. *Washington Post* 1987; see also Tcha et al. 2003). In response to the international pressures, the Korean government gradually softened its hold of the FX market up to a comprehensive plan for FX liberalization (*wayhuan chayuhua* 외환자유화) in 1988. Yet, the plan was very limited in terms of economic liberalization: "free" convertibility of FX for pre-approved international transactions, without much progress in trade liberalization (*tongsang chayuhua* 통상자유화) or capital liberalization (*chabon chayuhua* 자본

자유화). In the meantime, the government revalued the Korean won to a substantial extent (Table 1).

With regard to financing at the FX Dept. of DW, three key events unfolded in the five years up to the beginning of 1988: first, the general-loan rate declined to 11.5% PA (DW's benchmark rate around 15%): second, the Korean *won* had been appreciating, and: third, foreign-currency options were allowed.

7.2 Loans from Writing Deep-in-the-Money Options

An ***option*** is a right but not an obligation to buy or sell an asset. Once you have an option, you do not have anything to lose while at the same time keeping a profit opportunity open. Suppose that you have an option to buy ("call") the US dollar at 130 Japanese yen ("strike price") a year from today ("expiry"). There are two possibilities to happen at the expiry and you will react differently: ① if the dollar appreciates to 140 yen, you "exercise" the option and "call" the dollar at 130 and make a 10 yen-per-dollar profit, or; ② if the dollar depreciates to 120 yen, you do nothing and let the option "expire." By nature of the deal, *any* option is better than none and accordingly has *some* value. To secure or "buy" an option you have to pay some money called "option premium" in advance. At the other end of the trade, the option seller ("writer") gives the privilege to the option "buyer" in return for the premium. There are two types of option: a "call" option is the right to purchase (or *call* in) the asset at the strike price, and; a "put" option is the privilege to sell (or *put* away) at the given price. In the exchange between the dollar and the yen, a dollar call is a yen put and vice versa.

Instead of selling the dollar forward, for example, DW can buy a put option on the US dollars, earned form exports, against another major currency. A forward represents a complete hedge with negligible fees. An option works as a partial hedge because it keeps the upside potential open in return for a hefty premium. Here again, the theoretical *legitimacy* of taking a position in a non-dollar foreign currency is disputable, but is legally accepted then and now in Korea (see §6.2 above).

In effect, writing (- position) a call (+) option is the same as buying (+) a put (-) option. Writing (-) a put (-) option is equivalent to buying (+) a call (+) option. To the *letters* of the FX Act, DW can *write* (-) a call (+) in the dollar while taking in the premium, as a way of hedging the dollars from exports (+). In practice and to the *spirit* of the Act, an industrial firm may not write options because this is thought to be the job of the market makers or some types of financial institutions. However, in Korea which follows the civil-law tradition, firms may write options as long as they have the "real demand."

Late in 1987, the idea of writing deep-in-the-money options occurred to members of the FX Dept. They consulted the idea with dealers at a few foreign banks in Seoul in-

cluding, of course, CT Bank. By nature of the deal, a deep-in-the-money option is very probable to be stroke (or exercised). For example, if DW writes, when the spot rate is ¥130/$, a dollar call-yen put option at ¥100/$ for a year to CT, the latter will almost surely exercise the option. Of course, nothing is completely sure and there remains the so-called long-tail risk, that is, the extremely remote possibility of the yen becoming stronger than the strike price, say, to ¥95/$.

As long as the exercise of the option is a sure thing, DW may and can cover its exchange risk between the dollar and yen very easily through a forward contract. Then, all the cash flows can be fixed from the outset without risk (but for the long-tail one). The option premium from CT to DW becomes a loan which is to be paid back in a year. Because the scheme is a straight loan in substance, the interest or the difference between the premium and the repayment *is to be* set, in theory, at a 1% or so over the LIBOR. The spread might be a bit higher than normal in consideration of the remote-yet-possible long-tail risk.

In February 1988, DW *wrote* four *dollar call-yen put* options for a sum total of $200 million (¥20 billion) maturing in a year, one each with CT Bank, CM Bank, BTC Bank and Manny Hanny Bank, all from the US. The FX Dept. successfully created dollar loans for $36 million. Such a large sum of option premia was possible because the gap between the spot rates around ¥126/$ and the strike rate at ¥100/$ each was extraordinarily great. The options were *truly deep* in the money and DW had just created a massive long (+) position in the yen. Once again, writing (-) a put (-) in the yen is equivalent to a yen call (+). The four deals are sketched in Figure 5. DW submitted as the real demand to the four banks an E/L and a giant overseas construction contract. Later on, none other than MOF acknowledged DW's documents as *legitimate* in conjunction with a particular national scandal.

7.3 In the Aftermath of the Option Loans

In the theory of FX management, there was no reason whatsoever DW might intentionally create a FX exposure in the Japanese yen. If anything, the FX Dept. should have written the dollar call against the Korean *won*. (This is not directly possible because the dollar-*won* option markets are yet to be created but banks can emulate such a deal through combining a few contracts.) The only reason for creating a position in the yen was that the FX Dept. had a strong belief of yen appreciation in the coming year. In effect, they went *speculative*.

The interest rate implied in the initial option deals was in average 15% PA in the dollar. (The rate was calculated on the basis that DW sold the yen receivables forward at the time of the deals.) That was an eye-opening spread of 7.5% PA over the average funding cost of the foreign banks. It was astounding even after taking two types of residual risks into account. First, there was some risk of the yen would become stronger than ¥100/$.

Option style : European yen-put/dollar-call
Contract amount : U$50 million (yen 5 billion) each
Strike price : Y 100/U$

(In thousand U$, million won)

Bank	Contract	Expiry	Settlement	Premiums Received			B/E
				Date	Amt.(U$)	Amt.(won)	(yen/U$)
SFCB	08-Feb-88	08-Feb-89	10-Feb-89	10-Feb-88	8,850	6,888	126.22
FGB	12-Feb-88	10-Feb-89	14-Feb-89	16-Feb-88	9,000	6,960	126.78
FGB	17-Feb-88	15-Feb-89	17-Feb-89	19-Feb-88	9,175	7,064	127.45
FBB	11-Feb-88	14-Feb-89	16-Feb-89	16-Feb-88	8,800	6,805	126.03
Total					35,825	27,717	126.62

Note : The break-even rates on the settlement dates were calculated based upon very "conservative" assumptions, specifically that the rate of won-appreciation be 5% p.a. and that the financing cost be 11.5% p.a., the "official-rate."

< Rates on Contracts Dates >

Date	yen/U$	yen Libor (1 year)	U$ Libor (1 year)	Forward Rate (1 year)
08-Feb-88	129.25	4.2500	7.1875	125.71
12-Feb-88	129.70	4.1250	7.0625	126.14
17-Feb-88	130.35	4.3125	7.3125	126.71
11-Feb-88	128.85	4.2500	7.1250	125.39

Note : One-year forward exchange rates were calculated by way of the interest parity theorm.

Source: Ahn 1991 (Exhibit 8)

〈Figure 5〉 Some Details of the Option Contracts

Second, there was the compliance risk, that is, the possibility of the foreign bank getting caught by the Korean supervisory authorities. At any rate, it was always the firms that were desperate at the negotiation table of finance and had to accept unfavorable terms and conditions.

After concluding the four deals, the FX Dept. had to go through many months of serious troubles, which was largely of its own making, in managing the ¥20 billion to be received in February 1989. Fortunately, the Dept. *man-*

aged to eventually sell forward in the middle of 1988 all the yen at more or less favorable prices and effectively fixed the loans in the US dollar. All in all, the loans were a great success with a saving of some 8 million dollars in the funding cost. The detailed story about DW's troubles is available in Ahn 1991 (see also Jacque 1996, Chapter 3, which at the same time graphically illustrates options in general).

DW's effective rate of interest of the dollar loans, from the combination of initial options and forwards afterwards, was 8.5% PA in the dollar. Meanwhile, the *won* appreciated by 13.5% PA over the loan period. The FX Dept. turned out to have created loans for a total of some ₩28 billion at -5% (minus five percent) PA.

Such deals were quickly popularized in Seoul. By the end of February 1988, the total loan outstanding was reported to have reached $700 million from eleven American and French banks to various Korean firms (*Korean Herald*, 1988). Recognizing these unintended consequences, MOF got irritated and immediately suspended such option deals. Undeterred, however, DW jointly with foreign banks found some ways to renew such loans on an annual basis over many years. The legacy of this particular episode is still lingering around as the reporting obligation of such options in §7-40 of the MOF Regulations for FX Trade as in 2017.

Ⅷ. Others in the Grey Area

DW relied for foreign-currency trade on various other ways in the grey area as listed below. Most techniques were widely used by other GTCs and chaebol firms as well.

8.1 Long-term LCs

Letters of credit are issued to help promote international commercial trade. The payment of L/Cs is generally made "at sight" of the relevant bill of exchange. When the opening bank is short of money, the term can be a certain days "after sight." By nature of the *commercial* trade, the term is rarely longer than 180days.

In the beginning of 1980s, DW received a letter of credit for nearly $10 million with the payment term being 720 days after sight. Simply put, negotiation of such long-term bills of exchange was a loan from Korea F bank to DW in light of the abnormally long payment term. Moreover, the opening Sudanese bank did not have any credibility at all. Little wonder the Sudanese bank did not pay a single dollar to Korea F Bank. Years later, DW had to pay the negotiated bills back with its own money ("refund").

In the case of L/Cs, even a 360-day term is very unusual. Somehow in Korea, L/Cs for 360 days to 720 days became to be treated as more or less normal business around the year 1990 as for exports to Iran and Iraq (at war against each other). The Korean government

even encouraged exports under long-dated L/Cs by forcing the Korea Exim Bank to insure such risky bills of exchange. At DW, the outstanding balance in the early 1990s to Sudan was some 20 million dollars, and that to Iraq was 70 million, all on the 720-day basis. Later on, such long-term facilities were extended to Iran and Algeria, as well. As expected, DW had serious troubles collecting proceeds from those countries.

8.2 Exim Loans for an Unviable Project

One of the key jobs of the export-import ("Exim") bank in any country is to supply long-term loans to foreign importers of plants and ocean vessels of domestic origin, the payment of which is deferred over a number of years.

In the early 1980s, DW concluded a contract to build a tire manufacturing plant in Sudan for more than $80 million. DW got loans from the Korea Exim Bank with little regard to viability of the business. As a matter of fact, the plant was a foreign direct investment by DW and the business prospect was extremely negative from the beginning. All in all, it was a giant dollar loan form Exim to DW. Understandably, DW's contingency plan was to have the subsidiary in London or New York service the debt in lieu of the tire plant.

8.3 Buying and Selling the Same Forward Contract

In the second half of 1980s when a large number of Korean firms engaged in foreign-currency speculations using forward contracts with foreign banks in Seoul (e.g. *Korea Times*, 1989), DW did not join the frenzy. Instead, the FX Dept. in some occasions *bought* and *sold* at the same time a dollar-to-yen or dollar-to-mark forward contract for a certain amount and maturing at a certain point in the future (Ahn 1991). Of the two, one is certainly to gain while the other to lose. DW realized the gain at the maturity while rolling over the losing contract on the historic-rate basis. The scheme represented a loan at a relatively high rate of interest due to multiple deals involved. Not to mention, those speculations were unlawful.

8.4 The Backdated Dollar-*won* Forward

I explain in Section II that the dollar-*won* forward market is not viable due to inconvertibility of the *won*. Nonetheless, it had some use. The FX Dept. often sold the US dollar "forward" against the *won* to CT Bank or some other foreign banks. The trade was "spot" in disguise of a forward contract made the day before. More specifically, the "forward" rate was determined on the day of the deal and set at some point between the TT buying and the TT selling rates but the deal was recorded at the bank as if it had been made on the previous day.

The TT rates for the day were announced by the Bank of Korea early in the morning. DW could sell the dollar at a favorable rate

somewhere between the buying and selling rates, while CT could secure the dollar fund more cheaply than from Korean banks. Foreign banks were in a chronic deficit of the US dollar because nearly all the export bills of exchange, the main source of the dollar, were *negotiated* at Korean banks. Normally, foreign banks had to buy the US dollar from Korean banks at the TT selling rate. On the other hand, firms are to sell at the TT buying rate to banks by law as well as by definition. Here, TT is for telegraphic transfer and represents immediately-available funds.

8.5 Fake Banker's Acceptance

Like anywhere else, Korean importers can pay bills of exchange from exporters "at sight" with money from the bankers' acceptance finance. Some Korean banks created B/A finance for their clients on the basis of fake L/Cs. The mobilized money went to the pretended importers instead of the fictitious importers. In essence, this practice is equivalent to creation of general purpose foreign-currency loans.

Ⅸ. Closing Remarks

I list, for the purpose of recording, some bizarre techniques of foreign-currency finance, as summarized in Table 2, in the Development Era which were extensively used at DW and more or less popular in Korea as well. Regardless of legitimacy, those were handy and efficient financing methods for big firms in general and DW in particular.

One takeaway from those episodes I would like to suggest is that human beings are self-centered and try hard to find ways to round

〈Table 2〉 Illicit Financial Techniques in the Development Era

Category	Technique	Credit supplier
Letter of credit (L/C)	Advanced negotiation of L/C	Korean bank
Document against Acceptance (D/A)	Long-dated intra-corporate D/A	Korean bank/SUB
	Negotiation of forged D/A (F-D/A)	Korean bank/SUB
Red-clause L/C	Negotiation of intra-corporate red-clause L/C	Overseas subsidiary ("SUB")
Foreign-currency Working capital	Loan in the *won* with a forward exchange contract	Foreign bank
	Loan in a repo agreement in a foreign currency	CT Bank
Currency options	Loan from written options	Foreign bank
Others in the grey Area	Long-term L/C	Korean bank
	Exim loan for unviable project	Korea Exim Bank/SUB
	Buying and selling the same forward exchange	Foreign bank
	Back-dated dollar-*won* forward	Foreign bank
	Fake bankers' acceptance	Korean Bank

about excessive restrictions. And, the human ingenuity more often than not makes such circumventions happen. Finally, it should be clear to anyone that had the Korean government deregulated the financial markets all the illicit-and-costly techniques in this study would never have been practiced.

Worldwide, illicit capital flows out of developing countries have been a public concern since OECD Anti-Foreign Bribery Convention in 1997 and UN Anti-Corruption Convention in 2005. The purpose of illicit flows as in those Conventions is largely threefold: transfer of personal wealth, bribery to foreign officials, and tax evasion (e.g. OECD 2014; see also for a recent episode *The Guardian* 2018). Some techniques I present here can be used as a way of money laundering for such purposes. However, DW's illicit finance is very different in its motivation from illicit financial flows as the global concern: corporate finance vs. capital flight.

9.1 The Era after

As Paul Krugman had predicted, or is known to have done so, the Korean economy hit a wall and was pushed to the brink of a national bankruptcy in 1997, less than a year after closing of the Development Era. One reason of the economic crisis was unbearably heavy debts of chaebols. The national average debt-to-equity ratio of all industrial firms surpassed 300% and that for chaebols was much higher (e.g. Tcha et al. 2003; Y. Lee 2005).

The heavy debts were accumulated by low profitability on the one hand (e.g. Y. Lee 2005) and ambitious expansion plans on the other (Korean government 1997). The ratio of retained earnings, as the source of equity capital, to the total capital on the balance sheets of Korean firms stayed in the range of 5%, by far the lowest of comparable economies (Y. Lee, 2005). The actual ratio should have been much lower if the prevalent book-cooking practices, then and now, are taken into account (e.g. *Monthly Chosun* 2001; *Dong-A Ilbo* 2017). Certainly the super-high financial costs, as shown in this study, contributed to such meager retained earnings. In a sense, firms were struggling in a vicious circle: low profits to high debts to excessive financing costs to low profits.

Interestingly enough, the Korean government acknowledges the limitation of its development policies in *Letter of Intent* to IMF by saying, "In particular, the legacy of government intervention has left an inefficient financial sector and a highly leveraged corporate sector that lack effective market discipline" (1997, p.2). The government continues: "[S]ince the beginning of the year, an unprecedented number of highly leveraged conglomerates (chaebols) have moved into bankruptcy. …. The bankruptcies spilled over into a sharp increase in nonperforming loans …. to ₩32 trillion (7 percent of GDP) by end-September …. Financial institutions have priced risks poorly and have been willing to finance an excessively large portion of

investment plans of the corporate sector, resulting in high leveraging."

The fortune of the DW group, the most financially desperate of all large chaebols, was even worse. These are summary numbers what Korea's judiciary branch, the prosecution and the court, found around the year 2000 after investigations of the group in conjunction with a particular scandal: book-cooking and missing assets by 41 trillion *won* (*Monthly Chosun* 2001); tunneling abroad 23 trillion *won* (*Chosunilbo* 2005; *WSJ* 2006). Particularly, the money sent abroad was largely to fill the financial void of the two subsidiaries in London and New York. The prosecution could not discover any substantial hidden assets, which might well verify that the huge void was largely because of operational problems including payment of astronomical financial costs. After all, *continuous* reliance on *illicit* finance as at DW may symbolize very serious financial troubles at a firm and consequentially signal its imminent demise.

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개발연대 한국기업의 변칙적 외화자금 조달에 대한 사례연구

안영도*

요 약

모두 7차례에 걸친 경제개발 5개년 계획 기간(1962~1996)에 한국경제는 급속히 성장했다. 다만, 축적 자본이 거의 전무했던 까닭에 국가차원에서는 해외자본, 기업차원에서는 타인자본에 의존할 수밖에 없었다. 당시 사채(私債) 금리가 월 2~3% 이르렀던 점이 시중 자금난을 대변한다. 대기업으로서는 이미지 훼손을 염려해서 차마 사채시장을 이용할 수는 없었고, 상업은행 혹은 이른바 "단자(短資) 회사"를 통해 긴급자금을 조달해서 하루하루를 넘기는 일이 많았다.

현재도 큰 차이가 없지만 당시에 운전자본 조달을 위한 외화차입은 금지됐다. 엄격한 규제와 긴급한 자금 수요 사이에서 일부 대기업은 다양한 방법으로 사실상의 단기 외화자금을 조달했다. 규정의 허점을 파고든 것과 탈법적인 것이 뒤섞여 있었는데 어느 것이나 "핫 머니"를 우려한 정부정책에 배치된 변칙금융이었다. 본 사례연구에는 가장 일반적인 수출환어음의 선적전 매입에서 시작해서 각종 외화표시 운전자금 조달 방안, 외환 옵션을 가장한 외화차입 등 여섯 가지 유형, 열 두 종류의 기법을 통해 당시의 국가적 자금난 및 기업과 금융기관의 비상대처 방식을 소개한다. 기업입장에서 보면 변칙금융이 자금부족을 해소하는 소중한 기회였는데 고금리에다 환차손을 부담하는 경우가 많았지만 당시는 금융비용보다 "자금조달" 자체가 관건이 됐다. 변칙금융을 제공한 은행 입장에서는 수익창출, 실적제고 등의 혜택을 얻을 수 있었다.

본 사례연구는 기업의 외화금융을 장기간 직접 관찰한 저자가 개인 메모 및 각종 문헌자료를 참고하여 저술한 것이다. 특정 기업 혹은 인물을 비난하거나 정부의 외환정책을 비판하자는 것이 아니며, 기록을 남겨서 기업 재무담당자, 정부정책 입안자, 기업 역사가 등에게 참고가 되도록 하고자 할 뿐이다.

주제어: 변칙금융, 사실상 대출금, 금융규제의 한계, 개발연대의 금융

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〈Teaching Note〉

A Case Study of Illicit Foreign-Currency Finance at Korean Firms in the Development Era (1962-96)

Synopsis

Korea's foreign exchange regulations were extremely tight in its Development Era. Specifically, short-term foreign-currency loans were strictly prohibited. Nonetheless, some big firms could mobilize *de-facto* foreign-currency loans in the US dollar or other major currencies in meeting their urgent needs for money. They devised in cooperation with domestic and foreign banks various financing techniques which were abnormal if not outright illegal.

In this case study, there are 12 techniques in six groups explained, all of which represent a loan pegged to a foreign currency most often the US dollar. The cost of the US dollar financing is very high under the international standard, several percentage points over the LIBOR for instance, but could still be cheaper than the general loan rate in the *won*. At any rate, illicit finance might be an ingenious way out in the case of extreme liquidity crunches, which was a *normal* phenomenon for most Korean firms in the Development Era.

Of all, the most popular technique was the A/D NEGO, that is, negotiation of export bills of exchange "in advance" of shipment. In general, the payment for international trade is guaranteed by a L/C (letter of credit) from the importer's bank. Thanks to such a guarantee, the exporter's bank can safely discount the bill of exchange when duly issued after shipment (Figure 2). DW and other firms negotiated bills of exchange with fake documents as a way of borrowing money over the period from the A/D NEGO to the actual shipment. Particularly DW used the framework of intra-corporate D/A (document against acceptance) where all the terms and conditions were under its full control. In that scheme, the loan period was usually longer than a year. Sometimes in F-D/A, all the documents were forged from the beginning to the end.

Foreign-exchange forward contracts were often utilized as a tool for transforming *won* loans into foreign-currency loans. In addition, particularly in 1988, foreign-currency options, entailing a huge foreign exchange risk, were widely used as a way of creating foreign-currency loans. In these cases, the partner was always a foreign bank whose accounting currency is

the US dollar or a third currency depending upon their origin: the choice of their own currency is natural in terms of risk management. The flipside of their doing business in their accounting currency is Korean firms' *creation* of foreign-exchange exposures from loans, which is nothing other than currency speculation.

Speculation is what industrial firms are not supposed to do as explained in textbooks and as stipulated in the FX Act of Korea (외국환거래법). In the episodes in this study, Korean firms violated the spirit of the Act by engaging in foreign-currency speculation even though they somehow in some cases complied with the letters of the FX Act. Incidentally the FX Act does not define the accounting currency of Koran firms and makes it almost impossible to *legally* identify a currency trade as speculative.

Teaching Points

1) To explain why each technique represents a foreign-currency loan

2) To explain the foreign-exchange risk accompanying a foreign-currency loan

3) To explain risk management tools

4) To explain the difference between speculation and hedge in the foreign currency

5) To explain the difference between letters (what is said) and spirits (what is meant) of regulations.

6) To explain limits to regulation of human behavior

7) To explain capital necessity in times of fast economic growth of a national economy and of ambitious business expansion at firms

Assignment Questions

1) What are the typical sources of capital for business expansion?

Except for start-up firms, the expansion capital at a firm is in general mobilized from retained earnings. First, retained earnings from operating profits stand for viability of the current business model. Second, reliance on retained earnings implies a gradual expansion and prevents managerial over-reaching.

2) Why were Korean firms put in capital stringency in the Development Era?

On the one hand, Korean firms especially chaebols were overly ambitious in their business expansion often with encouragement of the government. On the other hand, the domestic financial markets were very small and

tightly regulated, and the foreign capital was scarce due to government policy. Third, they barely made a profit and accordingly could not count on retained earnings as a source of capital.

3) What were pros and cons of advanced negation of export bills of exchange?

Pros: Exporting firms could mobilize extra funds in a handy way.

Cons: They had to bear the dollar-*won* exchange-rate risk which might result in a substantial increase in the financing costs. Moreover, there followed heavy workload of making sham documents, presenting genuine documents later on, and adjusting differences between the two.

4) D/A contracts and red-clause L/Cs between the head office in Seoul and a subsidiary in the US is *de-facto* dollar loans in one form or another. What could the Korean government do to bar such undesirable short-term foreign loans?

D/A contracts: The government might not allow intra-corporate D/A longer than 180 days if it is ever concerned about short-term borrowings in the foreign currency.

Red-clause L/Cs: The government should not allow the intra-corporate red-clause L/Cs. There is no question that such a framework is effectively a short-term loan from abroad which the government tried to avoid.

5) What currency would you as the financing manager of DW choose in the loan-cum-forward scheme?

The vast majority of Korean firms' foreign-exchange risk comes from the volatility of the dollar-to-other major currency rates. Therefore, if ever, DW should have chosen the US dollar.

6) Please explain in your own words why writing a deep-in-the-money is a loan in disguise?

You can receive a big premium when you sell ("write") an option which is extremely favorable, or "deep in the money," to the option buyer. As long as the option is "deep," or the gap between the spot price and the exercise price is usually big, the buyer will almost *surely* exercise the option and you can fix all the future cash flows. If it is a *currency* option, you have two cash flows in different currencies at the maturity. And, you can fix all the cash flows in a single currency of your choice through a forward contract. Then, the premium you receive at the time of contract and the money you pay at the maturity are fixed in a currency, say, the US dollar. This is a loan by definition.

7) What currency would you choose for the option loans?

As long as possible, I should choose the US

dollar which is the *de-facto* accounting currency. That is the very basic in the foreign-exchange risk management.

Analysis

Issues in this case study are specific to the Development Era in Korea. However, there are some general takeaways for financial means at the firm level and as policy implications at the government level. On the one hand, firms by nature are self-interested and try to find ways to solve a given problem. In doing that, the ethical divide is not always clear-cut and firms tend to override the spirit of laws in difficult times. On the other hand, the government should direct firms so as to maximize the national economic welfare. In doing that, the right alignment of the national objectives with firm goals is always desirable. Otherwise unintended side-effects may outweigh intended policy outcomes.

1) Background

- Korea's capital accumulation was almost none when the government initiated speedy economic growth in 1962, the first year of the Five-Year Economic Development Plans.
- The national economy as a whole and firms individually had to rely on the debt capital. As a result, firms were almost always in great needs of working capital.
- As for bank loans, availability was limited and the interest rates were very high. In addition, foreign currency loans were prohibited.

2) Necessity as Mother of Invention

- The first pillar in the growth strategy of the government was promotion of exports. Taking advantage of export promotion policies firms devised various ways to mobilize short-term foreign-currency loans. The first and most popular way was negotiation of export bills before the shipment with fake documents.
- Later on, big firms came up with more ingenious ways, such as long-dated D/A and L/Cs, loans-cum-forward contract, and option loans. These were not illegal, if unethical.
- Particularly at DW which was in extreme cash crunch, some unique techniques such as F-D/A were also mobilized.
- On the bank side, illicit finance of various types simply represented additional business opportunities.

3) Law of Unintended Consequences

- It was quite legitimate that the Korean government be wary of short-term foreign-currency loans when the balance of payment was shaky with chronical deficits and the foreign exchange reserves (at Bank of Korea) was relatively small.

- However, too much and too tight regulations are often counterproductive. Firms are in general creative enough to come up with some ways to round about excessive restrictions. The end result is higher costs to the whole society. The government might well pay attention to overall efficiency of policy measures.

Glossary (key terms in the Korean language)

1) *Chabon chayuhua* (자본자유화, capital-account liberalization)

Financial capital, long- or short-term, freely moves in and out of a nation. This is sometimes called "free convertibility" (태환성) of the domestic currency and practically regarded as the final stage of economic liberalization (경제자유화).

2) *Changdan-pulmun, komli-pulmun* (장단불문, 금리불문):

Not minding terms, including the duration and the rate, of a loan

3) *Chockyok* (적격; 適格, eligible)

Qualified for application for a loan or other benefits. According to MOF guidelines, only profitable firms were eligible for the general loan and the privilege of being listed in the stock exchange. In the Development Era, the stigma of "red-colored firm" (적색기업: 赤色) was a death sentence. Partly because of this tight regulation book-cooking (분식회계) has become so prevalent in Korea. Even these days the popular press reports mega-scale book-cooking scandals from time to time.

4) *Chondaychaguan* (전대차관; 轉貸借款, onlending or re-lending)

In the Development Era low-credit commercial banks borrowed funds out of syndicated foreign loans (차관) mobilized by higher-credit state-owned banks. Additionally some firms could borrow long-term capital from abroad with a payment guarantee of the government.

5) *Hyonji komyung* (현지금융)

Foreign subsidiaries of Korean firms can borrow money or take other financial services from local banks on the basis of a stand-by L/C from a Korean bank or a payment guarantee of their head office is Seoul. Around the year of 1980 prevalent abuse of the system became a headache to the government (*cf.* BOK 1981).

6) *Ilsiday* (일시대)

Literally it means a temporary short-term loan and can be at the general loan rate over several days. In the Development Era, it was

often an overnight loan, sometimes back-dated, at a penalty rate.

7) *Koki* (꺾기, compensating balance)

Commercial bank sometimes require of borrowers to deposit part of the borrowed money back at a lower rate than the lending rate. The deposit may be taken as collateral but is more often than not used as a way of lifting the effective lending rate.

8) *Mironayghi suchul* (밀어내기 수출)

Some exporters shipped goods abroad, without consideration of the market condition, only for the purpose of enhancing their "export performance record" (수출실적) which entitled many benefits such as preferential financing and national recognition.

9) *Silsuyo principle* (실수요; 實需要, real demand)

The Korean government has not liberated international capital transactions (자본자유화) while liberalizing receipts and transfers from current transactions (외환자유화). Therefore residents should verify before buying or selling a foreign currency that the trade is a part of a current-account transaction or "it is really demanded."

10) *Suchul komyong* (수출금융, export-promotion loan)

Exporters need working capital before shipping goods on board to purchase raw materials or finished goods from suppliers and to pay other related costs. Commercial banks were to supply export promotion loans at a favorable rate to cover such working capital up to 90% of the L/C amount and for six months.

11) *Suchul myonjang* (수출면장, export permit)

The customs office (세관) is to physically check the goods to be shipped abroad to see if everything complies with regulatory rules and official guidelines and to issue thereafter a certificate to that effect. This certificate is for shipping goods on board and has nothing to do with the negation process.

12) *Tahipday* (타입대; 他入貸)

Honoring a returned check at a bank with another check drawn on a second bank. This is effectively an extension of a loan if the first bank holds the second check for a day as a type of collateral.

13) *Tangjuachawol* (당좌차월; 當座借越, overdraft facilities)

Commercial banks allow their customers to "overdraw," or cut checks over and above the deposit balance, up to a certain credit line

(여신한도). The credit line for overdraft is not big inasmuch as it is contingent or emergent and unpredictable.

14) *Tongsang chayuhua* (통상자유화, trade liberalization)

Residents may freely engage in international trade of goods and services.

15) *Wayhuan chayuhua* (외환자유화):

Residents may freely pay or receive foreign exchange from (pre-approved) current-account transactions. This is largely to avoid a double approval from the government and is closely related to the *silsuyo* principle.

16) *Wayhuan chipchung-je* (외환집중제)

By centralizing at the Bank of Korea all the foreign exchange earned by Korean nationals, the government intended to allocate the extremely scarce US dollar to the best uses and at the same time to prevent capital flight out of Korea.

17) *Yilsu* (일수; 日收)

A loan whose interest is to be paid daily. If the daily rate is 0.2% ("2厘"), the compounding annual rate becomes 107%. At 0.5% ("5厘"), the annual rate explodes to 517%.