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2011 Modularization of Korea's Development Experience

Korea's Capital Market Promotion Policies: IPOs and Other Supplementary Policy Experiences

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KDI SCHOOL
KDI School of Public Policy and Management

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Preface

The study of Korea's economic and social transformation offers a unique opportunity to better understand the factors that drive development. Within one generation, Korea had transformed itself from a poor agrarian society to a modern industrial nation, a feat never seen before. What makes Korea's experience so unique is that its rapid economic development was relatively broad-based, meaning that the fruits of Korea's rapid growth were shared by many. The challenge of course is unlocking the secrets behind Korea's rapid and broad-based development, which can offer invaluable insights and lessons and knowledge that can be shared with the rest of the international community.

Recognizing this, the Korean Ministry of Strategy and Finance (MOSF) and the Korea Development Institute (KDI) launched the Knowledge Sharing Program (KSP) in 2004 to share Korea's development experience and to assist its developing country partners. The body of work presented in this volume is part of a greater initiative launched in 2007 to systemically research and document Korea's development experience and to deliver standardized content as case studies. The goal of this undertaking is to offer a deeper and wider understanding of Korea's development experience with the hope that Korea's past can offer lessons for developing countries in search of sustainable and broad-based development. This is a continuation of a multi-year undertaking to study and document Korea's development experience, and it builds on the 20 case studies completed in 2010. Here, we present 40 new studies that explore various development-oriented themes such as industrialization, energy, human capital development, government administration, Information and Communication Technology (ICT), agricultural development, land development and environment.

In presenting these new studies, I would like to take this opportunity to express my gratitude to all those involved in this great undertaking. It was through their hard work and commitment that made this possible. Foremost, I would like to thank the Ministry of Strategy and Finance for their encouragement and full support of this project. I especially would like to thank the KSP Executive Committee, composed of related ministries/departments, and the various Korean research institutes, for their involvement and the invaluable role they played in bringing this project together. I would also like to thank all the former public officials and senior practitioners for lending their time and keen insights and expertise in preparation of the case studies.

Indeed, the successful completion of the case studies was made possible by the dedication of the researchers from the public sector and academia involved in conducting the studies, which I believe will go a long way in advancing knowledge on not only Korea's own development but also development in general. Lastly, I would like to express my gratitude to Professor Joon-Kyung Kim for his stewardship of this enterprise, and to his team including Professor Jin Park at the KDI School of Public Policy and Management, for their hard work and dedication in successfully managing and completing this project.

As always, the views and opinions expressed by the authors in the body of work presented here do not necessary represent those of KDI School of Public Policy and Management.

May 2012

Oh-Seok Hyun

President

KDI School of Public Policy and Management

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Summary

This report studies a series of capital market promotion policies Korea pursued over a 30-year period during its development era (1960s-1980s). The purpose of this report is to extract lessons that can benefit policy makers in the developing world, where capital market promotion is an important policy goal. Given that the Korean government's main interest during this era was to mobilize domestic capital for economic development and to lower its the firms' debt-to-equity ratio, I have left out bond markets from my analyses; and when discussing the stock market, I have put greater weight on its primary market policies than the secondary market policies.

It is a great challenge for developing countries to create a strong securities market. They lack many of the institutions necessary to control information asymmetry and self-dealing. That is to say, these countries are often without legal and market institutions which ensure that minority shareholders (i) receive reliable information about the value of a company's business and (ii) allow them to have trust and confidence in a company's management team and controlling shareholders. Regulators, prosecutors, and courts may not be honest or sophisticated enough to carry out this task. Accounting and financial disclosure rules may not be comprehensive or independently audited. Reputational intermediaries, such as investment bankers, accountants, and securities lawyers, may not be sophisticated enough nor subject to liability risk.

In the early 1960s, the Korean stock market also lacked the legal and market institutions necessary for a viable capital market. At the time, the stock market in Korea was akin to a legalized gambling casino, often plagued with speculative bubbles and bursts. With a limited score of listed firms, the size of primary market was very small. It hardly served as a channel through which firms raised their external equity capital. In contrast, it had an enormous secondary market. Because speculators made use of clearing transactions, which is similar to today's futures transactions, the trading volume often soared to unsustainable levels. On a number of occasions, it triggered the Korean government to step in and rescue the stock

exchange at the brink of a massive default. As of 2010, however, the Korea Exchange (KRX) has a market capitalization of 1.1 trillion USD. This ranks KRX as the 17th largest stock exchange in the world, in terms of equity market capitalization (World Federation of Exchanges). What explains this astonishing achievement over a 50-year period? This report is motivated to answer a part of this question.

There are two unique approaches or policy stances Korean government took in regards to the capital market. First, the Korean government was actively involved in promoting the capital market. The government, for example, gave tax incentives to encourage IPOs. It sometimes threatened to publicly admonish those that refused to go public. No stock exchange in a development country has ever experienced such government involvement. Combined with rapid economic growth, this interventionist approached allowed the Korean stock market to experience phenomenal growth over a short period of time. Second, the promotion of capital market had a number of objectives. One was to mobilize domestic capital for economic development. Another was to lowering firms' debt-to-equity ratio. But, most interestingly, the Korean government wanted to popularize stock ownership, and thereby let ordinary Koreans to share the fruits of economic growth. People's stock ownership plan was the most noteworthy example.

The report is composed of two parts: primary market policies (Chapter 2) and other supplementary policies (Chapter 3). The latter includes secondary market policies (Sections 1 and 2) and policy measures taken to expand the stock market's investor base (Sections 3 and 4). They are both supplementary to the primary market policies for obvious reasons. First, no country can have a vibrant primary market without a well-functioning secondary market, where share prices are set efficiently and shares are traded with reasonably low transaction costs. It is also obvious that the primary market cannot be enlarged by simply increasing the supply of shares. Instead, there should be a commensurate increase in the stock market's investors' base.

1. The Primary Market Policies

On primary market policies, I covered the initial public offering (IPO) inducement measures taken during 1968-71 (Chapter 2, Section 1), the coercive IPO orders implemented during 1972-78 (Chapter 2, Section 2), and the promotion of IPOs and Seasoned Equity Offerings (SEO) in the late 1980s (Chapter 2, Section 3).

2. The Initial Public Offering Inducement Measures (1968-1971)

In November 1968, the Capital Market Development Act was passed by the National Assembly. To encourage firms go public, the Act gave tax and special depreciation benefits to public firms. To induce stock investments, the Act even guaranteed minimal dividend yields. It also introduced the employee stock ownership plan (ESOP) for the first time, and established the Korea Investment Development Corporation, the objectives of which were to underwrite newly offered shares, promote dispersed share ownership, and stabilize share prices. To signal the government's strong determination, it even named 1969 as the "Year of Capital Market Development."

But the IPO inducement measures taken between 1968 and 1971 failed in spite of the government's great enthusiasm. At the time, most firms were not profitable enough to pay out cash dividends. Even if they were profitable, dividend yields were well below interest rates and even inflation rates, and therefore unable to attract investors to the stock market. In the absence of a broad investors' base, there was a high possibility that newly issued shares would not be fully absorbed in the primary market. Company founders who were reluctant to offer shares at deep discounts opted against going public, despite favorable tax benefits. These founders were also concerned that they would lose control over their firms once they became public.

3. The IPO Promotion Act: A Coercive Approach (1972-1978)

With the advent of the Yushin Regime in 1972, President Park passed the IPO Promotion Act, which took a coercive and an interventionist approach. This Act empowered the Minister of Finance with the authority to designate which firms would go public. If the designated firms did not comply, the Finance Minister had the power to penalize them by blocking access to bank lending.

The government's renewed effort was a big success. Despite the Oil Shock of 1973, the number of IPO firms soared. During the three-year period between 1975 and 1977, almost 300 firms went public. The most decisive factor was not the coercive approach taken by the government, but the low interest rates that were available during this period. With relatively high stock returns and dividend yields, investors were also attracted to the stock market. With a greater investors' base, large scaled public offerings were placed successfully, and without much difficulty.

Second, rapid economic growth during this period was also a crucial factor. Facing increased demand, firms were motivated to go public voluntarily in order to raise operating capital. It is no coincidence that this period, during which the number of listed firms increased the most, overlaps with the period when Korea experienced double-digit real GDP growth rates for three consecutive years (1976-1978). Third, President Park's incessant and unwavering support for more public firms in Korea was also crucial. The President's Special Order of May 29 and regular instructions at monthly economic development meetings to encourage IPOs were just few examples of his support.

Fourth, the government's timely introduction of various securities-related measures helped alleviate the prevailing concerns of company owners and investors. For example, the 10 percent ownership limit greatly mitigated concerns over losing corporate control. The syndicate formed to provide firm commitment underwriting also helped absorb large-scale public offerings. Mandatory registration and prior disclosure of financial statements alleviated investors' concern over lack of transparency.

An interesting way of understanding the policy efforts in the 1970s is to look at it from the perspective of mitigating information asymmetry, and the resulting adverse selection problems. The challenge that the Korean government faced in the 1960s and 1970s was overcoming these problems without adequate disclosure rules or securities laws. The option taken in the 1960s was to set up KIDC, which would serve as a reputational intermediary. KIDC proved inadequate for this purpose. The policy measures taken in the 1970s was an improvement over those taken in the previous decade, since the government involved itself directly in differentiating between high- and low-quality firms. By analyzing financial statements and designating qualified firms, the government served as a de facto screening agency. However, offering prices set by the government was judged too low by high-quality firms. As a result, these firms, such as Hyundai Construction, refused to go public at the time. This problem was partially solved in subsequent years through improvements in macroeconomic conditions. With higher earnings, offering prices had to be set higher, which led high quality firms to voluntarily offer their shares in the market.

Another interesting question is whether the government's shift to a more coercive and interventionist approach helped the the promotion of IPOs. My research shows that this shift contributed to the IPO boom during the late 1970s. By being directly involved in differentiating high- and low-quality firms, the government greatly mitigated the information asymmetry problem. Also, the incentives and the penalties it imposed aligned together the interests of the government and its designated firms. But their effects were also heavily influenced by improvements in macroeconomic conditions. Before Korea's economic boom, the number of IPOs increased only in moderate amounts. The Korean business community also complained about low offering prices. As mentioned above, Hyundai Construction refused to go public, despite the government's persuasions and threats. When the economy boomed, however, the number of IPOs also accelerated. With higher share prices, the offering prices were also set higher. When a recession inevitably followed the boom, there was, not surprisingly, a dramatic drop in the number of IPOs. During this particular recession, the number of listed firms actually decreased.

The government's success in increasing the number of IPOs, however, was undermined by its failure to detect and correct the imbalances that emerged in the stock market by the second half of 1978. There were too many shares being offered, compared to the size of stock market's investor base. Coupled with the government's contractionary monetary policy and a second oil shock, the stock market soon crashed, failing to recover for many years.

4. The Equity Offering Expansion Policies in the 1980s

The stock market stagnated for many years in the early 1980s. Firms started to rely once again on bank lending and private loans. Naturally, debt-to-equity ratio of these companies deteriorated. Policymakers at the government level concluded that the financial sector was lagging behind the real industrial sector. But within the financial sector, the stock market was in a worse situation. The financial system was also considerably bank-centered. To diversify external financing sources and to improve capital structure, there was a strong need to first normalize, and then expand, the capital market. From 1983 to 1987, the government introduced a series of policy measures to promote IPOs and seasoned equity offerings (SEOs).

These policy measures proved to be a great success. Once again, macroeconomic conditions played a key role. The Three Lows-low international interest rates, low value of the Korean Won, and low crude oil prices-significantly increased the demand for Korean export products, thereby inducing firms to raise capital from the stock market. With higher income, a greater number of Koreans participated in the stock market, greatly expanding the stock market's investor base. Measures taken to liberalize public offering prices and to allow share issuance at market prices also helped in the resurgence of the stock market.

During this period, the government refrained from using the term IPO orders. Instead it used the term IPO recommendations. In substance, however, the two terms were not greatly different from one another. The government still retained the power to influence banks, and to refuse bank lending, if recommended firms did not comply with its policies and recommendations.

The equity offering expansion policies in the 1980s was not without their problems. First, the economic boom in the second half of '80s was a double-edge sword. The boom encouraged firms to raise capital from the stock market. Concurrently, it created an economic environment that was ripe for a stock price bubble. Once the bubble burst, that stock market was left with an oversupply of shares. Once again, the government had failed to preemptively detect and correct the stock market imbalance. Second, controlling shareholders were criticized for intentionally diluting the value of company shares before their IPO's, and reaping massive capital gains after the public offerings. Third, the introduction of preferred shares was a violation against the one-share one-vote principle. This was because these preferred shares were more like non-voting common shares. In effect, the government had approved a de facto dual class equity system.

5. Other Supplementary Policies

On secondary market policies, I have covered the adoption of a regular transaction system in 1969, and the subsequent measure taken on June 3, 1971 (the 6.3 Measure) (Chapter 3, Section 1). I have also covered a number of securities deposit and settlement systems that have been introduced since 1973. The securities deposit system was aimed to reduce speculation in the secondary market, thus allowing share prices be set more efficiently. The settlement system was aimed to lower transaction costs for doing business in the secondary market.

Last but not least, I have also covered policy measures taken to expand the stock market's investor base. Specifically, I have analyzed the employee stock ownership plan (ESOP), introduced in 1968 and reinforced in 1974 (Chapter 3, Section 3). I have also covered the people's stock ownership plan (PSOP), which was chosen to privatize POSCO (1988) and KEPCO (1989) (Chapter 3, Section 4).

6. The Introduction of Regular-way Transaction and the June 3rd Measure

In 1969, the regular transaction system replaced the clearing transaction system, which was prone to speculation and often caused large fluctuations in the stock market. By replacing a system traded on margins with one that required next day settlements (with actual delivery of shares), the government hoped that would limit speculation in the stock market. Unfortunately, the new system was also flawed. It allowed delayed settlements, and with a nominal fee, it was possible to delay settlements indefinitely, which made the new system virtually indistinguishable from the previous one. It was essentially a margin transaction with a new name. The stock market continued to be vulnerable to speculative trading. Also, the government vacillated between two conflicting policy goals. Initially, it introduced the regular trading system to eradicate speculation. But later, it relaxed margin limits, hoping that it would stimulate the market. It is with no doubt that the government lost credibility among market participants during this time.

Against the backdrop of increasing open positions among market participants who were heavily engaged in margin transactions, the government came up with an extraordinary measure in 1971 to force market participants to cancel their open positions, and to ban settlements beyond a five-day delay. This measure, known as the Measure of June 3rd, was only partially successful, however. The government erred by changing the trading system not by the Presidential Decree, but by the Ministerial Order. Technically, this was in breach of the Securities and Transaction Act, which prescribed that any change in the trading system must be executed by a revision through a Presidential Decree. This triggered a series of lawsuits against the government. To end the legal dispute, on July 29, 1971, the government revised the Enforcement Decree and stipulated that stock transaction must be settled on the fifth day of contract.

7. The Introduction of Securities Deposit and Settlement Systems

With the June 3rd, Measure of 1971, stock transactions had to be settled with actual delivery of shares. This requirement, however, proved to be very inconvenient to implement. There was a risk of the share certificates being lost, as well as costs necessary to keep them. As a way of alleviating such inconveniences, the government began to introduce a series of measures since 1973. It introduced a book-entry clearing system in 1973, a centralized deposit system in 1983, a continued depository system in 1985, and a beneficial shareholder system in 1987. These measures all contributed to the development of Korea's secondary market, by allowing settlement of share transactions and transfer of shareholder's names without actual delivery of shares. They were also instrumental in supporting the primary market, especially during the second half of 1980s, when the number of IPOs soared.

One particularly regretful point was Korea's delay in adopting the continued depository system. The necessity was raised in 1980, but not adopted until 1985. The delay was attributable to the Commercial Code, which prohibited split votes, and the government took too much time to implement proper revisions.

It is also worth noting that Korea actively benchmarked other countries when adopting its securities deposit and settlement systems. The government received technical assistance from experts from USAID to establish the securities settlement system. As for the continued depository system, the government was influenced by precedents in the U.S., the U.K., and Japan.

8. The Employee Stock Ownership Plan

The employee stock ownership plan (ESOP) was first introduced with the Capital Market Development Act of 1968. In the beginning, ESOP was not widely accepted by Korean firms. The expected dividend yields were too low to attract employers into holding shares. Salary levels were also too low to warrant any extra savings in the form of shares. There were no tax benefits available at the time, and top management at Korea's leading companies had little understanding of such plans.

The employee stock ownership plans became widely accepted only after July 1974, when the Ministry of Finance announced a package of supporting measures. For example, it introduced a loan program for employees that wish to purchase company shares. Second, the ministry encouraged firms to give bonuses and severance payments in the form of company shares. Third, it encouraged even nonpublic firms to allocate 10 percent of IPO stocks to employee stock ownership associations. Fourth, it encouraged firms to sell company shares at a discount to their employees.

Two years after the announcement of the supporting measures, in July 1976, the number of firms with employee stock ownership association reached 249, with the number of employees enrolled reaching 91,497. By the late '70s and the late '80s, ESOP served as one of the most reliable investor groups to absorb newly issued company shares.

Despite such benefits, employee stock ownership plans are not without their problems. If a company were to go bankrupt, for example, employees enrolled in such plans will lose both their jobs and wealth. If one wishes to diversify his wealth, such "all in" programs are simply not desirable.

9. The People's Stock Ownership Plan

In 1988 and 1989, the government privatized POSCO and KEPCO by implementing a people's stock ownership plan (PSOP). This plan involved selling government-owned shares to low-and medium-income households at a discount, provided that they agree to a three-year mandatory holding period. The plan was based on two policy goals. First, it aimed to share the benefits of economic development with the Korean people, thereby giving them a sense of ownership and forming a consensus for further economic development. Second, it aimed to help low- and medium-income households accumulate wealth and expand the stock investors' base for the future.

The people's stock ownership plan was a success in term of expanding the stock market's investor base. The number of shareholders increased from 3 million at the end of 1987 to 19 million by the end of 1989. However, it failed to benefit medium- to low-income households, another important policy goal of the plan. Households received on average only 9.7 shares of POSCO and only 19.3 shares of KEPCO, which were not substantial enough to make much of a difference. The returns on allotted stocks over the three-year mandatory holding period, however, were satisfactory, thanks to the 30 percent discounted purchase price.

The dramatic increase in the number of stock investors had a negative impact as well, however. On one hand, it greatly expanded the stock market's investor base, and these new investors played a key role in absorbing new public offerings in the late 1980s. But on the other hand, it actually induced too many individuals to become investors in the stock market, including those unqualified to invest in stocks. It was all too common to see retirees living on pension or investors with imminent liquidity needs investing in the stock market, often with leverage, and then losing everything in a market downturn. Indeed, PSOP may have gone too far in attracting small and naïve investors to the stock market.

Policy makers in developing countries should fully understand this dilemma when pursuing PSOP. Normally, a new group of investors enter the stock market when the market is experiencing a boom. These are times when the government can easily sell the shares. But these are also the times when the market is at its peak. Investors who are subscribed to PSOP offerings, therefore, are highly likely to lose money when the market inevitably cools down. If these subscribers are mostly from low-income households, this inevitability could become a major social- and political problem.

Chapter 1

Introduction

Introduction

It is a great challenge for less developed countries to create a strong securities market. They lack many of the institutions that control information asymmetry and self-dealing. That is, legal and market institutions that ensure that minority shareholders (i) receive good information about the value of a company's business and (ii) allow them to have trust and confidence in a company's management and controlling shareholders. Regulators, prosecutors, and courts may not be honest or sophisticated enough to carry out this task. Accounting and financial disclosure rules may not be comprehensive or independently audited. Reputational intermediaries, such as investment bankers, accountants, and securities lawyers, may not be sophisticated enough nor subject to liability risk (Black, 2001).[1]

When the Daehan Stock Exchange was established in February 1956, none of the necessary legal and market institutions were present. At the time, the market was akin to a legalized gambling casino, often plagued with speculative bubbles and bursts. With a limited score of listed firms, the size of primary market was very small. It hardly served as a channel through which firms raised their external equity capital. In contrast, it had an enormous secondary market. The percentage of stock trading, which was marginal in the 1950s, had suddenly surpassed that of government bonds by 1961. But this was attributable to a high volume of speculative transactions. Because speculators made use of clearing transactions, which is similar to today's futures transactions, the trading volume often soared to unsustainable levels. On a number of occasions, it triggered the Korean government to step in and rescue the stock exchange at the brink of a massive default.

As of 2010, however, the Korea Exchange (KRX) has a market capitalization of 1.1 trillion USD. This ranks KRX as the 17th largest stock exchange in the world, in terms of equity market capitalization (World Federation of Exchanges). What explains this

1 One solution to this problem is to adapt another country's institutions. But this is feasible only in limited areas (Black, 2001).

astonishing achievement over a 50-year period? This report is motivated to answer a part of this question.

This report studies series of capital market promotion policies Korea pursued over a 30-year period during its development era (1960s-1980s). The purpose is to extract lessons that can benefit policymakers in the developing world, where capital market promotion is an important policy goal. Given that the Korean government's main interest was to mobilize domestic capital for economic development and to lower firm's debt-to-equity ratio, I have left out the bond market from my analyses, and when discussing the stock market, I have put greater weight on its primary market policies than the secondary market policies

The report is composed of two parts: primary market policies (Chapter 2) and other supplementary policies (Chapter 3). The latter includes secondary market policies (Sections 1 and 2) and policy measures taken to expand the stock market's investor base (Sections 3 and 4). They are both supplementary to the primary market policies for obvious reasons. First, no country can have a vibrant primary market without a well-functioning secondary market, where share prices are set efficiently and shares are traded with reasonably low transaction costs. It is also obvious that the primary market cannot be enlarged by simply increasing the supply of shares. Instead, there should be a commensurate increase in the stock market's investors' base.

During its development era, mobilization of domestic capital was not the sole objective of the Korean government's capital market promotion policies. Throughout this period, policymakers emphasized that IPOs can be used as means by which the country could share the fruits of its economic growth. This policy stance emerged repeatedly under many different names, such as popularization of stock ownership, democratization of stock ownership, and socialization of corporate ownership.

On primary market policies, I have covered the initial public offering (IPO) inducement measures taken during 1968-71 (Chapter 2, Section 1), the coercive IPO orders implemented during 1972-78 (Chapter 2, Section 2), and the promotion of IPOs and Seasoned Equity Offerings (SEO) in the late 1980s (Chapter 2, Section 3).

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Chapter 2

The Primary Market Policies

The Primary Market Policies

1. The Initial Public Offering Inducement Measures (1968-1971)

1.1 Background

Three points are worth noting as the background surrounding the IPO inducement measures that were taken in 1968. First, firms grew rapidly during the First 5-Year Economic Development Plan (1962-1966) period, but also experienced a significant deterioration in their debt-to-equity ratio. Second, in order to successfully finance the Second 5-Year Economic Development Plan (1967-1971), there was a compelling need to mobilize domestic capital from the stock market (Shin, 1987). But the stock market had been in a dismal state since a bubble burst in 1962, and did not function well as a source for equity capital. Third, as a way of raising domestic capital, the government was planning to sell its shares in state-owned enterprises. By doing so, the government hoped to sell its shares to the general public, thereby popularizing stock ownership throughout the country.

<Table 2-1> shows the external financing structure of Korean firms from 1963 to 1968. One notable observation is that the total amount of externally raised capital increased nearly tenfold during this five-year period, from 36.2 to 321.8 billion won. Another observation is that they were mostly raised either from foreign debt sources or from bank lending sources. Note that the figures under Others are mostly private loans. Also note that the proportion of equity financing drops from 25 percent in 1963 to 12 percent in 1966. In the following year, it would drop down further to 8 percent.

Table 2-1 | External Financing Structure of Korean Firms, 1963-1968

(Unit: billions of won, %)

Year	External Financing	Debt Capital				Equity Capital	
		Total	Foreign Debt	Bank Loans	Others	Amount	Percentage
1963	36.2	27.1	8.3	6.4	12.4	9.0	25
1964	26.9	19.8	2.7	6.4	10.7	7.2	27
1965	48.4	39.0	4.7	11.5	22.8	9.4	19
1966	107.9	95.0	48.8	10.4	35.8	12.9	12
1967	198.7	182.7	64.6	62.0	56.1	16.0	8
1968	321.8	296.7	108.7	107.8	80.2	25.1	8

Source: ECOS, Bank of Korea

With a greater reliance on debt financing, the debt-to-equity ratio deteriorated rapidly for many of these companies. <Table 2-2> illustrates the capital structure of manufacturing firms during the same time period. One can easily see that the debt-to-equity and interest-to-sales ratios increased, while the equity-to-asset and interest coverate ratios dropped.

Table 2-2 | Capital Structure of Manufacturing Firms, 1963-1968

(Unit: %)

Year	Debt-to-Equity	Equity-to-Asset	Interest Coverage	Interest-to-Sales
1963	92.20	52.03	405.56	3.02
1964	84.98	54.06	273.66	4.89
1965	82.51	54.79	320.86	3.91
1966	106.15	48.51	236.87	5.65
1967	127.75	43.91	227.21	5.19
1968	167.37	37.40	212.65	5.90

Notes: Interest coverage ratio refers to EBIT/(interest payments).

Source: ECOS, Bank of Korea

<Table 2-3> shows stock market statistics from 1963 to 1966. Although the number of listed firms increased slightly during this period, new equity offerings and trading volume dropped. The stock market index increased as well, but its growth rate was well below that of the producer's price index (PPI).[2] Moreover, a high bank deposit rate of around 30 percent discouraged people from investing in the stock market (Hong, 1973). Also, as of 1966, most of the listed firms were state-owned enterprises.[3] There were only six firms without state-ownership (Korea Securities Financing, Oriental Fire&Marine, Headong Fire&Marine, Kyungsong Spinning, Tong-Il Spinning, and Yuhan).

Table 2-3 | Stock Market Statistics, 1963-1966

(Unit: millions of won, %)

	1963	1964	1965	1966
No. of Listed Firms	15	17	17	24
Paid-in Capital Increase	608	369	100	369
Trading Volume	26,000	27,039	9,271	11,160
Modified Average Stock Price Index	57.27	62.47	60.94	62.87
Producers' Price Index (PPI)	46.30	62.30	68.50	74.40

Notes: Modified Average Stock Price Index (1972=100), PPI (1970=100).
Source: Rhee et al. (2005) and Hong (2005)
Original Source: Securities Market Yearly Statistics

In the second half of 1962, making stock ownership more popular emerged as a major policy objective.[4] It was a way to normalize the stock market, the reputation of which was significantly tarnished after the 1962 bubble-burst. It was also influenced by the Japanese experience after World War II (Kyunghyang Shimmun, Sep. 5, 1962). When Zaibatsu-Japanese family-controlled business conglomerates-were dissolved during America's occupation of Japan, a significant number of shares, originally held by the family members, were sold to company employees. This greatly helped to popularize stock ownership in Japan. Also, it changed the perception the Japanese had towards the stock market. No longer was the stock market perceived to be a place for gambling. It was instead seen as a market where firms raise long-term capital, as well as a place where people can invest their savings.

2 Stock market index refers to the Combined (12 issues) Index (1972=100).

3 There were 18 SOEs listed on the stock exchange. They include Korea Stock Exchange, five commercial banks (Choheung Bank, First City Bank, Commercial Bank of Korea, Han-il Bank, and Bank of Seoul), Korea Express, Korea Shipping, Korean Air Lines, Korea Tourist Service, Honam Fertilizer, Korea Electric, Korea Ship Building, Inchon Heavy Industry, Hankuk Machine Industrial, Korea Tungsten Mining, Korea Salt, Daihan Iron Mining Development.

4 The Democratic Republican Party (the ruling party) and the Association of Korean Industry Leaders prepared a bill named the Special Act on the Popularization of Stock Ownership.

1.2 The Legislative Process

The effort to enact laws to encourage capital market development started from the National Assembly. Mr. Nam-June Lee and 52 other National Assemblymen submitted a bill entitled the Stock Investment Security Act in January 1965. Although the bill did not pass the National Assembly, it triggered other similar bills (Rhee et al., 2005), including the Investment Promotion Act, the Stock Investment Promotion Act, and the Act Establishing Korea Investment Promotion Corporation. Eventually, on September 9, 1968, the Finance and Economy Committee-a standing committee of the National Assembly-proposed the Capital Market Development Act, based partially on the Act Establishing Korea Investment Promotion Corporation. The latter bill was also submitted by Mr. Lee with 45 other National Assemblymen.

The Capital Market Development Act passed the National Assembly on November 8, 1968 and was enacted, promulgated, and took effect on November 22, 1968. This Act, together with the Securities Exchange Act, constituted the two pillars of Korea's securities market regulation: one for the primary market, and the other for the secondary market. In order to lower corporate income tax rates for those public firms subjected to these laws, Mr. Lee also submitted a bill to revise the Regulation Law on Tax Reduction and Exemption in July 1968. This law also passed the National Assembly on November 8, 1968.

Mr. Lee is reputed to have worked very hard for these legislations. Over three years and eight months, he spent considerable time persuading fellow National Assemblymen and bureaucrats in the related Ministries. He believed that the Capital Market Development Act would alleviate income polarization and contribute to a balanced economic growth (Maeil Business Newspaper, Sep. 14, 1968).

The Ministry of Finance (Minister Bong-Kyun Seo) also echoed Mr. Lee's arguments in July 1967, by announcing the Capital Market Development Plan, which promised the sale of state-owned enterprises to the general public, as a way of raising government revenue and popularizing stock ownership (DongA Daily Newspaper, Jul. 15, 1967). But contrary to its original plan, the state-owned enterprises were sold to Chaebols-family-controlled Korean business conglomerates-at bargain prices. In response to criticism on such deals, Jong-Yeul Hwang, the new Minister of Finance, stated that the primary objective of selling government shares was to privatize inefficiently run state-owned enterprise. He also argued that the Ministry could not manipulate and influence how many shares each shareholder would own (Maeil Business Newspaper, Aug. 2, 1968).

Although it was claimed that the law wans enacted for the general public, its initial bill failed to incorporate the public interest in a meaningful way. Article 4 in the original bill provided that, for employees of central/local government and state-owned enterprises, bonuses, pensions, severance pays, and compensations would be paid in securities owned by the government. This triggered strong resistance from labor unions. The Federation of Korean Trade Union saw the provision as an infringement of property rights and resolved to strike as a way of protesting the new bill (DongA Newspaper, Jul. 1, 1968). Such movements led the National Assembly to revise the bill, so that government-owned securities would be used as means of payment only when specifically requested by the employee. (DongA Newspaper, Jul. 4, 1968). But even this revision proved unsatisfactory to labor unions, and as a result, Article 4 was removed in its entirety from the bill .

1.3 The Act Details and Their Implementations

Article 1 listed the Act's objectives, which included the promotion of IPOs, greater dispersion of share ownership, people's ownership of firm shares, greater reliance on equity financing, and ultimately the development of a sound capital market. Chapter 2 of the Act covered measures to encourage dispersed share ownership and stock investment. Chapter 3 covered provisions on IPOs and Chapter 4 included provisions on the establishment of the Korea Investment Development Corporation.

1.3.1 Dispersed Share Ownership and Stock Investment

First, to encourage the people's participation in stocks, the Act guaranteed minimum dividend yields. If dividends fell short of the level established in the Enforcement Decree (e.g. 10 percent), nongovernment shareholders would have priority in receiving dividends, until their yields reached the guaranteed level. To enable this, the Act allowed firms to adjust the dividends distributed to government shareholders. Second, the Act allowed shares to be used for paying security deposits. Government and state-owned enterprises were not disallowed from refusing such deposit payments.

Third, for shares held either by the government or by Korea Development Bank (KDB), the Act allowed discounted share offerings when selling them to the general public, civil servants, or SOE employees. Such shares were subject to a mandatory holding period specified in the Enforcement Degree (e.g. until the next annual shareholders' meeting day). This measure obviously aimed to encourage dispersed share ownership, and was at least partly influenced by the criticism raised against the first-price auction (Rhee et al., 2005) when privatizing SOEs. Most of the SOE privatizations under the first-price auction resulted in Chaebols acquiring significant ownership.

Fourth, as another way to encourage dispersed share ownership of listed firms (or non-listed public firms), the Act also allowed share offerings to company employees. This is an exception to the preemptive rights of existing shareholders. The portion of such shares, however, could not be more than 10 percent of outstanding shares. Fifth, the Act exempted the dividend income tax.

Box 2-1 | The Legal Definition of Public Firm

The term "public firm" is defined in the Corporate Income Tax Code (Article 22-3). According to the Code, a public firm is a listed firm or a non-listed firm that meets the following three conditions.

First, the percentage of holdings by minority owners(shareholders individually holdings less than 3 percent of outstanding shares) must be at least 20 percent of outstanding shares. Second, the number of minority shareholders must be at least 30. Third, the portion of holdings by any shareholder, together with his or her relatives defined in the Enforcement Decree, must be no more than 60 percent of outstanding shares.

1.3.2 Initial Public Offerings

To encourage firms to go public, the Act gave tax and special depreciation benefits to listed firms (or non-listed public firms). <Table 2-4> summarizes the corporate income tax rates applicable to public and nonpublic firms. In the highest income bracket, the two tax rates differ by 20 percentage points. As for depreciation, the Act permitted an extra 20 percent depreciation for listed (or non-listed public) firms.

Table 2-4 | Corporate Income Tax Rates (Public versus Non-public)

Income Ranges	Public Firms	Non-public Firms
Below 1 million won	15%	25%
Between 1 and 5 million won	20%	35%
Above 5 million won	25%	45%

Source: Rhee et al. (2005)

Some individuals, however, raised concerns that the number of corporate blackmailers would increase with a greater number of minority shareholders.[5] This led the Act to permit the chair of shareholders meetings have the authority to preserve and maintain order. This meant that the chair would be able to stop any person from speaking, or have him removed, if the chair were to judge that person as intentionally disturbing the orderliness of the meeting proceedings.

5 Corporate blackmailers are unique to Korea and Japan. They usually extort money from or blackmail companies by threatening to publicly humiliate companies and their management.

1.3.3 Korea Investment Development Corporation

The Act established the Korea Investment Development Corporation (KIDC), to underwrite newly offered shares, promote dispersed share ownership, and stabilize share prices.[6] Legally, the Corporation was a stock company, in which the government owned 50 percent of outstanding shares. Under its shareholders meeting, it had an Investment Review Committee that screened new offerings, underwrote government-owned shares, and set offering prices.

This Investment Review Committee was composed of nine members: (i) the President of KIDC, (ii) the President of Korea Stock Exchange, (iii) a person from the Ministry of Finance, as designated by its Minister, (iv) a person from Bank of Korea, as designated by its Governor, (v) a person from KDB, as designated by its President, (vi) a person nominated by the President of Korea Securities Dealers Association (KSDA) and appointed by the Minister of Finance, (vii) a person nominated by the President of Korea Chamber of Commerce and Industry and appointed by the Minister of Finance, (viii) a person nominated by the a Business Trade Association specified in the Enforcement Decree and appointed by the Minister of Finance, and (ix) a person who has knowledge and experience in securities market, appointed by the Minister of Finance.

The Act regarded KIDC as a securities company and required that it to be registered as one. The Act also permitted KIDC a wide scope of businesses: (i) securities underwriting, (ii) securities trading, (iii) public offerings and sales arrangements, (iv) stock price stabilization, (v) sales of government- or SOE-owned securities, (vi) research and advisory services to issuing firms, (vii) securities collateral loan business, and (viii) securities investment trust business.

It is also worth noting that KIDC had the potential of mitigating the information asymmetry problem in the primary market. As a securities underwriter and agent with a mandate of stabilizing newly offered shares, it had the potential to serve as a reputational intermediary.

The idea of establishing KIDC originated from Mr. Nam-June Lee. To protect minority shareholders, Mr. Lee argued that this organization must be set up to stabilize share prices on behalf of the government (Maeil Business Newspaper, Mar. 22, 1968).

1.4 Outcomes and Evaluation

KIDC was launched in December 1968 with a paid-in equity capital of 1.5 billion won (authorized capital of 3 billion won). Shareholders include the government (500 million won), KDB (500 million won), and other private sector participants (500 million won).

6 In December 1972, Korea Investment Development Corporation (KIDC) was renamed as Korea Investment Corporation (KIC). Korea Investment Corporation established in July 2005 as a sovereign wealth fund has no relevance to the KIDC established in December 1968.

Byung-June Lee was appointed as KIDC's first President. To establish the government's strong determination, it even named 1969 as the "Year of Capital Market Development" and May 3rd as the "Day of Securities."

Figure 2-1 | KSE and the Year of Capital Market Development

Note: A photo of the old Korea Stock Exchange building at Myeong-Dong, Seoul. A plank is hanging on the entrance in 1969. It says "The Year of Capital Market Development." Source: JoongAng Ilbo

Figure 2-2 | KIDC and the Year of Capital Market Development

Note: A photo taken at the entrance to Korea Investment Development Corporation (KIDC) in 1969. The top plank reads "The Year of Capital Market Development." Source: Presidential Archives

Despite such initial enthusiasm, the outcome was disappointing. From Table 2-5, one can observe that, over the period between 1968 and1971, market capitalization, capital stock of listed firms, number of listed firms, amount of paid-in capital increase, and number of shareholders increased, giving an impression that the government made some progress. But the reality behind the figures was far different. First, most of the newly offered shares were acquired by banks. As a result, bank lending was merely replaced by bank equity investments, thereby perpetuating the same reliance on banks as before. Second, the same firms that went public according to the definition set out in the Corporate Income Tax Code refused to be listed on the stock market itself. A tax code that did not distinguish between non-listed public firms and listed public firms when granting tax benefits was the primary reason for this refusal (Kyunghyang Shimmun, May 2, 1970).

Third, the fraction of shares owned by small-scale investors (those holding less than 1,000 shares) increased only by 0.8 percentage points over a four-year period, suggesting that the government had failed to achieve its goal of promoting dispersed ownership. Not surprisingly, the amount of public offerings was also a mere 5.29 billion won. Fourth, there were disguised public offerings during this period. In order to meet the conditions as a public firm, controlling shareholders of two different firms mutually exchanged their shares. By periodically trading the shares, they were even able to satisfy the requirements of a listed firm through this loophole(Maeil Business Newspaper, Oct. 15, 1970). As shown in <Table 2-5>, trading volume was insubstantial. In 1971, the total number of shares traded took up only 30 percent of shares outstanding.

Table 2-5 | Stock Market Statistics, 1968-1971

	Unit	1968	1969	1970	1971
Market Capitalization	Mil. of won	64,323	86,569	97,922	108,706
Capital Stock Listed	Mil. of won	96,585	119,902	134,292	141,356
No. of Listed Firms	New	10	8	6	2
	Cumulated	34	42	48	50
Paid-in Capital Increase	No. of Firms	10	6	13	7
	Mil. of won	20,317	5,983	6,225	2,090
Public Offerings	No. of Firms	2	12	9	4
	Mil. of won	160	2,211	2,068	850
No. of Shareholders	-	39,986	54,318	76,276	81,923
Share Ownership by Small-scale Investors	%	2.03	1.91	2.74	2.83
Yearly Turnover	Yearly	0.67	0.70	0.49	0.29

Notes: Small-scale investors refer to those holding less than 1,000 shares. Yearly turnover is measured by (total no. of shares traded a year / total no. of shares outstand at year-end)

Source: Securities Market Yearly Statistics, 1972

Such failure was predicted from the beginning (Kyunghyang Shimmun, Nov. 12, 1968), since stock returns were well below bank deposit rates, and since high inflation rates would discourage the general public from investing into the stock market.[7] Also, experts at the time predicted that the public would instead invest in the real estate market. The 10 percent dividend yield guaranteed by statute was also judged to be too low by experts. The level may have been sufficient for the controlling shareholders to produce a healthy return on their investments, but insufficient for outside minority shareholders.

Overall, the government's IPO inducement policy of 1968 failed to achieve its policy goals. Nevertheless, it contributed to the Korean capital market in two ways. First, it greatly dissipated the stigma of the stock market as a place for gambling.[8] Second, it created the KIDC, which would later play an important role in developing the Korean capital market.[9]

1.5 Implications for Developing Countries

According to the survey conducted by KIDC in 1972, firms (paid-in capital above 50 million won) gave three reasons behind their reluctance to go public: (i) pressure to pay cash dividends (40.3 percent), (ii) fear of not being able to place entirety of newly issued shares (25.0%), and (iii) concern over losing corporate control (11.9%) (Maeil Business Newspaper, Oct. 24, 1972).

At the time, not many firms were profitable enough to payout cash dividends. Even if they were profitable, dividend yields were well below prevailing interest rates (or even inflation rates, for that matter) and therefore unable to attract investors to the stock market. In the absence of a broad investors'base, there was a high likelihood that newly issued shares would not be fully absorbed in the primary market. Thus, company founders who were reluctant to offer shares at deep discounts opted against going public, despite favorable tax benefits. These founders were also concerned that they would lose control over theirs firms once they became public.

Clearly, there are important lessons that can be learned from this episode. The government's efforts to encourage IPOs cannot succeed without macroeconomic stability. Without stabilizing interest and inflation rates, one cannot expect to attract investors to the stock market. In the absence of a meaningful secondary market, one cannot expect the primary market to function properly. These lessons are equally applicable to other developing countries that wish to increase the number of listed companies.

7 Bank interest rates were raised in 1965 after years of suppression.

8 The negative perception of stock ownership, however, lasted for many years to come. Up until the mid '80s, bureaucrats who entered the government as level-5 civil servant by the virtue of passing the High Civil Service Examination preferred to work at the Financial Management Bureau, which overlooked commercial banks, and steered clear of the Securities and Insurance Bureau. Level-5 civil servants at the Securities and Insurance Bureau were mostly composed of those who were promoted to level 5 from level 6.

9 Korea Investment Development Corporation (KIDC) was the first institution that sold investment trust certificates (May 1970). When it was dissolved in 1977, its role and staff were transferred to the Securities Supervisory Board and Daehan Investment Trust Company.

2. The IPO Promotion Act: A Coercive Approach (1972-1978)

2.1 Background

Economic boom in the second half of 1960s spread optimism among the Korean business community. The boom encouraged large Korean firms to increase their bank borrowings. Borrowing from banks, however, was not enough to maximize revenues. To expand their business, these companies began to finance their activities through private loans. But this strategy proved to be a mistake. The monthly interest rates on these private loans were very high, about 5 percent on average. Some loans were as high as 10 percent per month (Koh, 2008). By 1972, many firms could no longer service their debts. The Federation of Korean Industries (FKI) asked the government to take emergency action. The government intervened, as requested. On August 3, 1972, the government announced that it would freeze all the existing private loans to businesses, and later restructured their terms, which were greatly in favor to the borrowers.

Box 2-2 | Debt Restructuring under the Emergency Measure of August 8, 1972

Maturities were extended to five years with a grace period of three years. Interest rates were also set as low as 1.35 percent per month. If the creditors were company owners, the loans were converted into shares. The government also restructured short-term loans extended by banks. Their maturities were extended to five years with a grace period of three years. Interest rates were set at 8 percent per annum. Interest rates applied to freshly-extended loans were also lowered. Consequently, the time deposit rate of 17.4 percent before the emergency measure dropped down to 12.6 percent.

Figure 2-3 | The Emergency Measure of August 3rd, 1972

Note: A photo of Wan-Sun Tae (Deputy Prime Minister, in the middle), Duck-Woo Nam (Minister of Finance, on the left), and Nak-Sun Lee (Minister of Commerce and Industry, on the right) taking questions from the press on the emergency measure of August 3rd that froze all existing private loans. Source: KTV

Policymakers who were involved in this Emergency Measure of August 8, 1972 opined that Korean firms should make definitive changes in their capital structure.[10] As a direct result, the necessity to promote public offering received a renewed interest in Korea. Public offerings were also perceived as a way to socialize corporate ownership in Korea (Kim, 2006). The failure of IPO inducement policy in 1968, however, led policymakers to establish a more coercive approach. Undoubtedly, the political environment under the Yushin Regime made such a coercive approach possible.

Box 2-3 | The Yushin Regime

In October 1972, after declaring a state of emergency, President Park dissolved the National Assembly and suspended the constitution. Soon the constitution was revised in a way that paved the way for President Park to take authoritarian and lifetime power without any limits. This new regime was called the Yushin Regime. The word Yushin is the Korean pronunciation of the Japanese word Ishin, which means restoration. Ishin is used in Meiji Ishin, which refers to the chain of events that restored imperial rule to Japan in 1868.

10 For details on the Emergency Measure of August 8, 1972, see Kim (2002). It argues that the new IPO promotion policies were already conceived when preparing for the private debt freeze measures.

Figure 2-4 | Yushin Regime and the New Constitution

Note: The Yushin Constitution was approved in a referendum held on November 21, 1972. The photo was taken at its promulgation ceremony on December 27, 1972. Source: KTV

Much lower interest rates set after the Emergency Measure of August 8 created an environment conducive to pursue an IPO promotion policy. Relatively high stock returns also attracted people to the stock market. This renewed interest in stock investment and initial increase in the number of IPOs, however, were temporarily interrupted by the oil shock in late 1973.

2.2 The Act Details

By the time the Emergency Measure of August 8 was fully implemented, the Ministry of Finance (Minister Duk-Woo Nam) finished its preparation of the bill enacting the IPO Promotion Act.[11] The Act was approved by the Emergency State Council on December 30, 1972 and came into effect on January 5, 1973.[12] The objectives set out in Article 1 of the Act were very similar to those listed in the Capital Market Development Act. The Act aimed to promote IPOs, facilitate equity financing, improve capital structure, promote people's ownership of stock shares, and contribute to the nation's economic development (Nam, 2009).

Although the two Acts were similar in their main objectives, the approaches taken to execute them were very different. The Capital Market Development Act of 1968 was a passive policy, aimed at inducing voluntary IPOs through tax incentives. In contrast, the

11 In September 1971, the Ministry of Finance established a new bureau exclusively for securities and insurance affairs. Mr. In-Kie Hong was appointed as the first Director-General of this bureau (September 1971-August 1973). Mr. Hong was succeded by Mr. Lee, Kun-Joong (August 1973-May 1976).

12 The Emergency State Council acted as Korea's National Assembly from October 1972 to March 1973, during which the National Assembly was dissolved by President Park. The Council was composed of the President, the Prime Minister, and other cabinet members.

approach taken in the IPO Promotion Act of 1972 was a coercive one, relying on government orders and penalties. Firms were unilaterally designated by the government to go public; if they did not comply, the government had the authority to penalize them by restricting bank lending. Such a coercive approach was only possible because of the new political environment under the Yushin Regime.

2.2.1 IPO Review Committee

The Act established the IPO Review Committee that would deliberate and finalize the policies necessary to implement the Act (Article 3). The committee was composed of 8 to 11 members. The ex officio members included the Prime Minister (who presided over the meetings), the Minister of Economic Planning Board (EPB), the Minister of Finance, the Minister of Industry and Trade, the Governor of Bank of Korea, the President of KIDC, and the President of the Korea Stock Exchange. In addition to these ex officio members, 1 to 5 civilians with knowledge and experience in securities matters were appointed as members by the President.[13]

2.2.2 Designation of Qualified Firms

According to the Act, the Ministry of Finance reviewed a set of firms (known as target firms) and designated a subset that would be selected to go public (qualified firms). The Minister of Finance had the power to order qualified firms to go public (Article 4). Target firms included (i) firms that were approved under the Foreign Capital Inducement Act to receive foreign loans or import capital goods in excess of their equity capital (1 billion won, if capital is greater than 1 billion won), (ii) firms that had borrowed from domestic financial institutions in the amount of more than 1 billion won, and (iii) firms which needed to become a public entity for the sake of Korea's economic development (detailed criteria were delegated to the Enforcement Decree).

Qualified firms were those that met the following conditions: (i) equity capital in excess of 50 million won, (ii) two or more years of operation since being established, (iii) dividend yields that were expected to be greater than 10 percent after IPO, and (iv) shares that were expected to trade above par value. When giving IPO orders, it was also required that the Minister of Finance give instructions concerning the details of the offering. These details included (i) the number of shares that needs to be publically offered, (ii) upper ownership limit per shareholder (including related parties), (iii) offering terms, and (iv) offering deadline. The Act set the upper ceiling of 51 percent as the restriction on ownership per shareholder.[14] The Act could have set the upper limit to a lower amount, but concerns by

13 According to Byung-Woo Koh, individual IPOs were authorized by the Assistant Minister of Financial Affairs at the Ministry of Finance. Mr. Koh served as the Assistant Minister of Financial Affairs from January 1975 to September 1977

14 A year earlier (Dec. 28, 1971), the Corporate Income Tax Code was revised in the same direction. The upper ownership limit per shareholder was set to be 51 percent. Previously, it had been 60 percent.

company owners over losing corporate control resulted in the government setting it slightly above 50 percent.

To facilitate the government's document review, the Act gave the Minister of Finance power to request documents from subject firms, and to review their financial statements (Article 6). The Minister of Finance also had the authority to ask for cooperation from government agencies and other related organizations. These agencies and organizations had to oblige unless there was a clear reason not doing to (Article 7).

To facilitate public offerings and achieve dispersed share ownership, the Act required the establishment of an organization that would act as a stand-by underwriter, and purchase unsubscribed shares, later reselling them in installments to the general public (Article 9). To encourage participation in this operation, the Act temporarily (1973-1976) exempted participating organizations from paying corporate income taxes, as long as capital gains were obtained within six months after the offering (Article 15).

2.2.3 Incentives for IPO

The Act gave firms a variety of economic incentives to go public. First, the Act permitted public or designated firms the opportunity to revalue their real estate assets annually, even if they were not directly used for operations. Normally, such real estate assets had not been eligible for asset revaluations. According to the Act, moreover, revaluation gains were subject to a special tax rate of 27 percent, well below the normal rate of 40 percent (Article 12). Second, the Act gave a 50 percent tax exemption on dividend income to shareholders (together with related parties) who owned less than 30 percent of outstanding shares (Article 13).

Third, if a designated firm had complied with the government order and went public, it was pardoned of previous tax evasion crimes, provided that it would correct its financial statement prior to the date the Act takes effect (January 5, 1973) (Article 14).

2.2.4 Penalties for Non-Compliance

The penalties established in the Act were as provocative as the incentives. If a designated firm refused to comply, it faced the following penalties during its period of non-compliance: (i) the interests on debt borrowed from shareholders or management could not be expensed, (ii) entertainment and other similar costs could be expensed at a rate only half of other compliant firms, (iii) special depreciation privileges granted to firms with honest tax filing records could not be allowed, and (iv) a 20 percent increase in corporate income tax would be required.

Second, the Act penalized not only the non-complying firms, but also their shareholders. The shareholders would face a 20 percent increase in their general income tax payments. Probably the most effective tool, however, was the Minister of Finance's power to ask financial institutions to limit their lending and other assistances to non-complying firms.

2.3 Implementation of the Act

2.3.1 IPO Review Committee during 1973-1974

On March 10, 1973, the government formed the IPO Review Committee by appointing five civil members.[15] The first meeting was held on March 22, presided over by Jong-Pil Kim, the Prime Minister. At this meeting, the Committee selected 110 firms to request submission of their financial statements by April 12. These firms were either (i) firms that had foreign debt of more than 5 million dollars, (ii) firms that had restructured its debt under the Emergency Measure of August 8 in the amount of more than 500 million won, or (iii) firms that had borrowed more than 1 billion won from domestic financial institutions (DongA Daily Newspaper, Mar. 22, 1973). 104 firms submitted their financial statements by the deadline, with four submitting statements after the deadline, and two not complying at all.

On July 23, the IPO Review Committee meeting conducted its second meeting, and decided to add firms with a restructured debt greater than 100 million won to the target list. This resulted in an additional 350 firms (Maeil Business Newspaper, Jul. 23, 1973). They had to submit their financial statements by the end of August.[16] At the same meeting, 40 out of 108 firms that had previously submitted their financial statements were identified as qualified firms. Among these 40 firms, 14 had already gone public, 12 were identified as firms for whom an IPO was feasible, and the remaining 14 were regarded as infeasible. Public offering orders, however, were not issued at this time, with Prime Minister Jong-Pil Kim giving instructions that IPOs should be carried out as voluntarily as possible.

The IPO Review Committee met two additional times, in September and November. No additional firms were added in the target list, nor wers there any firms that received a public offering order from the government. On April 26 in the following year, the Ministry of Finance had completed its due diligence of 32 firms, which were asked to submit offering details, including number of shares to be offered, terms, and the offering date.

2.3.2 Oil Shock of 1973 and the Slow Progress

<Table 2-6> summarizes stock market performance during the period of 1971-1974. Thanks to rising stock prices until 1973 (the stock price had peaked in July 1972 to 394), most of the stock market indicators had improved during this time period. Market capitalization, capital stock of listed firms, number of listed firms, amount of paid-in capital increase, number of shareholders, aggregate share holdings by small-scale investors

15 The first civil members include Sang-Nak Oh (Seoul National University), Kee-Chul Song (Korea University), Jong-Ha Lee (Yonsei University), Il-Chung Hwang (Sogang University), and In-Sang Song (Korea Economic Development Association).

16 In 1973, the Ministry of Finance made a visit to Bovespa (Sao Paulo Stock Exchange). The visit was recommended by the head of United States Operations Mission (USOM). USOM was later renamed as USAID-K.

(holding less than 1,000 shares), and turnover statistics showed progress. This was by no means a coincidence. 1973 was also the year when Korea had grown by 14.8 percent in real terms.

This upward trend, however, was interrupted by an oil shock that hit the economy near the end of 1973. Consequently, in 1974, only 26 firms were newly listed on the stock exchange. During 1973-74, in fact, there were firms that even experienced a decreased in capital or were de-listed altogether.

Table 2-6 | Stock Market Statistics, 1971-1974

	Unit	1971	1972	1973	1974
Stock Price Index	1972 = 100	-	227	311	297
Market Capitalization	Mil. of won	108,706	245,981	426,247	532,824
Capital Stock Listed	Mil. of won	141,357	174,339	251,620	381,343
No. of Listed Firms	New (Delist)	2	16	40 (2)	26 (2)
	Cumulated	50	66	104	128
Paid-in Capital Increase	No. of Firms	7	31	53	62
	Mil. of won	2,090	15,175	33,617	37,052
Public Offerings	No. of Firms	4	7	47	19
	Mil. of won	850	1,080	21,475	14,337
No. of Shareholders	-	81,923	103,266	199,999	199,613
Share Ownership by Small-scale Investors	%	2.83	3.37	5.94	4.91
Yearly Turnover	Yearly	0.30	0.43	0.53	0.39
Economic Growth Rate	Real GDP %	10.4	6.5	14.8	9.4

Notes: Small-scale investors refer to those holding less than 1,000 shares. Yearly turnover is measured by (total no. of shares traded a year / total no. of shares outstand at year-end)

Source: Securities Market Yearly Statistics (1975) and Bank of Korea (ECOS)

2.3.3 Special Presidential Order of May 29

Due to the government's measures to lower import tariffs, Korean firms endured the oil shock of 1973 without much difficulty (Interview with Byung-Woo Koh). Firms did not make much progress in their IPOs, however, which caused President Park to intervene.[17] Based on advice provided by the Chief Secretary of Economic Affairs, President Park issued a special order to his cabinet on May 29, 1974, entitled the "Five Special Orders on Firms' Public Offerings and Corporate Culture." Following is the full translation in English.

17 This import tariff reduction measure was a part of a comprehensive set of measures announced on January 14, 1974. Other measures include lowering the income tax burden for low income households and instituting higher tax rates on luxury goods (Kyunghyang Shimmun, Mar., 21, 1974).

Box 2-4 | Five Special Orders on Firms' Public Offerings and Corporate Culture

I emphasized on many occasions that firms-the key driver of our economic development-should enhance their efficiency and fulfill their social responsibility as the people's firm.

Furthermore, at this juncture when we aim to transform our industry to one that is centered around heavy equipment and chemical industries (HCI), it is important that they expand their size and make every effort to avoid lagging behind international standards. This can be achieved only when firms establish a corporate culture that is balanced between capital and management, with cooperation between the labor and management. Such a corporate culture can induce people to actively participate in our endeavor to promote the heavy equipment and chemical industries (HCI).

Today, there are families forming business conglomerates, calling themselves as a group, overstretching themselves to engage in many different businesses. Some have retained the old habit of moving corporate assets and concentrating them under the control of family members, instead of finding value in starting new firms and growing them. No doubt, such behavior is harmful for the sound development of our firms.

It is true that our firms have started with a meager amount of equity capital. And it was inevitable for our firms, with a short corporate history, to rely heavily on bank borrowing and foreign debt to fuel their growth. But, it is now time to move away from such an old-fashioned management philosophy, and offer company stocks to the public-at-large. This will free firms that have relied only on their founders for capital and managerial talent.

Against this backdrop, the government should improve firm's capital structure, and make sure that private firms are not over-exposed to bank loans and foreign capital. It should also make greater efforts on its IPO-drive and strengthen its tax enforcement. On the other hand, the business community should realize its responsibility and role in our society, and establish innovative management systems by opening up its door to outsiders. It is important for our firms to leap forward and become global players, and for the country to prosper in the 1980s with an improved economic constitution.

Therefore, I give the following five orders to the cabinet. The cabinet should come up with a comprehensive package of measures for implementation as soon as possible.

1. Actively induce initial public offerings by making use of bank lending, foreign capital, and tax benefits. In particular, when providing assistance, give priority to public firms established by new and innovative management.
2. Establish a system that can monitor and manage active loans, as well as taxes paid out by large private firms (including sister firms within the group) and their major shareholders.

3. Prevent large firms, and large private firms in particular, from relying too much on bank debt.
4. For firms that currently rely heavily on bank debt, guide them to raise capital by issuing shares to the public if they wish to enter new business.
5. Improve firms' public trustworthiness and substantiate their corporate assets by strengthening tax enforcement and through external audits.

Source: Kim (2002)

Stock price soared upon the news of the President's special order (Maeil Business Newspaper, May 30, 1974). But the responses from firms were not encouraging. They were still concerned with the possibility that newly offered shares might not be fully purchased, and the possibility of losing control over their businesses (Chosun Ilbo, May 31, 1974).

Figure 2-5 | Heavy Equipment and Chemical Industry (HCI) Promotion Policy

Note: A photo of oil refinery at Ulsan industrial complex located on the Southern East corner of the Korean peninsula. The photo was taken in 1981. Source: KTV

Amidst this stalemate, the government decided to ask for cooperation from Sung-Kohn Kim, the head of Korea Chamber of Commerce and Industry, hoping that if he decided to go public with Ssanyong Cement Industrial, it may trigger others to follow. Yong-Hwan Kim, the Chief Secretary of Economic Affairs, invited Chairman Kim to the Blue House and proposed a deal (Kim, 2002). The decision to make this deal was not easy for Chairman Kim, as he had great concerns over losing corporate control. He nevertheless could not refuse the government's request. On July 8 1974, Chairman Kim called a press conference and announced his plan on Ssangyong Cement Industrial's IPO.

2.3.4 IPO Supplementary Measures of August 8

Despite all such efforts, it was still rare for a key blue-chip firm within a group to go public. The firms that went public were mostly secondary firms within a group. To address this situation, the government on August 8 1975 announced its IPO Supplementary Measures. Kun-Joong Lee, the Director-General of Securities and Insurance Affairs at the Ministry of Finance, summarized the significance of the new measure in two ways:

Box 2-5 | IPO Supplementary Measures of August 8

First, in the past, dividend yield was used as the key criterion when selecting IPO candidates. This resulted in selecting mid-sized firms in light industries. Consequently, based on this criterion, firms in the HCI sector that needed the infusion of outside capital the most were not chosen. The supplementary measures of August 8 aim to target these firms.

Second, in the past few years, even after the introduction of IPO Promotion Act, the government waited for the firms to go public voluntarily. But these firms have not met the government's expectations. Even blue chip firms that could successfully float their shares refused to go public. With the introduction of supplementary measures of August 8, the government will adopt a more selective and coercive approach

Source: Maeil Business Newspaper, Aug. 16, 1975

The Supplementary Measures of August 8 came up with a new set of target firms, which included: (i) primary firms within a Chaebol group, (ii) top 100 firm in terms of company size, (iii) firms with more than 3 million dollars of foreign debt, (vi) top 100 exporting firm, (v) firms classified as a qualified firm according to KIDC, or (vi) firms in the HCI sector.[18]

2.3.5 Other Government Measures

Besides the Supplementary Measures of August 8, there were other government policy measures that later greatly facilitated firms going public. One was the Capital Market Preparation Measures, announced in June 1974. The measures aimed to prepare the capital market for large public offerings by forming a syndicate of financial institutions that would purchase unsubscribed shares from issuers, and later reselling them to the general public. KIDC and securities firms with equity capital above 300 million won were the key participants. Besides underwriting, the Capital Market Preparation Measures covered policies on securities savings, securities investment trusts, and employee stock ownership plans.

18 On the details of heavy-equipment and chemical industries promotion policy, see Kim (2011).

In December 1976, the Securities and Exchange Act also underwent a major revision. The revisions included the establishment of: (i) the Securities Management Commission (SMC) and the Securities Supervisory Board (SSB), (ii) a 10 percent ownership limit in listed firms,[19] (iii) the ex post management of listed firms, (iv) supplementary measures to improve corporate disclosures, and (v) measures to prevent insider trading.

Related to corporate disclosure, the Act mandated firms to register at least a year before their listings and required a number of disclosures. To prevent insider trading, the Act banned stock trading by company management and employees. The Act also mandated that company management, employees, and major shareholders (owning more than 10 percent) return their capital gains back to the company if the gains were obtained by selling or purchasing company shares within six month after their purchase or sale, respectively.

2.4 Outcome and Evaluation

2.4.1 Outcome

The government made public the list of qualified firms and their public offering schedules on October 6, 1975 and July 1, 1976. In 1975, it included 105 firms, from which 30 were strongly recommended to go public before the end of the year.[20] These 30 firms include mostly primary firms within conglomerate groups, such as Samsung Mulsan (Samsung C&T), Korea Explosives (Hanwha Corporation), Yonhap Mulsan, Dongkuk Steel, and others. In the event of non-compliance, they would be subject to public offering orders (issued by the IPO Review Committee), as well as financial and/or tax-related sanctions.[21] For the remaining 75 firms, they would receive public offering recommendations or orders in 1976 (DongA Daily Newspaper, Oct. 6, 1975). Of the initial 105 firms, 65 went public by the first six months of 1976 (Maeil Business Newspaper, Jul. 1, 1976).

19 According to Article 200 of the Securities and Exchange Act, no shareholder was allowed to own more than 10 percent of outstanding shares in a listed firm. Shareholders owning more than 10 percent of shares at the time of listing, however, were not subject to this rule.

20 105 firms include 60 firms classified as a primary firm with a group, 24 firms classified as a top 100 firm in terms of company size, 1 firm classified as a top exporting firm, and 20 firms classified as a qualified firm by KIDC.

21 At the working-level, public offering promotion policy was carried out by the Securities and Insurance Bureau at the Ministry of Finance, KIDC, and banks with the largest loan exposures. The Securities and Insurance Bureau was under the supervision of the Assistant Minister of Financial Affairs. Since the bureaus in charge of banks (Financial Management Bureau) and foreign exchange transactions (Foreign Exchange Bureau) were also under the control of the Assistant Minister of Financial Affairs, it was easy to obtain cooperation from other related organizations (interview with Byung-Woo Koh).

In 1976, the government included 101 firms designated to go public between the second half of 1976 and the first half of 1977.[22] It was reported that the government placed special weight on firm profitability when coming up with the 1976 list (Maeil Business Newspaper, Jul. 1, 1976). Many firms, however, could not go public due to profitability- or capital structure-related reasons. Among the 46 firms designated to go public in 1976, only 20 complied. Even very profitable firms refused to go public during this time, the most noteworthy example being Hyundai Construction.[23] On March 15, 1978, the Securities Supervisory Board organized a meeting with firms that were recommended to go public, strongly warning that if they did not comply, public offering orders would be issued, along with appropriate sanctions (Kyunghyang Shimmun, March 15, 1978).

Figure 2-6 | Hyundai Construction's Refusal of IPO

Note: A photo of Ju-Yung Chung, founder and Chairman of Hyundai Group, holding a press conference in July 1977. He announced that he would donate 50 percent of his shares in Hyundai Construction to Asan Foundation, which will build five general hospitals around the country. With this donation, Hyundai Construction was able to remain private despite the government's IPO drive. Source: KTV

Although some firms refused to go public, overall, the government's effort was deemed a success. <Table 2-7> shows the development of Korean stock market during the period of 1974-1978. One can see that the number of listed firms and the amount of paid-in capital increased significantly, along with a rising stock market index. In September 1976, the government celebrated raising more than 1 trillion won in equity capital during a one-year period. During the three-year period between 1975 and 1977, almost 300 firms went public

22 101 firms include 36 firms classified as a primary firm with a group, 57 firms classified as a top 100 firm in terms of company size, 1 firm classified as those with more than 3 million dollars of foreign debt, 4 firms classified as a monopoly, 1 firm classified a top borrower, and 2 firms classified as top exporting firm.

23 Firms wanted to raise the offering price, while the government wanted to lower it. It was government's strong belief that high offering price cannot attract enough investors to purchase all the newly issued shares (Interview with Byung-Woo Koh)

(Koh, 2008). Low interest rates and high economic growth rate were important factors behind this growth. In 1975, dividend yields for listed firms averaged 23.3 percent, while the time deposit rate was only 15 percent (Rhee et al., 2005). Korea also experienced three consecutive years of two-digit real GDP growth rate during 1976-1978.

Table 2-7 | Stock Market Statistics, 1974-1978

	Unit	1974	1975	1976	1977	1978
Stock Price Index	1975 = 100	105.0	139.4	146.8	178.2	207.2
Market Capitalization	Bil. of won	533	916	1,436	2,351	2,892
Capital Stock Listed	Bil. of won	381	643	1,153	2,117	2,959
No. of Listed Firms	New (Delist)	26 (2)	62	87	49	33
	Cumulated	128	189	274	323	356
Paid-in Capital Increase	No. of Firms	62	68	81	97	148
	Mil. of won	37,052	82,929	101,941	141,859	285,201
Public Offerings	No. of Firms	19	62	87	49	33
	Mil. of won	14,337	39,875	74,005	44,113	41,521
No. of Shareholders	-	199,613	290,678	568,105	395,275	963,049
Share Ownership by Small-scale Investors	%	4.91	5.31	3.58	3.38	6.59
Yearly Turnover	Yearly	0.39	0.51	0.51	0.71	0.56
Economic Growth Rate	Real GDP %	9.4	7.3	13.5	11.8	10.3

Notes: Small-scale investors refer to those holding less than 1,000 shares. Yearly turnover is measured by (total no. of shares traded a year / total no. of shares outstand at year-end)

Source: Securities Market Yearly Statistics (1979) and Bank of Korea (ECOS)

Among the firms that were listed between September 1975 and December 1978, 104 firms still remain on the stock exchange as of August 2011. Noteworthy companies include Samsung Mulsan (Samsung C&T, Dec. 12, 1975), Sunkyong (SK Networkds, Jun, 30, 1977), Korea Explosives (Hanwha, Jun. 24, 1976), Daewoo Securities (Sep. 30, 1975), Hyundai Securities (Sep. 30, 1975), Hanbo Securities (Woori Investment and Securities, Sep. 30, 1975), Taekwang Industrial (Dec. 27, 1975), Goldstar Cable (LS Cable&System, Jun. 30, 1977), Nongshim (Jun. 30, 1976), YungPoong Commerce (YungPoong, Jun. 12, 1976), Korea Fertilizer (Samsung Fine Chemicals, Apr. 15, 1976), Bando Corporation (LG International, Mar. 10, 1976), Sunkyong Chemical Fibers (SK Chemical, Jun. 29, 1976), Korea Steel (Kiswire, May. 25, 1976), Pan Korea Insurance (LIG Insurance, Jul. 5, 1976), Samchully Industry (Samchully, Dec. 23, 1976), Modopa (Lotte Midopa, Dec. 12, 1975), Namyang (Jun. 24, 1978), Miryung Engineering and Construction (Dongbu Corporation, Oct. 30, 1978), Tongyang Machinery (S&T Dynamics, Jul. 8, 1976).

2.4.2 Evaluation

Although the government threatened on a number of different occasions that it would penalize non-compliant firms, it never sanctioned any company. Nevertheless, the government made significant achievements in increasing the number of listed firms. The success factors can be summarized as follows. First, the low interest rates that prevailed during this period contributed most to this success. With relatively high stock returns and dividend yields, investors were attracted to the stock market. With a much greater investors' base, large-scaled public offerings were placed successfully without much difficulty. Correlatively, the influx of dollar receipts from the construction boom in the Middle East resulted in an expansionary monetary policy. Undoubtedly, the resulting excess liquidity also contributed to the stock market growth.

Figure 2-7 | Construction Boom in the Middle East

Note: A photo of construction workers waving before their departure to the Middle East in 1974.

Figure 2-8 | Jubail Port Construction Project

Note: A photo of Jubail Port at Saudi Arabia. Hyundai Construction emerged as a global construction company thanks to this 960 million dollar project in 1976. The size of this contract was a quarter of Korean government's annual budget. It also greatly helped increase Korea's FX reserve.

Second, rapid economic growth was also crucial. Facing increased demand, firms had to raise capital and were motivated to go public voluntarily. As mentioned earlier, the period during which the number of listed firms increased the most overlaps with Korea's two-digit real GDP growth rates for three consecutive years (1976-1978). Third, President Park's incessant and unwavering support was also crucial. The Special Order of May 29, occasional instructions at monthly economic development meetings were just few examples of his support. Without his support, Korea's IPO promotion policy would not have been pursued consistently over the five-year period (1973-1978).

Fourth, the government's timely introduction of various securities-related measures also helped alleviate the concerns of company owners and investors. For example, the 10 percent ownership limit greatly alleviated the concern over losing corporate control. The underwriting syndicate formed to provide firm commitment underwriting helped to absorb large-scale public offerings. Mandatory registration and prior disclosure of financial statements alleviated investors' concern over firm's lack of transparency.

An interesting way of understanding the policy efforts in the 1970s is looking at it from the perspective of mitigating information asymmetry, and the resulting adverse selection problem. The challenge the Korean government was facing in the 1960s and the '70s was to overcome these problems without a good disclosure rule or securities law. The option taken in the 1960s was to set up KIDC that would serve as a reputational intermediary, which did not work out. The policy measures taken in the 1970s was an improvement over that in the 1960s in a sense that the government was directly involved in differentiating high and low quality firms. By going through the financial statements and designating qualified firms, the government served as a trustworthy screening agency. But the offering prices set by the government were too low for high quality firms. As a result, they refused to go public, as in the case of Hyundai Construction. This problem was partially solved when macroeconomic conditions improved in subsequent years. With higher earnings, the offering price had to be set higher, which led high quality firms to voluntarily offer their shares in the market.

Box 2-6 | Information Asymmetry and Adverse Selection

It is well known in economics that information asymmetry can lead to adverse selections (Akerlof, 1970). That is, an uninformed buyer's decision can drive out high-quality sellers. Stock market is a vivid example of this principle. Since company outsiders do not know which company's future prospects are bright and which are not, they set their purchasing price at the mid-point. This means that firms with a brighter prospect cannot receive fair value for their shares, and retire from the market. Firms with poor prospects, on the other hand, will not be discouraged, remaining in the market to try to sell their shares. This is the adverse selection problem faced by outside investors. If they are rational, they will react to the lower average quality of issuers by discounting the price further more. This again drives out the high-quality issuers and exacerbates the adverse selection problem. Theoretically, this process can continue until no firm remains in the market.

Box 2-7 | Legal and Institutional Preconditions for Strong Securities Markets

Black (2001) lists 18 core institutions that can control this information asymmetry problem. He groups them in six broad categories. Under "effective regulators, prosecutors, and courts," the list includes (1) a securities regulator that is trustworthy, and has the staff, skill, and budget to pursue complex securities disclosure cases, (2) a judicial system that is honest and sophisticated enough to handle complex securities cases; can intervene quickly when needed to prevent asset stripping; and produces decisions without intolerable delay, (3) procedural rules that provide reasonably broad civil discovery and permit class actions or another means to combine the small claims of numerous investors.

Under "financial disclosure," the list includes (4) extensive financial disclosure, including independent audits of public companies' financial statements, (5) accounting and auditing rules that address investors' need for reliable information, (6) a rule-writing institution with the competence, independence, and incentives to write good accounting rules and keep them up-to-date.

Under reputational intermediaries, the list includes (7) a sophisticated accounting profession with the skill and experience to catch at least some instances of false or misleading disclosure, (8) securities or other laws that impose on accountants enough risk of liability to investors, (9) a sophisticated investment banking profession that investigates securities issuers because the investment banker's reputation depends on not selling overpriced securities to investors, (10) securities or other laws that impose on investment bankers enough risk of liability to investors, (11) sophisticated securities lawyers who can ensure that a company's offering documents comply with the disclosure requirements, (12) a stock exchange with meaningful listing standards and the willingness to enforce them by fining or delisting companies that violate disclosure rules.

Under "company and insider liability," the list includes (13) securities or other laws that impose liability and other civil sanctions on companies and insiders for false or misleading disclosure, (14) criminal liability for insiders who intentionally mislead investors.

Under "market transparency," the list includes (15) rules ensuring market transparency (the time, quantity, and price of trades in public securities must be promptly disclosed to investors), (16) rules banning manipulation of trading prices (and enforcement of those rules).

Under "culture and other informal institutions," the list includes (17) an active financial press and securities analyst profession that can uncover and publicize misleading disclosure and criticize company insiders and (when appropriate) investment bankers, accountants, and lawyers, (18) a culture of disclosure among accountants, investment bankers, lawyers, and company managers, who learn that concealing bad news is a recipe for trouble.

Box 2-8 | Self-Dealing and Moral Hazard

Aside from information asymmetry, the second major obstacle to a strong public stock market is the potential for insiders engaging in self-dealing to expropriate minority investors. This potential for self-dealing can also create the adverse selection problem, and the causes are very similar. Since company outsiders do not know which company insiders are likely to engage in self-dealing, they set their purchasing price at the mid-point. This means honest firms cannot receive fair value for their shares, and will likely retire from the market. Self-dealing firms, on the other hand, will not be discouraged by their assigned values, and will remain, continuing to sell their shares. If investors are rational, they will react to the lower average quality of issuers by discounting the price further. This again drives out the honest issuers and exacerbates the adverse selection problem.

Moral hazard can also exacerbate the problem. Firms that successfully issued their shares may have an incentive to renege on a promise not to self-deal (Black, 2001 and Milgrom and Roberts, 1992). This is similar to a health insurance policyholder that may have an added incentive to ask for pricier and more elaborate medical services.

Another interesting question is whether this coercive and interventionist approach helped. My investigation shows that such approach contributed to the IPO boom during the late 1970s. By being directly involved in differentiating between high and low quality firms, the government greatly mitigated the information asymmetry problem. Also, the incentives and the penalties it imposed aligned the interests of both the government and the designated firms. But their effects were heavily influenced by improvements in macroeconomic conditions. Before the economic boom, the number of IPOs increased only moderately. Also, Korea's business community complained about low offering prices. A good example of this was Hyundai Construction, which refused to go public despite the government's persuasions and threats. But when the economy boomed, the number of IPOs also accelerated. With higher share prices, the offering prices were also set higher. Then, a recession followed, which resulted in a dramatic drop in the number of IPOs. The number of listed firms actually dropped during this time.

The government's success in increasing the number of IPOs was tarnished with a bubble that formed in 1978. With the construction boom in the Middle East, construction companies became overly subscribed by investors, while other sectors experienced under-subscription (DongA Daily Newspaper, Jun. 7, 1978). In 1976, the portion taken up by construction firms in total amounts of public offerings and the increase in capital were respectively 9.7 percent and 1.4 percent. The figures respectively increased to 63.9 percent and 25.4 percent in 1978 (Rhee et al., 2005). Although many construction firms went public during the bubble years, interestingly, the top-ranking firms did not. Hyundai Construction is a good example.

Box 2-9 | Hyundai Construction's Refusal of IPO

The reason behind Hyundai Construction's continued refusal to go public boils down to its offering price. Hyundai Construction, which became a global player in 1976 by winning Saudi Arabia's Jubail port contract (worth 960 million dollars), wanted to offer its shares at 7,000 won per share. This was significantly higher than the 3,000 won suggested by the government (Maeil Business Newspaper, Jun. 4, 1977).

Despite such disagreements, in 1977, the government and Hyundai Construction struck a deal to go public. But the decision was overturned at the last moment when Chairman Ju-Yung Chung succeeded in persuading President Park that Hyundai Construction would build five general hospitals around the country if it could remain private. Chairman Chung calculated that investors would benefit by 50 billion won if Hyundai Construction shares were to be offered below its true value. He promised that the same amount of money would be used to build hospitals. The origin of Asan Medical Center can also be traced back to this promise. Asan Medical Center is now one of the most prestigious hospitals in the country (Koh, 2008).

The government failed to detect and correct the imbalances that emerged in the stock market by the second half of 1978. There were too many shares being offered, compared to the size of stock market's investor base. Coupled with the government's tight monetary policy to fight against inflation and a second oil shock, the stock market soon crashed, failing to recover for many years afterward (Rhee et al., 2005).

2.5 Implications for Developing Countries

The implications of IPO promotion policies during the period between 1972 and 1978 can be summarized as follows. First, the Korean experience shows the importance of leadership exerted by its head of state. As mentioned earlier, President Park's incessant and unwavering support was crucial. It is also worth noting that Korea's IPO promotion policy benefited from the Yushin Regime. Without such a regime, the IPO Promotion Act, which authorized the government to penalize non-compliant firms, could not have been enacted. But given that the entire time period devoted for this policy lasted only five years, and that the government never actually sanctioned any firms, one can deduce that the Korean experience can be at least partially applied to other countries as well.

Second, the Korean experience shows the importance of securities-related measures that alleviate the concerns of company owners and investors. Examples include the 10 percent ownership limit to mitigate concerns over losing corporate control,[24] the underwriting syndicates formed to provide firm commitment underwriting services, and the mandatory registration and prior disclosure of financial statements.

Third, the Korean experience also shows the importance of macroeconomic conditions. The economic recovery and the low interest rates during the second half of 1970s created an environment where investors and firms both showed interest in the stock market. This is in stark contract with the situation in the late 1960s. The IPO promotion policies in the 1960s failed because of high interest rates, but succeeded in the 1970s because of low interest rates. The importance of macroeconomic conditions was demonstrated again during the two oil shocks (October 1973 and November 1979). Thus, the best time for developing countries to pursue IPO promotion policies is when the economy is recovering and the interest rates are low.

Fourth, the Korean experience also shows the importance of balancing the supply of, and the demand for, stocks in the primary market. The imbalance that emerged in the second half of 1978 no doubt exacerbated the stock market collapse when the government had to tighten its monetary supply. Of course, it is somewhat inevitable to see share price drops after public offering. This is because firms tend to offer shares when the share prices are at their peaks. This, however, does not mean the government is helpless. To prevent a hard landing, it should closely monitor and the market, and if necessary, limit the amount of share offerings.

24 The 10 percent rule lasted for 21 years until January 1997 when it was replaced by the mandatory bid rule. Given the difficulty to finance acquisitions in 1997, a mandatory bid rule was considered as an anti-takeover device.

3. The Equity Offering Expansion Policies in the 1980s

3.1 Background

3.1.1 Stock Market Stagnation and the Need to Expand the Role of Government

The stock market stagnated for many years after the bubble burst in 1978. Firms started to rely again on bank lending and private loans. Naturally, the debt-to-equity ratio deteriorated. Amidst this backdrop, in October 1983, Man-Jae Kim became the Finance Minister. Unlike his predecessors, he had a deep understanding and keen interest in the capital market, and was very active in developing the market during his tenure (Interview with Ho-Joo Shin).[25]

Government policymakers, including Minister Kim, thought that the financial sector was lagging behind the real industrial sector. Undoubtedly, this had to do with twenty years of financial repression during the period of government-led interventionist industrial policies. But within the financial sector, the stock market was in a worse situation. The financial system was considerably bank-centered. To diversify external financing sources and to improve capital structure, there was a strong need to first normalize and then expand the capital market (Interview with Ho-Joo Shin).

It is worth noting here that nation-wide resource mobilization, which was an important policy goal behind capital market development policies in the 1970s, did not play a key role in this particular decade.

3.1.2 The Three Lows and the Economic Boom

During the second half of the 1980s, Korea greatly enjoyed the Three Lows, which refer to low international interest rates, low value of the Korean won, and low price of crude oil. With low international interest rates, the debt service burden on foreign borrowings dropped significantly. A stronger Yen against the US dollar, a result of the Plaza Accord, made Korean export goods relatively cheap. Lower crude oil price significantly lowered production costs. Consequently, Korea's current account turned in to a surplus after many years of a chronic deficit. Real GDP growth rate that was 9.9 percent and 7.5 percent respectively in 1984 and 1985, increasing to 12.2 percent, 12.3 percent, and 11.7 percent respectively in 1986, 1987, and 1988.[26]

25 His tenure as the Minister of Finance ran from October 1983 to December 1985. Between January 1986 and May 1987, he served as the Deputy Prime Minister, heading the Economic Planning Board (EPB). Previously (March 1971 and January 1982), he had served as the founding President of the Korea Development Institute (KDI). Ho-Joo Shin, who was the Director of Securities Division at the Ministry of Finance between June 1984 and April 1987, also worked briefly at KDI when Man-Jae Kim was the President.

26 There were two occasions when Korea experienced three consecutive years of double-digit real GDP growth rate. One was during the second half of 1970s (76-78) and the other one was during the second half of 1980s (86-88). Interestingly, these two periods overlap with the period when initial public offerings soared. These IPO waves, however, resulted in over-supply of public offerings and a market crash.

Such economic boom no doubt helped the government's policy to expand equity offerings. Faced with greater demand on their products, firms had to increase their capital expenditures. Higher share prices meant that they could raise equity at a cheaper cost. There were also plenty of interested investors available. With rising per capita income and wealth, a greater number of people participated in the stock market.

3.1.3 Market Opening and Privatization

Capital market internationalization was first contemplated in January 1981, when the government announced its Long-Term Plan on Capital Market Internationalization. In preparation of opening Korea's market, it became very important to enlarge the size of the stock market.[27] The privatization of SOEs also made it necessary to expand the stock market. Since the government privatized firms by selling its shares directly in the stock market, it was deemed very important to have a well-developed primary market.

3.2 The Policy Details

The equity offering expansion policy in the 1980s, the subject matter of this section, refers to a series of policy measures announced and implemented during the period of 1983-87, either to encourage public offerings or to expand the investors' base. The policy makers at the Ministry of Finance believed that they should give priority to the former over the latter, if they were forced to choose between the two. They thought that once blue-chip shares were offered, this would trigger an increase in investors' demand, i.e., supply essentially creating demand (Interview with Ho-Joo Shin). According to this logic, the government focused on policy measures that would either induce or coerce blue-chip firms to offer their shares in the open market.

3.2.1 The Measures Expanding the Role of Capital Market (July 1983)

As mentioned earlier, the stock market had stagnated for many years. The number of listed firms, which had peaked at 356 in Dec. 1978, dropped down to 334 by Dec. 1982. The Korea Composite Stock Price Index (KOSPI), which had peaked at 144.86 in Dec. 1978, dropped down to 127.31 by Dec. 1982. Consequently, public offerings were few and far between.

To resume the stock market's function as a source of equity capital, the government on July 18 1983, came up with the Measures Expanding the Role of Capital Market. The key components included (i) the expansion of the primary market, (ii) a plan to gradually allow share offerings at market price, and (iii) the expansion of securities firms' role (Maeil Business Newspaper, Jul. 18, 1983).

27 The market was opened gradually. The first Korea Fund was listed in the NYSE in August 1984. Foreigners' direct investment in the Korea Stock Exchange was allowed in January 1992. Foreigners' ownership limit was completely lifted in May 1998.

Specifically, the government relaxed the requirements necessary to become a public firm. The minimum amount of paid-in capital was lowered from 2.4 billion to 0.5 billion won, allowing medium-sized firms to go public.[28] The maximum inside ownership was raised from 60 percent to 80 percent. To separate these firms from those that meet higher ownership standards, the government also decided to split the stock exchange into two boards. The first board would accommodate firms with low inside ownership (< 60 percent) and the second board would accommodate firms with high inside ownership (> 60 and < 80 percent). To encourage firms to disperse their share ownership, firms that were on the second board for three years and had paid-in capital above 5 billion won, or book equity above 10 billion, would move to the first board by meeting the share ownership requirement.

To encourage seasoned equity offerings by listed firms, the government decided to designate target firms. They were designated based on two criteria: a high debt-to-equity ratio and average share prices being 30 percent above their par values. The government warned that these target firms would be penalized if they tried to borrow from banks instead of issuing shares. The government also decided to gradually allow share offerings at market prices. If the market price was above the par value, the difference was allowed to be retained and be classified as a part of book equity, under the name of capital surplus reserve.

3.2.2 Linking Equity Offerings to Debt Issuance (February 1984)

In February 1984, the government announced the Money Market Promotion Plan, which raised the cap on corporate bonds and commercial papers issuances for firms that publically offered their shares either through IPOs or SEOs.

By Dec. 1984, KOSPI reached 142.46, almost recovering its level in Dec. 1978 (144.86). It was also in 1984 when the long-awaited IPO of Hyundai Construction took place.

3.2.3 The Capital Market Development Plan (June 1985)

In June 1985, the government announced a plan that intended to boost stock market investment demand from institutional investors (Maeil Business Newspaper, Jun. 13, 1985). First, the plan established an investment trust that would mobilize pension money-mostly from government employee pension funds-for stock investment. This investment trust had a maturity of five years with a three year lock-up period. Second, to increase stock investments by insurance companies, it required insurance companies to allocate five percent of net increase in annual premium revenue for stock investment.

Third, the plan raised the minimum weight on equity for equity-type investment trusts. Fourth, the plan allowed merchant banks to issue corporate bonds, so that they could use

28 Relatively speaking, medium-sized firms were more desperate to raise equity capital than large scale firms. Therefore it was much easier for the government to persuade their IPO (Interview with Won-Koo Baik and Ho-Joo Shin).

newly raised funds for securities finance investments. Fifth, the plan relaxed the eligibility requirement to participate in employee's securities savings, by raising the monthly salary cap from 400 thousand to 600 thousand won. Sixth, the plan lowered the tax burden of small-scale investors (investing less than 5 million won) by lowering the dividend income tax rate from 16.75 percent to 15 percent. Seventh, the plan allowed firms to buy back shares for the purpose of paying out bonuses.

3.2.4 The IPO and SEO Promotion Plan (March 1986)

The Capital Market Development Plan announced in June 1985 intended to boost investment demand from institutional investors for stocks, while the IPO and SEO Promotion Plan announced in March 1986 aimed to increase public offerings.[29] It took the approaches similar to those in the 1970s, where the government selected and announced the list of firms that should go public and mobilized a variety of policy tools to make sure that it happened.[30]

In particular, for seasoned equity offerings (SEOs), it targeted firms with share price 30 percent above its par value, and equity-to-asset ratio less than 30 percent. It also allowed stock offerings at market price if the share price was two times greater than the par value. The cap on securities companies' debt guarantees on corporate bonds were raised for firms that went public, or offered shares after their listing on the stock exchange (Rhee et al., 2005).

3.2.5 The Measures to Enforce Equity Financing (April 1986)

In April 1986, the Securities Supervisory Board (SSB) came up with a detailed mechanism to link firms' public offerings with the credit management system. First, SSB informed creditor banks of firms that need to increase public offerings (97 large blue-chip firms and 100 medium-sized firms). Second, these firms were allowed to borrow, on the condition that a certain percentage of their loans would be raised in equity capital from the stock market. Third, if firms refused to raise capital from the stock market, their bank borrowings or their corporate bond issuances would be restricted.

The government also relaxed the eligibility requirements for market price stock offerings. It removed all existing requirements, except for the requirement that share price must be 20 percent above par value.

29 Policymakers believed that the key to enlarging the capital market was to make blue-chip companies offer its shares to the market. They thought investors would voluntarily participate in the stock market once such shares were available (Interview with Won-Koo Baik and Ho-Joo Shin).

30 In fact, the government announced the list including 65 large blue-chip firms (including 26 primary group firms) and 117 medium-sized firms.

3.2.6 The Measures to Strengthen the Foundation of Capital Market (June 1987)

The most comprehensive package of measures to expand equity offerings was announced in June 1987. First, to induce blue-chip firms to offer their shares, the government came up with a number of incentives for them. They included (i) relaxing the market-price share offering rule, (ii) strengthening tax benefits, (iii) relaxing the asset revaluation requirements, (iv) relaxing the cap on corporate bond issuances and stock dividends, (v) allowing the issuance of exchange bonds and participation bonds, and (vi) relaxing the cap on the issuance of preferred shares.[31]

Second, to enlarge the stock investors' base, the government introduced a number of measures, including (i) privileged access to IPO stocks given to holders of long-term savings accounts, (ii) strengthened regulation of insider's trading, and (iii) supplementary measures to improve company disclosures. To support employee stock ownership associations, they were given 20 percent preemptive rights over publically offered shares. Previously, these associations had 10 percent preemptive rights. Third, the government designated firms in nationally important industries (hereafter "public interest firms") and came up with ways to protect these entities from takeovers, including ownership limits and restrictions on foreign acquisitions.

Most of the measures announced in June were incorporated into the Capital Market Development Act, revised in November 28. Also, the IPO Promotion Act was repealed and merged into the revised Capital Market Development Act. With the IPO Promotion Act's repeal, the term 'IPO order' was also replaced by the term 'IPO recommendation.'[32] The key contents of the revised Capital Market Development Act can be summarized as follows.

First, the government had the power to recommend IPO or SEO transactions, according to the criteria (about the size of capital and profitability) outlined in the Enforcement Decree. For non-compliant firms, the government also had the power to refuse the receipt of their public offering applications for a pre-specified period of time (Articles 3 and 5).

Second, the revised Act raised the limits on the dividends that a company could pay in the form of shares, from 50 percent to 100 percent of total dividends (Article 8). The Act also relaxed the upper ceiling on the issuance of convertible bonds (CBs) or bond with warrants (BWs), by excluding the portions that could be converted into shares or exercised to purchase shares from the amount of issuance (Article 11).

Third, the revised Act also introduced provisions that facilitated the sale of government-owned shares. For example, they were allowed to be sold to the general public with no limitations, provided that it would help to disperse share ownership (Article 12). The Act also allowed government-owned shares to be sold to employee share ownership associations

31 Preferred shares were first allowed in the Commercial Code in 1984. The maximum number of preferred share issuance was capped at one quarter of outstanding shares. But the Capital Market Development Act permitted listed firms to issue up to half of outstanding shares.

at a discount; in addition, the employees would be allowed to pay for them in installments (Article 13). The Act also allowed the government to limit eligible acquirers and the maximum number of shares they would be able to acquire (Article 14).

Fourth, the revised Act also introduced provisions to strengthen employee stock ownership associations. For example, dividends from firms in nationally important industries could be paid out, in full or in part, to employee stock ownership associations (Article 15). Also, the preemptive rights given to employee stock ownership associations were raised from 10 percent to 20 percent of newly offered shares (Article 17). Listed firms were allowed to hold treasury stocks for a year. if they were purchased to pay out bonus to employee stock ownership associations.

Fifth, for firms operating in nationally important industries, the Act restricted, for national security reasons, shareholders' book inspection rights and the scope of investigation (Article 24).

3.3 Outcomes and Evaluation

3.3.1 Outcomes

In the beginning, not all the firms were enthusiastic about public offerings. For example, only 40 out of the 59 firms (11 Chaebol member firms and 44 non-Chaebol firms) that received IPO recommendations on April 29 1986 from the Securities Supervisory Board, submitted their IPO plans by the May 20 deadline (Maeil Business Newspaper, Apr. 29, 1986 and May 21, 1986). 19 firms refused to comply, despite threats of bank loan restrictions. By October 1988, only five out of 59 firms designated in 1986, 16 out of 77 firms designated in 1987, and six out of 15 firms designated in 1988 went public (Kyunghyang Shimmun, Oct. 24, 1988). Occasionally, the Securities Supervisory Board summoned executives from non-complying firms in order to pressure them into going public.[33]

The situation changed in later years. As one can see from <Table 2-8>, the number of newly listed firms, that was only 35 in 1987, jumped to 115 in 1988 and 124 in 1989. Figure 2-9 shows the number of listed firms from 1963 to 1993. One can easily visualize that there were two IPO waves, one during the late 1970s and the second during the late 1980s.

32 Although the Act was using a softer term, it does not mean the government was taking a softer approach. In reality, the IPO recommendations in the '80s were no different from IPO orders in the '70s.

33 Samhwa Paints and Korea Sangsa are known to have missed their deadlines twice (Maeil Business Newspaper, Jun. 29, 1989).

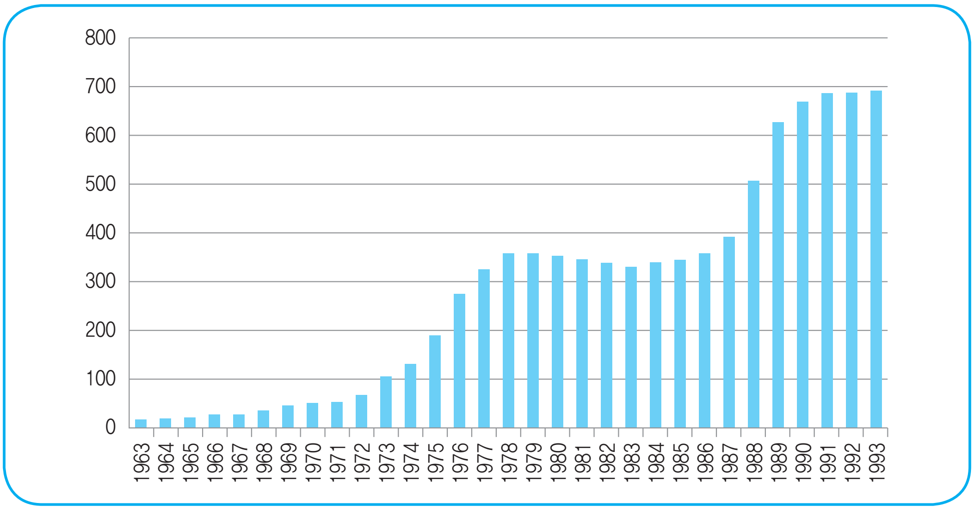
Table 2-8 | Stock Market Statistics, 1985-1989

	Unit	1985	1986	1987	1988	1989
KOSPI	1980 = 100	139.53	161.40	264.82	532.04	919.61
Market Capitalization	Bil. of won	6,570	11,994	26,172	64,543	95,477
Capital Stock Listed	Bil. of won	4,665	5,649	7,591	12,212	21,212
No. of Listed Firms	New (Delist)	11 (5)	17 (4)	35	115	124
	Cumulated	342	355	389	502	625
Paid-in Capital Increase	No. of Firms	60	110	178	298	274
	Bil. of won	260	798	1,656	6,721	11,125
Public Offerings	No. of Firms	11	16	44	112	135
	Bil. of won	35	43	244	1,049	3,545
No. of Shareholders	-	772	1,410	3,102	8,541	19,013
Share Ownership by Small-scale Investors	%	9.76	13.27	20.12	24.21	23.74
Yearly Turnover	Yearly	0.72	1.11	1.30	1.54	1.12
Economic Growth Rate	Real GDP %	7.5	12.2	12.3	11.7	6.8

Notes: Small-scale investors refer to those holding less than 1,000 shares. Yearly turnover is measured by (total no. of shares traded a year / total no. of shares outstand at year-end)

Source: Securities Market Yearly Statistics (1989) and Bank of Korea (ECOS)

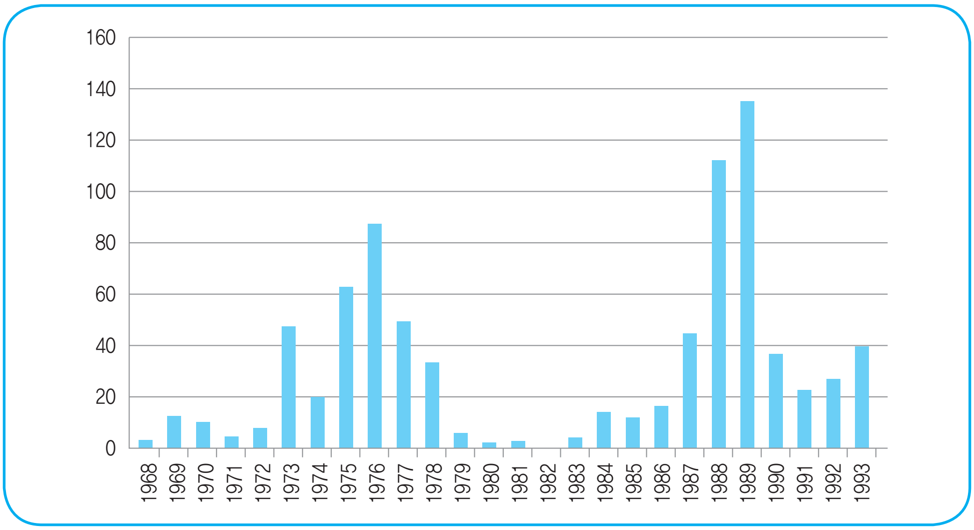
Figure 2-9 | The Number of Listed Firms, 1963-1993



Source: Securities Market Yearly Statistics

There were also increases in paid-in capital and public offerings. As can be seen from <Table 2-8>, there were approximately 4.9 trillion won of public offerings and 20.6 trillion won of paid-in capital increases during 1985-1989. The introduction of market-price share offering greatly contributed to this increase. [Figures 2-10 and 2-11], respectively, show the number of public offerings and paid-in capital increases from 1968 to 1993. Both figures have two arcs, suggesting once again that there were two waves of public offerings and paid-in capital increases.

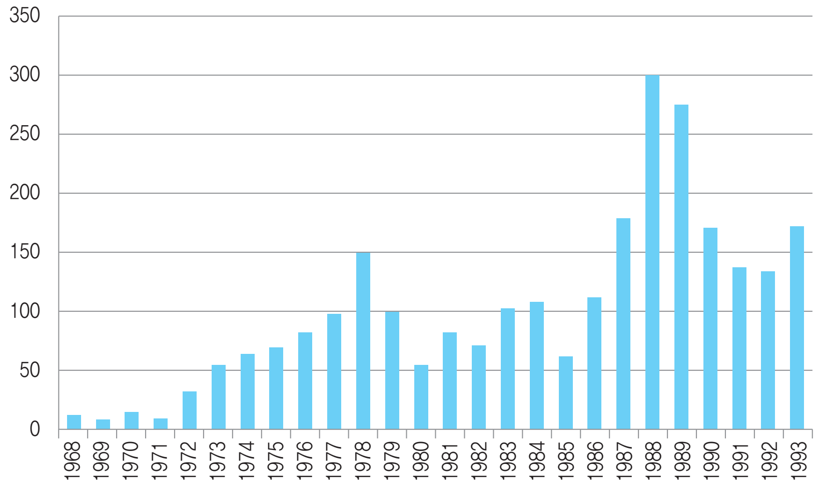
Figure 2-10 | The Number of Public Offerings, 1968-1993



Source: Rhee et al. (2005)

Original Source: Securities Market Yearly Statistics

Figure 2-11 | The number of Paid-in Capital Increases, 1968-1993



Source: Rhee et al. (2005)

Original Source: Securities Market Yearly Statistics

Other stock market indicators improved as well. During the four-year period between 1985 and 1989, the number of stock investors, the KOSPI, and the amount of listed capital stocks increased respectively by 24.6, 6.6, and 4.5 times. During the same time period, turnovers of listed shares (0.72→1.12) and the percentage of shares held by small-scale investors (holding less than 1,000 shares) increased respectively by 9.76 and 23.74 percent.

<Table 2-9> reports how the composition of external financing evolved over time. In 1988, the fraction of equity financing accounted for 39 percent. This was in great contrast to only 8 percent in 1968.

Table 2-9 | External Finance Structure of Korean Firms, 1975-1990

(Unit: trillions of won, %)

Year	External Financing	Debt Capital				Equity Capital	
		Total	Corporate Bonds	Bank Loans	Others	Amount	Percentage
1975	3.3	2.7	0.1	0.7	1.9	0.6	17%
1976	3.5	2.9	0.2	1.0	1.7	0.5	16%
1977	4.7	3.9	0.3	1.3	2.3	0.8	17%
1978	7.0	5.7	0.5	2.9	2.3	1.2	17%

Year	External Financing	Debt Capital				Equity Capital	
		Total	Corporate Bonds	Bank Loans	Others	Amount	Percentage
1979	8.9	8.3	0.8	3.7	3.8	0.6	7%
1980	11.8	10.5	1.5	4.2	4.9	1.3	11%
1981	13.5	12.0	2.2	4.1	5.7	1.6	12%
1982	14.4	11.2	2.8	5.2	3.2	3.2	22%
1983	13.0	10.5	2.6	4.3	3.6	2.4	19%
1984	13.8	11.3	1.9	7.2	2.2	2.5	18%
1985	15.2	13.4	3.3	7.1	3.0	1.8	12%
1986	15.3	12.8	2.5	6.2	4.1	2.5	16%
1987	18.6	13.3	0.9	7.2	5.2	5.4	29%
1988	21.3	12.9	3.3	5.2	4.4	8.4	39%
1989	38.8	28.6	11.2	13.7	3.7	10.3	26%
1990	50.8	43.2	14.5	19.5	9.2	7.6	15%

Source: ECOS, Bank of Korea

With the increase in equity financing, capital structure also improved. <Table 2-10> reports the capital structure of manufacturing firms during 1980-1990. Debt-to-equity ratio which was 462 percent in 1980 dropped down to 260 percent by 1989. Also, the interest coverage ratio, which was below 100 percent in 1980 jumped to 162 percent in 1986. [Figures 2-12, 2-13, and 2-14], respectively, show how equity capital as a percentage of total external financing needs (1975-1990), debt-to-equity ratios of manufacturing firms (1980-1990), and interest coverage ratios of manufacturing firms (1980-1990) evolved over time.

Table 2-10 | Capital Structure of Manufacturing Firms, 1980-1990

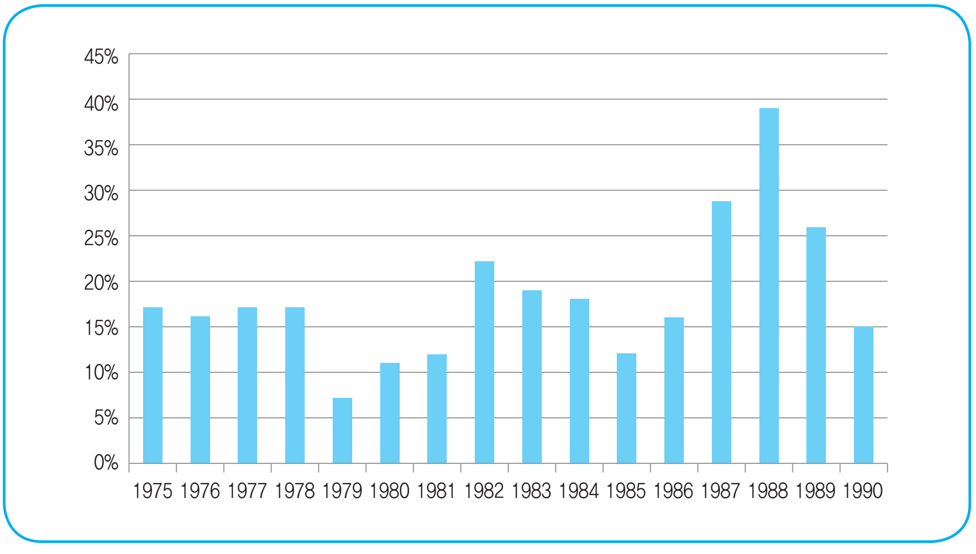
(Unit: %)

Year	Debt-to-Equity	Equity-to-Asset	Interest Coverage	Interest-to-Sales
1980	461.82	17.80	98.46	7.39
1981	440.87	18.45	96.64	8.01
1982	364.94	21.47	113.02	6.55
1983	347.63	22.29	147.55	5.18
1984	338.76	22.75	146.36	5.00
1985	363.81	21.51	147.36	5.31

Year	Debt-to-Equity	Equity-to-Asset	Interest Coverage	Interest-to-Sales
1986	346.16	22.36	162.21	4.89
1987	349.33	22.20	157.44	4.60
1988	292.58	25.15	148.43	4.60
1989	260.05	27.53	118.37	5.08
1990	297.15	25.18	127.49	5.12

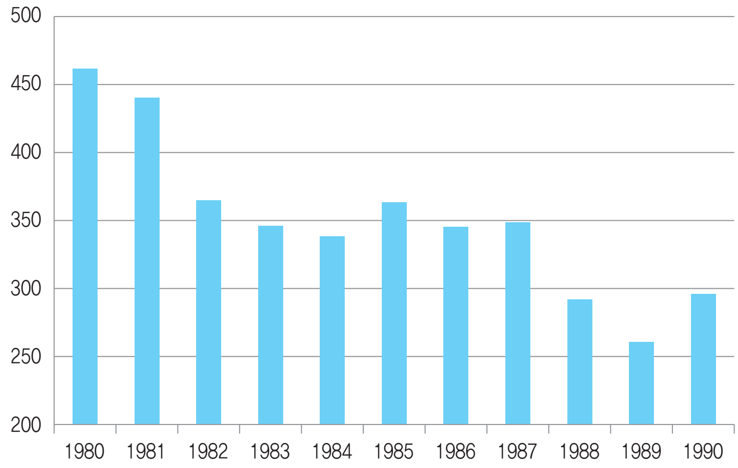
Source: ECOS, Bank of Korea

Figure 2-12 | Equity Capital as a Fraction of Total External Financing, 1975-1990



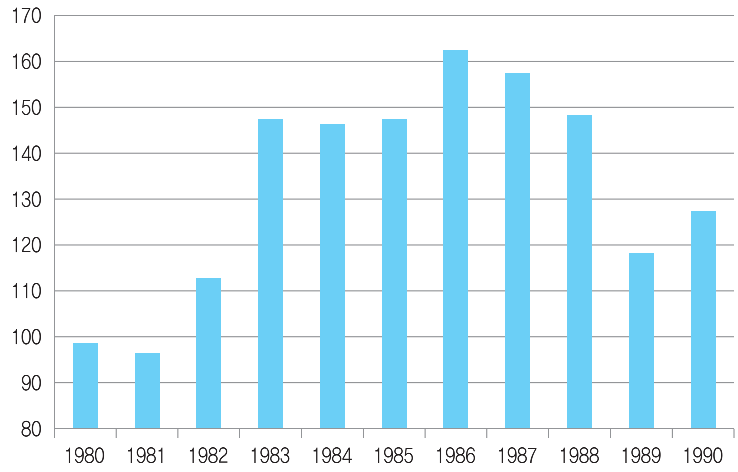
Source: ECOS, Bank of Korea

Figure 2-13 | Debt-to-Equity Ratio of Manufacturing Firms, 1980-1990



Source: ECOS, Bank of Korea

Figure 2-14 | Interest Coverage Ratio of Manufacturing Firms, 1980-1990



Source: ECOS, Bank of Korea

In 1988 and 1989, it was not rare to see firms offering shares at high premiums. For example, Saehan Media and Daeduck Industrial offered their shares respectively at 500 and 300 percent premiums. Their shares were also oversubscribed respectively by 10.5:1 and 45:1 (Rhee et al., 2005). Facing favorable market conditions, firms went public and increased their paid-in capital voluntarily, and there was no need for the government to exert any pressure. On the contrary, the government had to become more strict in its screening process of firms that had applied to go public.

The second half of 1980s also witnessed an increase in preferred share issuances. Preferred shares became popular among firms that did not want to dilute the shares held by their controlling families. Stock investors also did not object to investing in them, as they did not prioritize voting rights. The very first preferred share was issued by Oriental Brewery in June 1986. The issuance of preferred shares that took up only 1 percent of all paid-in capital increases in 1987 had jumped to 36 percent in 1989 (Rhee et al., 2005).

But preferred shares issued in those years were different from the ones that have been allowed since 1996. The pre-1996 preferred shares had dividend yields 1 percent higher than that of common shares.[34] Although dividend yields were higher than that of common shares, these figures fluctuated over time. The post-1996 preferred shares, on the other hand, provided a fixed dividend yield. In some sense, the pre-1996 preferred shares were like non-voting common shares. With the revision of Commercial Code in 1996, the issuance of such preferred shares are now banned.

3.3.2 Evaluation

The success in expanding share offerings in the second half of 1980s is, to a large extent, attributable to the Three Lows and the resulting economic boom. Firms, facing increased demand on their products and recognizing the need to raise more capital, became more inclined to go public or increase their paid-in capital. With higher income and wealth, a greater percentage of the population became stock investors, thereby expanding the stock investors' base.

The government also played an important role. Two measures were noteworthy in particular. One was the liberalization of offering prices at the time of IPO. The other was the introduction of market-price share offerings for listed firms. The IPO offering price, the restrictions of which had been considerably relaxed in April 1987, was completely liberalized in June 1988 (Rhee et al., 2005). With such liberalization, many firms were able to offer their shares at premiums. As a result, cost of equity capital fell significantly, from 24.3 percent during 1982-1983 to 9.3 percent in 1986-1990 (Rhee et al., 2005).

The rise in paid-in capital was attributable to market-price share offerings, which were, in return, attributable to increasing demand for stocks. The firms also benefited by retaining

34 Here, dividend yield refers to cash divided by par value.

the difference in market price and par value. It was classified as a part of book equity, under the name of capital surplus reserves.

In the beginning, the government allowed market-price share offerings only under limited circumstances. But soon thereafter, it began to require it for all firms, provided that their share price was 10 percent above par value (February 1987). This action was prompted to combat the distortion in the market, where investors preferred to purchase distressed firms that were offering shares at par value over blue-chip firms offering shares at market price. In September 1989, the government removed all the remaining restrictions on market price share offering (Rhee et al., 2005). The maximum discount rate applied to market price was also lowered from 50 percent in 1987 to 10 percent in 1989. Market-price share offering, as a percentage of total paid-in capital, increased from 4-6 percent during 1984-1985 to 100 percent in 1989. Average premium (over par value) also increase from 11 percent in 1986 to 340 percent in 1989.

Overall, the government's share offering expansion policy was a success, but was not without its problems. First, share offerings increased in the late 1980s, disproportionately exceeding their demand. KOSPI, which had peaked in March-August 1989, nosedived continuously until it hit bottom in July 1992. A number of individuals who had invested with borrowed money committed suicide out of despair. Of course, it was somewhat inevitable for share price to drop after the public offerings, since firms generally offer shares when their share prices are peaking. This, however, does not mean that the government is helpless and should not be held accountable. To prevent a hard landing, it should closely monitor the market, and if necessary, preemptively intervene in the primary market by limiting the amount of share offerings, or inducing a greater demand for stocks. This was what the government did when it announced a stock market stabilization plan in November 1989. It was too late to prevent the downfall, however.

Second, controlling shareholders were criticized for intentionally diluting the value of their company shares before IPO, thereby reaping capital gains afterwards. This scheme worked in the following manner. First, controlling shareholders significantly increased the number of shares they held, e.g., by reclassifying asset revaluation reserves as capital stock.[35] The number of new shares existing shareholders would receive equaled the amount of reserves that had been reclassified divided by par value. Since the total number of outstanding shares increases without any new capital injection, per share net assets value falls, thereby creating a capital loss for existing shareholders. This, however, is exactly offset by the capital gains they make. Notice that reclassifying reserves as capital stock is equivalent to receiving shares worth ex post net asset value (per share), but paying only par value for each share they receive. Diluting the value of stocks, therefore, did not give any net gain per se.

35 Broadly speaking, shareholders' equity is composed of four parts: (i) capital stock, (ii) capital surplus, (iii) retained earnings, and (iv) reserves. A company can issue new shares without raising any capital from outside shareholders by moving a part of capital surplus, retained earnings, or reserves to capital stock. If a company pays out stock dividends, a part of retained earnings is reclassified as capital.

It makes a big difference, however, when post-IPO share prices remain high, regardless of how many pre-IPO share issuances there were. With a stock-buying spree, this was the market environment in the late 1980s. Firms were able to offer shares at 300-400 percent premiums, regardless of their pre-IPO share issuances. As a result, the existing shareholders, mostly Chaebol families, received huge capital gains.

Box 2-10 | Diluted Stocks and Public Offerings at a Premium

Suppose there is a private firm with a net asset value of 1 billion won. If there are 100 thousand outstanding shares, the per-share net asset value is 10,000 won (= 1,000,000,000 / 100,000). For simplicity's sake assume that the founder owns 100 percent of these shares. Par value per share is 5,000 won.

Suppose now this firm revalues its assets and the net asset value of this firm increases to 1.5 billion won. On the right-hand side of the company balance sheet, shareholder's equity is now divided into capital stock (1 billion won) and reserves (0.5 billion won). The per-share net asset value now increases to 15,000 won (1,500,000,000 / 100,000). The total value of shares held by the founder is 1.5 billion won (15,000 × 100,000).

Now suppose the firm increases the number of outstanding shares by reclassifying asset revaluation reserves as capital stock. Capital stock becomes 1.5 billion and the number of outstanding shares become 200 thousand shares (= 100,000 + (500,000,000 / 5,000)). This means that the per-share net asset value is 7,500 won (= 1,500,000,000 / 200,000). The share value is diluted from 15,000 won to 7,500 won. But, the total value of shares held by the founder remains at 1.5 billion won (7,500 × 200,000).

However, let's suppose there is a bubble in the market and the IPO offering price will be set at 20,000 won regardless of the pre-IPO share issuance. In the absence of pre-IPO share issuance, the post-IPO value of shares would be 2 billion won (= 20,000 × 100,000). But with a pre-IPO share issuance, the post-IPO value of shares would be 4 billion won (= 20,000 × 200,000).

Third, the introduction of preferred shares was a violation against the one-share, one-vote principle. This is because preferred shares that were introduced were more like non-voting common shares. In effect, the government approved a de facto dual class equity system. Consequently, chaebol families were able to have control rights well above their cash flow rights. But surprisingly, there was hardly any opposition against preferred shares in the beginning. Problems with this system, however, gradually emerged. In late 1989, controlling shareholders dumped their preferred share holdings, which triggered a further share price drop of preferred shares (Rhee et al., 2005). These shareholders did not, however, dump common shares, in an obvious attempt to retain control. Incidents of preferred shares being used for stock price manipulation later emerged. Any new issuance of problematic preferred shares was finally outlawed in 1996, through revisions to the Commercial Code in November 1995.

3.4 Implications for Developing Countries

The lessons that can be drawn from the second half of 1980s are very similar to those mentioned in the previous section. As before, the macroeconomic situation was the most decisive factor. Massive public offerings would not have been possible without the Three Lows, and the resulting economic boom. If policymakers from developing countries wish to induce more equity offerings, they should concentrate their efforts during a stock market boom period. [Figures 2-9, 2-10, and 2-11] effectively show the importance of macroeconomic conditions.

Second, it should be noted that an economic boom alone is not sufficient in and of itself. The government must take timely measures to remove obstacles that may be hindering equity offerings. In Korea, there were two important measures that served such a purpose: the liberalization of IPO offering prices and the introduction of market-price share offerings by listed firms.

Third, in order to change firms' perception of the stock market, it is important to engage in continuous education and public campaigns. In the 1960s and '70s, the stock market was perceived as a place for gambling. By the second half of 1980s, capital market was well-recognized by firms as a source of raising long-term capital.

Fourth, it is important to make sure that the magnitude of public offerings does not exceed their demand. If it does, the government should abandon their yearly listing targets and try to restrict share offerings. To a certain extent, an economic boom is like a double-edge sword. It induces new share offerings. But concurrently, it induces a stock price bubble that attracts inexperienced and naïve investors into the stock market. When the bubble inevitably bursts, it leaves many damaged investors behind, some in heavy debt.

Figure 2-15 | The Stock Market Bubble Bust during 1989-1992

Note: A photo of an angry investor throwing a chair at a securities firm customer lounge. The Korea Composite Stock Price Index that peaked at 1007.8 on April 1, 1989 dropped down to 462.1 by August 17, 1992.

Source: The Hankyoreh

Fifth, the government's coercive approach did not make much of a difference either way.[36] As we have seen before, the number of newly listed firms followed real GDP growth rate or the stock price index closely. Even with government pressure, firms refused to go public during a recessionary economy.

36 Even though the political system had been democratized in the second half of the 1980s, the government was able to use coercive measures, such as restricting bank loans. This was because most of the financial institutions were still under government control.

Chapter 3

Other Supplementary Policies

Other Supplementary Policies

The primary market, where firms offer shares, is closely intertwined with the secondary market, where those shares are traded among investors. If share prices are set inefficiently or transaction costs are too high in the secondary market, firms will have hard time discovering favorable offering prices, and investors will face liquidity constraints. Both markets should be well-developed to have an advanced capital market. In Sections 1 and 2 of this Chapter, I go through a number of policies that shaped the secondary market in the 1970s and the 80s.

It is also clear that the primary market cannot be enlarged by simply increasing the supply of shares. There should be a commensurate increase in the stock market's investors' base. In the absence of a wide investors' base, the supply of, and the demand for, shares would be in great imbalance, ultimately hindering stock market development. Since the 1960s, the Korean government made a series of efforts to expand the stock market's investor base. In Sections 3 and 4 of this Chapter, I cover two of those policies: the employee's stock ownership plan and the people's stock ownership plan.

1. The Introduction of Regular-Way Transaction and the June 3rd Measure

1.1 Background

Clearing transactions were allowed until 1969, and were more popular than cash transactions.[37] This was the case during Daehan Stock Exchange years and even after the Korea Stock Exchange was established in 1963. Clearing transactions were like today's futures transactions. A buyer (seller) promises to pay (receive) a certain price today but

37 Cash transaction requires all aspects of a trade including delivery of payment to be finalized on the same date.

makes the actual payment (delivery) at a later date.[38] Also, the buyer and the seller can enter opposite transactions, thereby canceling their initial positions. In this case, there would be no actual delivery of shares. The transaction was settled by paying or receiving the difference between the two contracted share prices, and both parties would have to open margin accounts with the exchange.

Box 3-1 | Daehan Stock Exchange, Korea Stock Exchange, and Korea Exchange

Deahan Stock Exchange existed from March 1956 to December 1962. Korea Stock Exchange (KSE) existed from January 1963 to December 2004. It is worth noting the nature of their legal entities. Daehan Stock Exchange was initially not a stock company, but was able to issue investment certificates that were traded like stocks in the secondary market. With the enactment of Securities and Exchange Act in January 1962, Daehan Stock Exchange became a joint stock corporation three months later. But a speculative bubble, which burst during the first half of 1962, led Daehan to be reorganized into a government-run, non-profit corporation by 1963. It was also renamed as the Korea Stock Exchange. In 1988, it was privatized and reorganized again as a membership organization. Its successor, Korea Exchange (KRX) is a joint stock company.

Figure 3-1 | The Old Stock Exchange Building at Myeong-Dong, 1956-1979

Note: A photo of the old stock exchange building at Myeong-Dong, Seoul. It accommodated the Daehan Stock Exchange during 1956-1962 and the Korea Stock Exchange during 1963-1979. Source: KRX.

38 The transaction had to be settled within one or two months.

Since the transaction required only a small margin, clearing transactions were often used for speculative reasons, sometimes resulting in speculative bubbles. Two episodes during this era are noteworthy. The first involved Daehan Stock Exchange shares in 1959, and the second involved Daehan Stock Exchange and Korea Electricity Power Corporation (KEPCO) shares in 1962. In those years, clearing transactions took up 80-90 percent of all trading volume.

Box 3-2 | The Stock Market Bubbles in 1959 and 1962

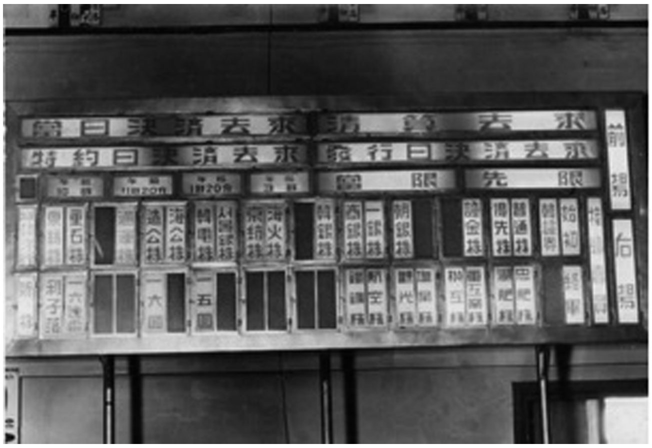
The 1959 incident took place when speculators amassed Daehan Stock Exchange shares, betting on the possibility that it would be reorganized as a stock company, and that investment certificates would be exchanged with shares. The stock price jumped from 39 chon in February to 90 chon in May 1959. Chon was a currency unit used before Korea's June 1962 currency reform.

During March-May 1962, speculators again amassed Daehan Stock Exchange shares. This time, it was triggered by rumors that the stock exchange would complete a massive capital increase. The securities firms that had amassed shares were also the same firms that made money out of KEPCO shares in February 1962. A share price of 9.2 hwan (equivalent to 100 chon) in March jumped to 42.5 hwan in April. Trading volume of Deahan Stock Exchange shares also increased dramatically, taking up 52.7 percent of total trade volume by April. The Daehan Stock Exchange was criticized for its lack of timely intervention. A conflict of interest problem was also pointed out; since Daehan Stock Exchange managers were also its shareholders, they would not be enthusiastic about stabilizing the stock market.

With a rising stock price, investors that took a short position were unable to make their payments. The stock exchange was also unable to make the required payments on behalf of the sellers. Ministry of Finance stepped in and pressured Bank of Korea to extend securities loans to the stock exchange. Chang-Soon Yoo, the Governor of BOK, refused to cooperate, and resigned in May 26. BOK ended up extending a loan of 33 billion hwan by June 1.

The stock market speculation in 1962, however, cannot be solely attributed to the clearing transaction system. Investigation in later years revealed that Jong-Pil Kim, then serving as the head of Korea CIA, created the speculative environment in order to fund and launch the Democratic Republican Party (Hankyoreh, Mar. 1, 2005). Kim instructed Korea CIA to give 980 million hwan to Eung-Sang Yoon, who in return, established three securities firm that heavily purchased Daehan Stock Exchange shares, which in turn triggered the bubble. Yoon was able to provide 6.7 billion hwan to Jong-Pil Kim with these investments.

Figure 3-2 | A Bulletin Board inside the Old Stock Exchange Building



Note: A photo of a bulletin board inside the old stock exchange building at Myeong-Dong, Seoul. The upper right corner is the area that shows information on clearing transactions. Source: KRX

1.2 Detailed Contents

1.2.1 The Adoption of Regular Way Transactions

On February 1 1969, the Ministry of Finance (Minister: Jong-Yeul Hwang) repealed the clearing transaction system, adopting the regular way transaction system. Under regular way transactions, a trade had to be settled on the following day. A day after the contract, the buyer completed payments and the seller delivered the shares. Certain exceptions were allowed, some of which made it look similar to clearing transactions. If one party failed to settle on the following day, the transaction could be extended, provided that both parties pay margins, and the party failing to complete the transaction pay a small postponement fee (Kyunghyang Shimmun, Feb. 4, 1971).[39]

This delayed settlement, coupled with a 30 percent margin requirement, enabled investors to replicate futures trading, even without entering opposite transactions (Kyunghyang Shimmun, Feb. 4, 1971).[40] For example, there are two investors, A (buyer) and B (seller), who wish to trade 2,000 shares of Korea Securities Finance Corporation (KSFC) on January

39 In the beginning, the settlement could be delayed for 30 days by extension. Later in July 1969, as a measure to boost up the stock market, it was relaxed to 60 days. If one made a two-sided order on the 60th day, it was possible to delay settlement forever.

40 In October 1969, the government lowered the margin requirement from 40 percent to 30 percent for Korea Securities Finance Corporation shares. As for asset stocks (e.g. shares with high book-to-market ratio), the margin requirement was lowered from 30 percent to 25 percent. In December, the government also relaxed the prepaid margin requirement. Previously, a member had to prepay the full margin if the order exceeds 8 million won per session or 30 million won per day. But, this was relaxed by requiring member to prepay margins only for the excess amount.

1 at 800 won per share. Once they deposit a margin of 480,000 won (= 0.3 × 800 × 2,000) at the Korea Stock Exchange, they can enter a de facto futures position. If share prices were to rise to 1,000 won by January 10, investor B would receive 80,000 won (= 480,000-400,000) from the Exchange, while investor A would receive 880,000 won (= 480,000 + 400,000).

Sometimes positions escalated to alarming levels. A good example of this excess was speculation involving shares of the Korea Securities Finance Corporation (KSFC) in November 1969. One group of investors took a long position, while the other took a short position. Each party tried to enlarge its position to influence the share price in its favor (Maeil Business Newspaper, Jan. 24, 1970). When the size of the position increased, even more investors joined in herds.[41] Share prices fluctuated with high volatility, and in the process, harmed investors who were not involved in speculative trading. These investors staged a demonstration to express their anger and frustrations (Maeil Business Newspaper, Feb. 6, 1970). With the sheer size of position increasing to new levels, there was great concern that one of the two parties would default on payment obligations.

Figure 3-3 | Open Outcries at the Trading Floor

Note: A photo of traders making hand signals at the Stock Exchange Trading Floor. Source: KRX

1.2.2 The Measure of June 3

The Ministry of Finance (Minister: Duck-Woo Nam), which had showed reluctance to intervene, finally came up with a measure on June 3, 1971. First, it required all stock transactions to be settled on its fifth day, beginning on August 5, 1971.[42] Second, it also banned two-sided trading, also beginning on August 5. Third, as an interim provision, it

41 The Korea Securities Finance Corporate shares had the nickname "mop or rag shares."

42 In February 1972, the Ministry required the transaction be settled on the 3rd day.

ordered all existing and unsettled positions to be liquidated within 60 days (Maeil Business Newspaper, Jun. 8, 1971). Minister Nam stated that a slump in the stock market would be ineluctable with the new measure. He also stated that it was an unavoidable choice to normalize the capital market.

The new measure, however, had to be suspended as securities firms filed injunctions against it. They claimed that the measure was infringing upon their property rights. They also pointed out that the measure was based on the Enforcement Decree, which was in breach of the Securities and Exchange Act. Since Article 79 of the Act delegated the choice of transaction systems to the Enforcement Decree it was not allowed, legally speaking, to delegate again to the Enforcement Regulation. According to this logic, the administrative order based on the Enforcement Regulation was invalid.

They filed two injunctions, one against the Ministry of Finance at the appellate court on the new transaction system, and the other against the Korea Stock Exchange at the civil district court of Seoul on the interim provision (Maeil Business Newspaper, Jun. 16, 1971). On June 23, the civil district court of Seoul accepted the injunction against the Korea Stock Exchange. According to the court's verdict, the liquidation order had to be suspended until August 4. In July, speculative positions on Korea Securities Finance Corporation shares got even larger. To end the legal dispute, on July 29 1971, the government revised the Enforcement Decree and stipulated that stock transactions must be settled on the fifth day of contract. The effective date was set to be December 1.

Thanks to the Ministry's continuous persuasion and pressure, on August 16, the two parties reached an agreement (Maeil Business Newspaper, Aug. 17, 1971). But this was not without any resistance. For example, the Sambo Securities management strongly criticized the government and refused to comply, stating that they were forced by the government to give in with substantial monetary losses (Maeil Business Newspaper, Aug. 17, 1971).

1.3 Evaluation and Implications

It was the correct policy decision to repeal clearing transactions and adopting the regular-way transaction system. But the devil was in the details. There were two notable problems with the regular-way transaction system, as adopted in 1969. First, the loopholes it allowed became common. Investors abused delayed settlements, two-sided transactions, and low margin requirements. Second, policymakers were inconsistent, moving back and forth between two conflicting policy objectives of reducing speculative transactions and boosting up the stock market. A good example is the measure of relaxing margin requirements (July and October 1969). As a result, the government failed to serve its main objective of reducing speculative transactions.

The Measure of June 3 was both a success and failure. The Ministry of Finance did not have a proper justification to liquidate existing unsettled positions. If the Ministry knew that there would be resistance, it should have designed its policies with great care, but failed to do so. It triggered lawsuits by executing the measure with an administrative order, which was in breach of the Securities and Exchange Act.

A number of lessons can be drawn for policy makers in developing countries. First, once a policy goal has been set, the government should make steady and persistent efforts to achieve it. In this respect, the 1969 adoption of a regular-way transaction system can be considered as a failure. Despite the initially-set goal of reducing speculative transactions, the government later tried to boost the stock market by fostering speculation. Market participants lost confidence in the government. It was not at all surprising to see securities firms filing injunctions against the government, when the measure was announced.

Second, when designing a new policy, it is very important to consider its policy environment sufficiently. If the government had fully acknowledged that stock market participants were accustomed to margin trading for too many years, and could not switch to regular-way transactions overnight, it would not have allowed delayed settlements. But the government failed to acknowledge this condition, and allowed delayed settlements, which allowed margin trading to become an accepted practice.

Third, when adopting a new measure that may infringe upon property rights, it is very important that there are no legal flaws. In this respect, the Measure of June 3 was a failure because changing the transaction system through an administrative order was clearly in breach of the Securities and Exchange Act. The government should have also considered ways to compensate damaged investors, but failed to do so.

2. The Introduction of Securities Deposit and Settlement Systems

2.1 Background

With the June 3rd Measure of 1971, stock transactions had to be settled with the actual delivery of shares, which proved to be very inconvenient. There was the risk that share certificates would be lost, as well as costs of keeping them. To alleviate such inconveniences, the government decided in 1972 to adopt a securities settlement system based on a German model, and later in 1968, based on US and Japanese systems (Rhee et al., 2005). To replicate the U.S. model, the government received technical assistance from USAID during October-November 1972. The key topic from this technical assistance was the establishment of a securities settlement system.

Figure 3-4 | A Sample of Share Certificate in the 1960s

Note: A photo of share certificate issued by the Commercial Bank of Korea in 1961. During the 1960s, stock transactions had to be settled with the actual delivery of shares. Source: Korea Securities Depository.

2.2 Detailed Contents

2.2.1 The Establishment of Korea Securities Settlement Corporation (KSSC)

Korea's first securities settlement system was introduced in February 1973, when the Securities and Exchange Act was revised. Initially, securities settlements were carried out within the stock exchange (November 1973-December 1974). But the function was soon transferred to the newly established Korea Securities Settlement Corporation (KSSC) on December 6, 1974.[43] The new system, however, made slow progress, which prompted the government on July 7, 1975 to make it mandatory to settle all secondary market transactions by book-entry transfers (Korea Securities Depository, 2003).

2.2.2 Centralized Securities Deposit

With the establishment of KSSC and its book-entry transfer system, incidents of actual share delivery dropped considerably. But, there was no centralized depositary institution, and stocks were kept in many securities firms, in addition to the KSSC. As a result, shares had to be delivered from one securities firm to another (Maeil Business Newspaper, Sep. 13, 1979). There were even incidents of shares being stolen (Maeil Business Newspaper, Jun. 13, 1980).

43 It was renamed as Korea Securities Depository (KSD) in 1994.

Against this backdrop, on December 20 1979, the Korea Securities Dealers Association decided that it would adopt a centralized depositary system. This system required that headquarters deposit 100 percent of shares they administered at KSSC, and regional branches deposit at least 70 percent of shares they administered at KSSC (Maeil Business Newspaper, Dec. 21, 1979). Shares deposited with the KSSC, did not increase significantly, however, and the government was forced to intervene. In January 1983, the government made it mandatory to deposit at least 90 percent of shares at KSSC by no later than June 30 (Maeil Business Newspaper, Jan. 10, 1983).[44] Related to this, on March 31 1983, the Securities Supervisory Board required all institutional investors to settle their transactions through the book-entry transfer system, as administered by the KSSC.

Figure 3-5 | The New Stock Exchange Building at Yeouido, 1979-Present

Note: A photo of the new stock exchange building at Yeouido, Seoul. It accommodated the Korea Stock Exchange during 1979-2004 and the Korea Exchange thereafter. Source: Newsis

2.2.3 Continued Depository System

A problem related to the centralized deposit system emerged early on. Whenever one provided shares as collateral, or transferred shares to a different name, the shares had to be withdrawn from KSSC. In fact, near fiscal year-end, securities firms had to withdraw a large number of shares from KSSC, transfer the shares to another name, and then re-deposit them at KSSC. In response to this inconvenience, industry experts called for adopting a continued depository system (Maeil Business Newspaper, Jan. 19, 1980). This refers to a system where all the shares are kept under the name of depositary agency, and shareholder

44 The deadline was later moved up by three months to March 31 (Maeil Business Newspaper, Feb. 12, 1983).

rights are exercised indirectly through the agency. As a result, shareholders do not need to withdraw their shares when they provide them as collateral or transfer them to another name.

Although its need was well-recognized, the continued depository system could not be immediately introduced, because of the Commercial Code that would not allow split votes, or voting in disunity. If the continued depository system were introduced, shares would need to be under KSSC's name, meaning that no two beneficiary owners holding the same company shares can exercise their votes differently. To resolve this problem, the government revised the Commercial Code in April 1984 and allowed voting in disunity.[45] In September, it was also decided that the voting rights of shares under KSSC's name will not be exercised, unless requested by the beneficial owner (Maeil Business Newspaper, Sep. 22, 1984).

The continued depository system was launched in June 1985, but it took some time for the new system to become settled. For the firms with fiscal-year ending in June 1985, only 30 percent of shareholders had transferred their shares to KSSC's name (Maeil Business Newspaper, Jul. 4, 1985).

2.2.4 Beneficial Owner System

The continued depository system was adopted in 1985, based on a decision made by the Securities Management Commission, and not by the Securities and Exchange Act. To stave off any legal disputes, the government revised the Securities and Exchange Act (promulgated on November 28), and introduced provisions on the continued depository system and beneficial owner system. The beneficial ownership system gives beneficial owners the shareholder rights equivalent to those held by shareholders in the roster. Key provisions in the revised Act can be summarized as follows.

First, for securities deposited at KSSC, a person who is stated in the account book shall be considered to hold the respective securities. Also, if there is a transfer between accounts for the purpose of transferring securities or establishing the right of pledge, the securities shall be considered delivered (Article 174-3). Second, for securities deposited at KSSC, the depositor and KSSC shall be presumed to have co-ownership over the deposited securities (Article 174-4). Third, for deposited securities, KSSC can transfer them to its name and exercise its rights as shareholder (Article 174-6).

Fourth, if the issuing firm closes the shareholder roster to determine the list of shareholders that can exercise shareholder rights, such as voting rights, KSSC should immediately notify

45 Clause ①, Article 368-2 of the revised Commercial Code provides that a shareholder with two or more votes may exercise them in disunity. In this case, he shall notify the company in writing of his intension of so doing and the reasons thereof three days before the meeting is to be held. Clause ②, provides that the company may reject such exercise of vote in disunity by a shareholder, unless he has accepted a trust of shares or he holds the shares on behalf of another person.

the issuer the roster of beneficial shareholders (Article 174-7). Fifth, the issuing firm must keep the roster of beneficial shareholder received from KSSC. This roster shall have the same effect as the roster of shareholders (Article 174-8).

2.3 Evaluation and Implications for Developing Countries

The securities settlement system, the concentrated deposit system, the continued depository system, and the beneficial owner system all made significant contributions in advancing the secondary market. But it also made contributions to the primary market. If not for the reductions in trading and settlement costs in the secondary market, large public offerings during the second half of 1980s would have been impossible.

One regretful point was the delay in adopting the continued depository system. The necessity was raised in 1980, but was not adopted until 1985. The delay was attributable to the existing Commercial Code, which prohibited split votes. Moreover, it took much too long to revise the Code.

It is also worth noting that Korea actively benchmarked other countries when adopting its securities deposit and settlement systems. For the securities settlement system, the government received technical assistance from the experts dispatched from USAID. For the continued depository system, the government was influenced by precedents in U.S., U.K., and Japan (Maeil Business Newspaper, Sep. 6, 1979 and Sep. 21). As was the case in Korea, other developing countries should also actively benchmark systems in advanced countries when it comes to adopting securities deposit and settlement systems.[46]

3. The Employee Stock Ownership Plan

3.1 Background

In 1968, the government was criticized for allowing shares of state-owned enterprises be acquired by a small number of Chaebols, a move clearly against the government's stated goal of popularizing stock ownership. As a way to promote dispersed share ownership, the business and labor alike proposed to the government the introduction of an employee stock ownership plan (Maeil Business Newspaper, Jun. 8, 1968). The proposal was accepted by the government, and the Capital Market Development Act was enacted in November 1968, with provisions legalizing employee stock ownership plans (Kyunghyang Shimmun, Nov. 9, 1968).

The Act had a provision which allowed discounted share offerings to SOE employees (Article 5) and a provision giving company employees the preemptive rights to purchase

46 Since 1995, Korea has started its own technical assistance for securities systems. The first case was designed and implemented for Vietnam. Some recent examples include the assistance on a securities IT system (Uzbekistan) and the establishment of a joint stock exchanges (Laos and Cambodia).

newly offered shares (Article 6). This was clearly a step forward, yet still incomplete in a sense that such provisions applied only to listed firms or non-listed public firms.

The employee stock ownership plan was pursued to achieve many goals, such as popularizing stock ownership, accumulating employee wealth, encouraging peace between labor and management, instilling company loyalty, motivating workers' willpower, and expanding the stock investors' base.

Despite such enthusiasm, employee stock ownership plans were not widely accepted by firms in the beginning for many reasons. Dividend yields were too low to attract employers to hold shares. Salary levels were also too low to warrant any extra savings through shares. There were no tax benefits for these plans, and top management understood little about them (DongA Daily Newspaper, Dec. 28, 1972). The government tried to promote employee stock ownership plans in 1972 when it revised the IPO Promotion Act. The Act introduced a provision that allowed company employees a 10 percent preemptive right to buy newly-offered shares (Article 8).

3.2 The Supporting Measures of 1974

The employee stock ownership plans became widely accepted only after July 1974, when the Ministry of Finance (Minster: Duck-Woo Nam) announced a package of supporting measures. The package was prompted by the May 29th Special Order from the President (see section 2.3.3, for details). President Park believed that the employee stock ownership plan, coupled with the factory-level Saemaeul Movement, could greatly promote peace between labor and management (Kim, 2006).

Supporting measures can be summarized as follows (DongA Daily Newspaper, Jul. 13, 1974). First, it introduced a loan program for employees who wished to purchase company shares. Provided that an employee covers 50 percent of stock purchasing costs from his own salary, the company was required to give a loan (no interests during the first year of the loan) to finance the remaining amount. To induce companies to cooperate, interest earnings were excluded from taxable income in later years. If employees purchased old shares, it was also possible for loans to be extended by the controlling shareholder. Again, no interest was charged during the first year.

Second, it encouraged firms to give bonuses and severance payments through company shares. In such payments, a significant portion was exempt from labor income tax obligations. Third, it encouraged nonpublic firms to allocate 10 percent of IPO stocks to employee stock ownership associations.[47] To induce firms, shares owned by employee stock ownership associations would be regarded as publicly-owned shares.

Fourth, it encouraged firms to sell company shares at a discount. To alleviate employee's tax burden, moreover, the resulting labor or gift income tax was partially exempted.

47 The 10 percent upper limit was raised to 15 percent in September 1987.

Dividend income received by employees of nonpublic firms was also partially exempted from dividend income tax obligations.

To prevent tax benefits from being abused, the government made it clear that benefits do not apply to employees owning more than three percent of outstanding shares. Also, to prevent controlling shareholders from disguising their share ownership as employee owned shares, the Ministry required shares held by employees be deposited at Korea Investment Development Corporation (KIDC) for at least one year for public firms, and multiple years for nonpublic firms until IPO.[48]

3.3 Evaluation and Implications for Developing Countries

Two years after the announcement of these supporting measures, the number of firms with employee stock ownership associations reached 249 (217 public firms and 32 nonpublic firms) by July 1976. The number of enrolled employees also reached 91,497 by this time. Among the 249 firms, 202 (including 17 nonpublic firms) were firms depositing shares at KIDC. The most exemplary firm was Daewoo Corporation, with all of its 691 employees enrolled owning 6.55 percent of company shares (DongA Daily Newspaper, Jul. 10, 1976). In 1987, the number of firms with employee stock ownership association grew to 455 companies.

As mentioned earlier, employee stock ownership plans were thought to popularize stock ownership, accumulate employee wealth, encourage peace between labor and management, instill company loyalty, motivate the will to work, and expand the stock investors' base. Among these various goals, two objectives were clearly achieved; popularizing stock ownership and expanding the stock investors' base. The employee stock ownership plan played a key role in absorbing newly offered shares during the 1970s and 80s.

Despite such benefits, employee stock ownership plans were not without their problems. Enrolled employees had to lose both their jobs and wealth, if the company were to go bankrupt. Employee stock ownership plans, therefore, may not be the most desirable policy for someone who simply wishes to diversify his wealth.

4. The People's Stock Ownership Plan

4.1 Background

Privatization has two main objectives: enhancing managerial efficiency and maximizing government's fiscal revenue. But the privatization initiatives that took place in the 1950-'60s in Korea failed to place much weight on maximizing the government's fiscal revenue. The divesture in the 1950s of government-vested properties originally owned by the Japanese,

48 Since 1977, KSFC became the depositary institution for ESOA held shares. During 1988 and 1993, MoF imposed a restriction that employees cannot sell their shares until they retire.

and the privatization of SOEs in the late 1960s, were both criticized for selling government-owned shares at bargain prices for the acquirers. The privatizations of POSCO and KEPCO in the late 1980s were no exceptions. Because their privatization took the form of a people's stock ownership plan (PSOP) that aimed to share the fruit of economic development with ordinary people, assisted wealth accumulation of low-to medium-income households, and expanded the stock investors' base, government-owned shares had to be sold at a discount, which inevitably reduced the government's fiscal revenue prospects.

The discussion of privatizing state-owned enterprises (SOE) in the form of PSOP first emerged in October 1986, when an outside consulting project was launched to assess the viability of people's stock ownership plan (PSOP) for Pohang Steel Corporation (POSCO) (Maeil Business Newspaper, Oct. 25, 1986). In January 1987, the Economic Planning Board (EPB) made public the idea of privatizing 3-4 SOEs within a year (Maeil Business Newspaper, Jan. 15, 1987). EPB stressed the necessity of privatizing SOEs to improve managerial efficiency. In March 1987, the government announced that it would gradually privatize 25 SOEs in phases. Immediately, the SOE Privatization Committee, chaired by the EPB's vice minister, was established.

Box 3-3 | Privatization of State-Owned Enterprises during 1949-1980

The history of privatization dates back to 1949, when the Syngman Rhee government started to sell the government-vested properties, originally owned by the Japanese. These properties included mines, factories, production equipment, inventories, and real estate. Its total value was estimated to be approximately 80 percent of national wealth (Compilation Committee, 2010). Since they were sold at pre-1945 book values with 15 years of installed payments, despite a high inflation rate, it was a great bargain for the business entrepreneurs who were chosen to acquire the government properties (Chang, 2003). Because priority was given to those with managerial ability, most of the assets were sold to those directly or indirectly involved with management during the Japanese occupation (Compilation Committee, 2010).[49]

Entrepreneurs also acquired commercial banks from the government; easy access to bank loans further enriched them. But this did not last long. Chung-Hee Park, who seized power through a military coup in 1961, accused and imprisoned the entrepreneurs for amassing wealth illicitly. Byung-Chull Lee, the founder of Samsung Group, and other entrepreneurs were forced to relinquish their control over commercial banks to the government. For many years to come, bank loans were used as an effective tool to incentivize and discipline Korean Chaebols.

49 To some extent, sales of government-vested properties were used to mitigate resistance against farmland reform in 1949. When selecting purchasers, the government promised that it would give priority to those who cooperated in surrendering their farmland.

In the late 1960s, a number of inefficiently run state-owned enterprises were privatized. But, contrary to the government's intension, they were acquired by a small number of Chaebols. Hanjin Group, for example, acquired Korea Shipping (1968), Korea Ship Building (1968), and Korean Airlines (1969). Daewoo, Dong-A, and LG Group, respectively, acquired Hankuk Machine Industrial (1968), Korea Express (1968), and Korea Mining&Smelting (1971) (Koh, 1992). The government also privatized a number of commercial banks in 1980.

Figure 3-6 | POSCO Groundbreaking Ceremony

Note: A photo of President Chung-Hee Park (in the middle), Tae-Joon Park (on the left), and Hak-Yeol Kim (on the right, Deputy Prime Minister) at the groundbreaking ceremony of "Pohang Works Phase 1" in April 1970. Source: Yonhap News

Figure 3-7 | Pohang Steelworks in early 80s

Note: A photo of Pohang Steelworks in early 80s. Source: Chosun Daily

In May 1987, the government made public the need of enacting a special law that would impose individual share ownership limits on newly privatized firms (Kyunghyang Shimmun, May 6, 1987). The government did not want privatized firms to fall into the hands of few individuals, but remain widely held by the general public. In June 1987, the SOE Privatization Committee announced plans to privatize seven SOEs. The Committee decided to impose a five percent ownership limit per shareholder (DongA Daily Newspaper, June 17, 1987).

SOE privatization, however, did not proceed as expected (Maeil Business Newspaper, Oct. 30, 1987). Disagreements over a number of issues-efficiency vs. public interest, full privatization vs. partial privatization, and individual share ownership limit vs. no limit-stalled any semblance of progress. SOE privatization regained its momentum, when Tae-Woo Noh, the head of the ruling party (the Democratic Justice Party) and also the candidate for the 1987 Presidential Election, announced a plan outlining the basic structure of PSOP on November 3. In response, the Ministry of Finance formed a Committee (chaired by the Vice Minister) mandated to carry out the plan (Maeil Business Newspaper, Nov. 9, 1987). PSOP was considered a policy that could win popular votes from low income households.

1987 was a good year for the stock market. KOSPI, which was only 139.53 by the end of 1985 reached 264.82 by the end of 1987. For a variety of reasons, the stock market expansion created an environment that was favorable for PSOP implementation. First, the rise in stock prices attracted people to the stock market. The number of stock investors that recorded 770 thousand at the end of 1985 jumped to 3.1 million by the end of 1987. Optimism was widely prevalent among these investors. They were willing to pay high share price for newly issued blue-chip shares. High share price level also was a favorable condition for the government, since it meant that the government would be able to sell its shares at a higher price.

New privatization trends in other countries also stimulated the Korean government to push for privatization via PSOP. When the U.K. privatized British Telecom and British Petroleum in 1986, low income households were given priority to purchase their shares. Japan also took a similar approach when it privatized NTT. There was also an old example of Vokeswagon in 1961. When privatizing the firm, The West German government gave low income households priority to purchase company shares (Maeil Business Newspaper, Nov. 10, 1987).

4.2 Detailed Contents

4.2.1 The People's Stock Ownership Plan (Dec. 1, 1987)

As a Presidential campaign pledge, the Democratic Justice Party took the initiative, rather than the government.[50] The plan announced by the Ministry of Finance, on December 1 1987, was also very similar to the plan announced by the Democratic Justice Party on November 3, 1987. The objectives of PSOP that appear in MOF's plan can be summarized as follows (Rhee et al., 2005). First, it aimed to share the fruit of economic development with the people, thereby giving them a sense of ownership and forming a consensus for further economic development. Second, it aimed to sell shares of privatized firms to low- to medium-income households, thereby helping with their wealth accumulation and expanding the overall stock investors' base.

The detailed contents of the plan are as follows (Kyunghyang Shimmun, Dec. 2, 1987 and DongA Daily Newspaper, Dec. 15, 1987). First, the target SOEs were chosen to be Pohang Steel Corporation (POSCO), Korea Electric Power Corporation (KEPCO), Citizens Bank, Industrial Bank of Korea (IBK), Korea Telecom (KT), Korea Exchange Bank (KEB), and the Korea Monopoly Corporation. The government announced plans to privatize POSCO by March 1988, and to privatize KEPCO and Citizens Bank by September 1988. The reason why POSCO was chosen to be privatized first was because it was already a stock company, and it did not require any revision of law. The value of shares to be sold was estimated to be 5 trillion won over a five-year period (1988-1992). This estimate was based on the assumption that the combined value of seven SOEs was 12 trillion won and that the government would retain more than 50 percent of shares.[51]

Second, when selling shares to low-and medium-income households, a discount rate ranging from 20 to 30 percent was tentatively applied. Low-and medium-income households were defined as employees receiving a monthly salary below 600 thousand won, farmers owning a farmland below 6,612 m^2, and individual proprietors with monthly income below 600 thousand won. 75 percent of shares would be allotted to low-and medium-income households, 20 percent to employee stock ownership associations, and the remaining 5 percent to all other investors. It was estimated that the first two groups would be approximately 5-8 million people. No one was allowed to make duplicate applications or subscribe to purchase more than 3 percent of outstanding shares.[52]

50 It could, however, be the other way around. The Presidential candidate, Mr. Noh, and the Democratic Justice Party could have asked the Ministry of Finance to propose a new policy that could appeal to the general public. When the Ministry came up with the PSOP idea, Mr. Noh and the Democratic Justice Party could have simply taken it (Interview with Ho-Joo Shin).

51 As of Dec. 1987, the total market capitalization of firms listed on the Korea Stock Exchange was 26 trillion won.

52 In the process of privatizing POSCO, the Ministry of Finance found many unqualified applications. By making use of tax filing data from the National Tax Office, the Ministry detected many of them and nullified their applications. The Ministry also penalized them by disqualifying right to subscribe for any future privatizations (DongA Daily Newspaper, Mar. 31, 1988).

To alleviate the financial burden to low-and medium-income households, installment payments and long-term loans at concessional rates we made available. To take advantage of these benefits, these households were required to open a deposit account exclusively for people's stock subscription. The Ministry also introduced a new investment trust account that would manage the people's stock holdings. If investors wished to combine stocks with fixed income, they were also given access to loans to pay for their fixed income purchases. Any investment income from this investment trust was exempt from tax obligatons. For the convenience of shareholders, the Ministry also decided to let companies be listed, even if it did not meet the requirements of a public firm (e.g. 30 percent of shares held by the public).

The greatest concern regarding the PSOP initiative was the risk of share price dropping after the massive share offering (DongA Daily Newspaper, Dec. 1, 1987). For this reason, the Democratic Justice Party proposed that the government should buy back the shares, using a special government account, if share price were to drop down to a level that damaged to stock holders.

The government opposed this feature on three grounds. First, the government argued that a large share price drop was not likely given the condition of firms and their profitability. Second, it argued that PSOP would create a new group of stock investors that would effectively absorb massive stock offerings. Third, the government stressed that investors should focus on the long-term outcome rather than short-term capital gains.

Regarding the last point, the government came up with a number of measures to either require or encourage long-term stock holding. First, investors that were eligible to purchase stocks at a discount were required to hold onto the shares for at least three years. Others were not subject to the requirement. Second, to encourage long-term stock holding, the government guaranteed dividend yield levels. If dividend yield were to fall below a certain level, the government then were required to compensate for the loss, using its share of cash or stock dividends.

4.2.2 The POSCO PSOP Offering

The subscription for POSCO shares took place from April 1 to 11 in 1988. There were a total of 31.28 million shares to be sold. This took up 34.1 percent of total outstanding shares.[53] Following the established guidelines regarding shares distribution of 75, 20, and 5 percent, the low-to medium-income households, employee stock ownership associations, and others were respectively allocated with 25.6, 6.8, and 1.7 percent of shares. Although the offering price was 15,000 won, low-to medium-income households had the privilege of buy the shares at a 30 percent discount (10,500 won), provided that they hold on to the shares for at least three years.[54] <Table 3-1> shows the key features of POSCO's offering.

53 Even after the privatization, a significant portion of POSCO shares was expected to be held by the government (35 percent), commercial banks (25.3 percent) and Korea Tungsten (2.4 percent).

54 The offering price of 15,000 won was significantly higher than the level recommended by the Korea Appraisal Board and many other securities firms. They criticized the government for setting the offering price too high (Kyunghyang Shimmun, Mar. 4, 1988). But, contrary to their expectations, the first-day share price jumped to 43,000 won, suggesting that the offering price was set too low.

Figure 3-8 | A Stock Certificate of POSCO

Note: A photo of POSCO stock certificate issued on March 7, 1987. Source: Korea Securities Depository

Table 3-1 | Details of POSCO and KEPCO Offerings

	POSCO	KEPCO
Subscription Period	April 1988	May 1989
No. of Shares Offered	31.28 million	127.75 million
Offering Price	15,000 won	13,000 won
Discounted Price	10,500 won	9,100 won
Amount of Sale	413.3 billion won	1.27 trillion won

Source: Rhee et al. (2005)

Table 3-2 | Subscription Results of POSCO and KEPCO Offerings

		Total	Low-and Medium Income				Others	ESOA
			Sum	No Discount	Discount	Inv't Trust		
POSCO	No. of Subscribers (1,000)	3,222	3,101	2,575	265	261	101	20
	Average No. of Subscribed Shares	9.7	7.8	7.0	7.0	16.6	7.0	312.9
	Total No. of Subscribed Share (1,000)	31,283	24,319	17,979	1,849	4,491	707	6,257
	Fraction (%)	(100)	(77.7)	(57.5)	(5.9)	(14.4)	(2.3)	(20.0)
KEPCO	No. of Subscribers (1,000)	6,605	6,411	4,493	745	1,173	162	32
	Average No. of Subscribed Shares	19.3	15.8	6.0	38.2	39.0	6.0	798.4
	Total No. of Subscribed Share (1,000)	127,750	191,236	26,954	28,485	45,797	964	25,550
	Fraction (%)	(100)	(79.2)	(21.1)	(22.3)	(35.8)	(0.8)	(20.0)

Source: Rhee et al. (2005)

The POSCO offering was very popular, with floods of people visiting their banks to subscribe. As a result, a total of 31.28 million shares were subscribed by 3.22 million individuals. This meant one out of ten Koreans subscribed to POSCO stocks. But they were mostly regular subscribers purchasing the shares at the 15,000 won offering price, with no mandatory holding period. Not many subscribed to purchase at a discount, which came with the obligation to hold for three years. Therefore, it was expected that many subscribers would sell POSCO shares once they realize certain capital gains (Kyunghyang Shimmun, Apr. 8, 1988). <Table 3-2> summarizes the subscription results.

The POSCO shares were listed on the Korea Stock Exchange on June 10, 1988. The 25.5 million shares free from the three-year mandatory holding period were traded in the secondary market. With large buy orders, the share price jumped on the first day of listing. The closing price was 43,000 won. This was a 187 percent increase on the first day of trading. With its listing, POSCO became the firm with the largest market capitalization, taking up 7 percent of total market cap. And as expected, many sold their POSCO shares. 30 percent of original subscribers sold them during the first month. By December, 50 percent had sold their POSCO shares (DongA Newspaper, Dec. 27, 1988 , Kyunghyang Shimmun, Aug. 10, 1989). The share price also fell, dropping down to 26,400 won by August 25, 1988.

4.2.3 The KEPCO PSOP Offering

The KEPCO offering, which was originally planned in September 1988, was postponed a couple of times. It was first delayed because of the 1988 Seoul Olympics (Maeil Business Newspaper, May 6, 1988), then because of an inter-ministerial conflict over the KEPCO Act revision.[55] As a result, in October 1988, the offering was postponed to the following year.[56]

Figure 3-9 | A Stock Certificate of KEPCO

Note: A photo of KEPCO stock certificate issued on May 30, 1989. Source: Korea Securities Depository

The subscription for KEPCO shares took place from May 27 to June 5 in 1989. Table 3-2 shows the details of the offering. By selling 21 percent of shares to 6.6 million subscribers, the government was able to raise 1.27 trillion won. The offering price was set at 13,000 won. As was the case in the POSCO offering, a 30 percent discount was applied to subscribers who opted to hold the shares for at least three years.

55 The KEPCO Act had to be revised so that KEPCO can be transformed into a stock company. But there was another important decision that had to be made. The Act had to decide which government agency will be exercising the shareholder rights in the remaining government-owned KEPCO shares. The Ministry of Energy and Resources and the Ministry of Finance both wanted to retain these rights for themselves, thereby delaying the revision of the KEPCO Act (Maeil Business Newspaper, Aug. 25, 1988).

56 The government also expanded the list of SOEs that would offer people's stock. The Citizens Bank, the Industrial Bank of Korea, the Korea Exchange Bank, Korea Telecom, National Textbooks, the Korea Appraisal Board, and Hangkook Engineering were scheduled to be offered in 1989. The Korea Monopoly Corporation was scheduled to be offered in 1990 (DongA Daily Newspaper, Oct. 19, 1988).

Unlike the case of POSCO subscription, there were a greater number of subscribers that applied to purchase at a discount. This accounted for 78.9 percent of subscribers that were eligible to do so. Also, a significant percentage (35.8 percent) of people subscribed to hold shares through the special investment trust the government introduced to assist low-and medium-income households. This was partly influenced by the performance of investment trusts for POSCO stocks. One POSCO investment trust, established on May 12, 1988, recorded an annual return of 120 percent for its investors (Maeil Business Newspaper, May 17, 1989). During the KEPCO subscription period, furthermore, POSCO shares had rebounded back to the 30,000 won level.

Since 21 percent of shares were sold to public, KEPCO did not meet one of the requirements as a public firm. Publically-held shares had to amount to at least 30 percent of total outstanding shares. As mentioned earlier, an exception was allowed when the plan was announced in December 1987. As such, the KEPCO shares were listed on the Korea Stock Exchange on August 10, 1989. The share price jumped on the first day of listing, closing at 23,000 won. As a result, the firm with the largest market capitalization switched from POSCO to KEPCO, which took up 19.1 percent of total market cap. Though not as dramatic as POSCO, many subscribers of sold KEPCO shares by Dec. 1989. The number of shareholders dropped from 5.40 million in August to 3.26 million in December. With the market downturn, the share price of KEPCO also began to fall.

4.2.4 The Suspension of PSOP (May, 1990)

KOSPI peaked on March 31, 1989 at 1,000, and started to fall from the second half of 1989. By December, it had recorded 847.5. In the following year, on February 7, it fell below 800. This continued drop in share prices led the government, on May 8 1990, to indefinitely postpone all the people stock offerings (DongA Daily Newspaper, May 9, 1990).

4.3 Evaluation

The POSCO and KEPCO people's stock offerings greatly contributed to expanding the stock market's investor base. The number of shareholders grew from 3.1 million at the end of 1987 to 19 million by the end of 1989.[57] This is attributable to the low-and medium-income households who entered the stock market with PSOP for the first time.

The offerings, however, failed to assist low-and medium-income households accumulate wealth. Long-term wealth was impossible to generate with only 9.7 POSCO shares and 19.3 KEPCO shares allocated per subscriber. If valued at non-discounted offering prices, the total value of these stocks was only 400 thousand won, less than the monthly salary of 600 thousand won used to define low- and medium-income households. It certainly would have helped if all the planned offerings took place, but this did not happen.

57 Readers should be aware that, until 1989, Securities Market Yearly Statistics counted the number of securities accounts, not the actual number of unique shareholders.

Contrary to what many believe, if the 30 percent discount rate is taken into account, the shares produced reasonable returns. In the case of POSCO, the price was 19,500 won on April 11, 1991 (three years after the last subscription day). Even if we ignore all cash dividends, the share return is calculated to be 22.9 percent per annum over the three-year mandatory holding period.[58] In the case of KEPCO, the price was 12,400 won on June 5, 1992 (three years after the last subscription day). Even if we ignore all cash dividends, the share return is calculated to be 10.9 percent per annum over the three-year mandatory holding period.[59] This return looks even better if compared to KOSPI returns, which fell from 901.5 to 569.2 during the same period.[60]

It is true that returns were higher for those who sold their shares immediately after the listings. In the case of POSCO, if the shares were sold on the first day of listing, investors could have obtained a 176 percent return over a two-month period.[61] In the case of KEPCO, the return was 177 percent over a two-month period. From these results alone, one cannot conclude that the POSCO and KEPCO people's stock offerings failed to obtain its objectives. As explained above, the POSCO and KEPCO shares produced a reasonable return, once the 30 percent discount rate was taken into account. They also greatly helped to expand the stock market's investor base.

What would happen if the original POSCO and KEPCO subscribers held the shares for a ten-year period? The returns are even higher. In the case of POSCO, the share price was 66,900 won on April 11, 1998. This translates into a 20.3 percent return per annum. In case of KEPCO, the share price was 43,000 won on June 5, 1999. This translates into a 16.8 percent return per annum.[62]

[Figures 3-5 and 3-6] depict the share prices of POSCO and KEPCO shares over a ten year period since their PSOP offerings. [Figures 3-7 and 3-8] compare the share prices of POSCO and KEPCO, respectively, against KOSPI.

58 $(19{,}500 / 10{,}500)^{1/3}-1 = 0.229$.

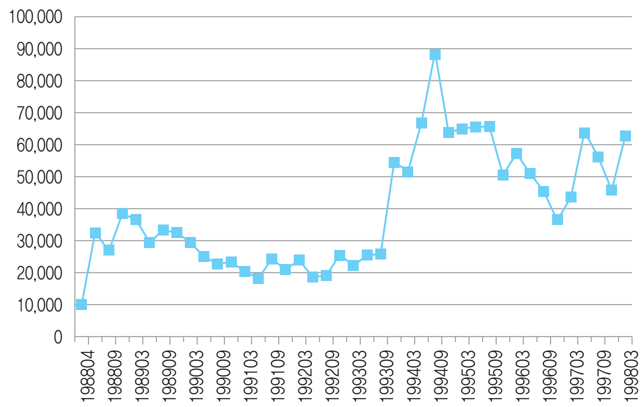
59 $(12{,}400 / 9{,}100)^{1/3}-1 = 0.109$.

60 Of course, KEPCO share return falls short of bank deposit rate.

61 (41,400 / 15,000)-1 = 1.76. The last day of POSCO share subscription and the first day of POSCO listing were apart by approximately two months.

62 If we calculate POSCO return over a twenty-year period, it becomes 21.2 percent per annum. In case of KEPCO, the return becomes 6 percent per annum.

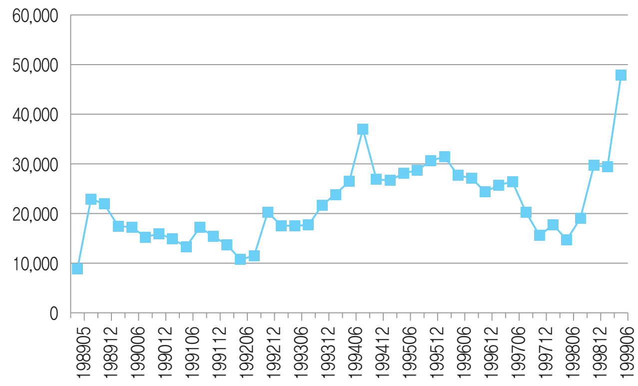
Figure 3-10 | Share Price of POSCO, April 1988-March 1998



Note: The line chart shows quarter-end share prices of POSCO (exception: use 10,500 won discounted offering price instead of March 1988 share price)

Source: DataGuide

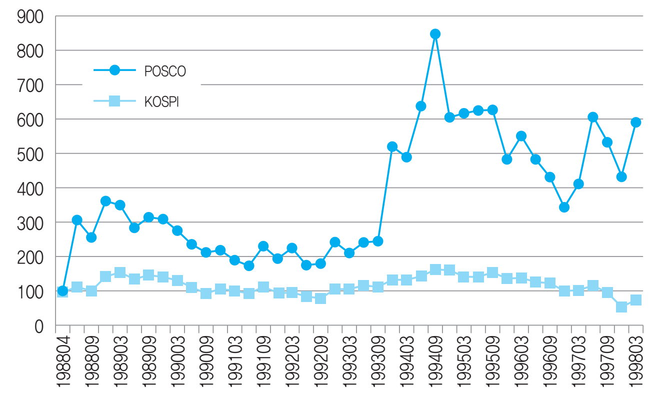
Figure 3-11 | Share Price of KEPCO, May 1989-June 1999



Note: The line chart shows quarter-end share prices of KEPCO (exception: use 9,100 won discounted offering price instead of June 1989 share price)

Source: DataGuide

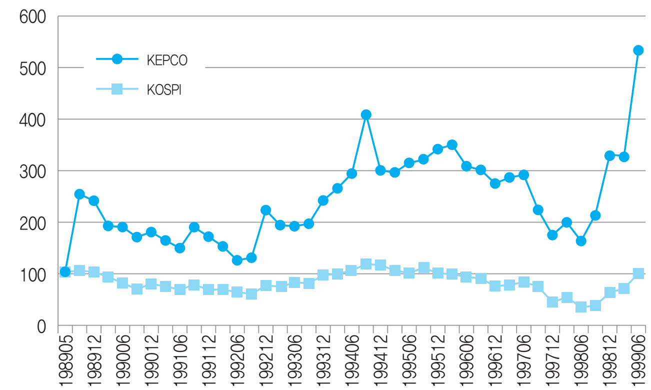
Figure 3-12 | Share Price of POSCO versus KOSPI, April 1988-March 1998



Note: The share price of POSCO and KOSPI normalized to be 100 in April 11 1988, quarterly returns applied thereafter (exception: use returns from April 11 1988 to June 1988 instead of returns from March 1988 to June 1988)

Source: DataGuide

Figure 3-13 | Share Price of KEPCO versus KOSPI, May 1989-June 1999



Note: The share price of KEPCO and KOSPI normalized to be 100 in June 5 1989, quarterly returns applied thereafter (exception: use returns from June 5 1989 to September 1989 instead of returns from June 1989 to September 1989)

Source: DataGuide

The dramatic increase in the number of stock investors, however, had a dark side as well. On one hand, it greatly expanded the stock market's investor base and played a key role in absorbing new public offerings during the late 1980s. But on the other hand, it induced too many individuals to the stock market, including individuals who should never have been investing in stocks in the first place. It was all too common to see retirees living on pension, or investors with imminent liquidity needs, investing in the stock market, often with heavy leverage, and losing all they had in market downturns. PSOP may have gone too far in attracting inexperienced and naïve investors to the stock market.

As mentioned earlier, PSOP was not the most effective method to increase government's fiscal revenue. Because PSOP aimed to share the fruit of economic development with ordinary people, assist wealth accumulation of low-to medium-income households, and expand stock investors' base, government-owned shares had to be sold at a discount, which reduced the government's actual fiscal revenue. This shortcoming in revenue, however, does not mean that PSOP was a failure. It simply had different set of objectives and it achieved some, but not all.

4.4 Implications for Developing Countries

The Korean experience with PSOP is quite relevant for transition economies in Asia that need to privatize their enormous public sector at some point in the future. Implications for these countries can be summarized as follows. First, the policymakers should fully understand the dilemma they would face if they were to pursue a PSOP policy. Normally, new group of investors enter the stock market when the market is in a boom, when the government can easily sell their shares. However, this is also the time when the market is at its peak. Investors that subscribed to PSOP offerings are highly likely to lose money when the market inevitably cools down. If subscribers are mostly from low-income households, a downturn mean a major social- and political problem.

Second, given the dilemma discussed above, shares should be offered with a substantial discount, as was the case in Korea. If not for the 30 percent discount, many subscribers would have lost money. The discounted offerings, of course, reduce the government's fiscal revenue. But this can be considered as a justifiable cost if the main purpose of PSOP is to help low-income households to accumulate personal wealth.

Third, if the government truly wishes to help low-income households to accumulate personal wealth, it should not be satisfied with privatizing one or two SOEs. The number of shares allocated per person would be too small. The government should privatize a greater number of SOEs over a longer period of time. Concurrently, when doing so, it should not overwhelm the public offerings of non-SOES. In the case of transition economies, this may not be a considerable problem, since there is a very limited number of non-SOEs to go public.

Fourth, the government should make efforts in educating the public about not only the advantages, but also the dangers, of investing in the stock market. In particular, it should teach people how risk tolerance, investment horizon, financial strength, and tax can all influence the desirability of stock investment. Otherwise, small and naïve investors who should not have invested in stocks in the first place could be irreparably damaged. And if the number of such investors is large, it could turn into a social or a political problem.

Insert a space inbetween Newspapers and Akerlof Kyunghang Shimmun, DongA Daily Newspaper, and Maeil Business Newspaper.

Akerlof, George (1970), “The Market for “Lemons” Quality Uncertainty and the Market Mechanism,” Quarterly Journal of Economics Vol.84, pp.488-500

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Table A-1 | Equity of Firms Listed on the Korea Stock Exchange, 1963-1993

Year	Public Offerings		Increase in Paid-in Capital	
	No.	Amount (mil. of won)	No.	Amount (mil. of won)
1963			4	608
1964			2	369
1965			1	100
1966			3	369
1967			3	1,301
1968	2	160	10	20,317
1969	12	2,211	6	5,983
1970	9	2,068	13	6,225
1971	4	850	7	2,090
1972	7	1,080	31	15,175
1973	47	21,475	53	33,617
1974	19	14,337	62	37,052
1975	62	39,875	68	82,929
1976	87	74,005	81	101,941
1977	49	44,113	97	141,859
1978	33	41,521	148	285,201
1979	5	4,875	98	211,927
1980	1	345	52	170,803
1981	2	3,045	81	302,996
1982	-	-	69	276,868
1983	3	30,800	102	431,769
1984	14	81,390	107	397,672
1985	11	35,060	60	259,528
1986	16	43,060	110	797,705
1987	44	243,763	178	1,654,950
1988	112	1,049,431	298	6,720,644
1989	135	3,544,648	274	11,124,538
1990	36	336,023	169	2,581,808
1991	22	506,894	136	2,180,178
1992	26	638,701	133	1,711,188
1993	39	469,908	171	2,788,862

Source: Rhee et al. (2005)

Original Source: Securities Market Yearly Statistics

Table A-2 | Stock Market Summary Statistics, 1963-1993

Year	No. of Listed Firms	No. of Shareholders	No. of Shares Traded (mil. of shares)	Market Capitalization (mil. of won)
1963	15	14,800	98,621	10,000
1964	17	13,900	317	17,100
1965	17	14,700	43	14,600
1966	24	31,800	49	19,500
1967	24	33,100	72	38,500
1968	34	39,986	76	64,323
1969	42	54,318	99	86,569
1970	48	76,276	79	97,923
1971	50	81,913	51	108,706
1972	66	103,266	85	245,981
1973	104	199,999	130	426,247
1974	128	199,613	157	532,825
1975	189	290,678	311	916,054
1976	274	568,105	592	1,436,074
1977	323	395,300	1,272	2,350,835
1978	356	963,000	1,369	2,892,512
1979	355	872,100	1,561	2,609,414
1980	352	753,300	1,645	2,526,600
1981	343	696,300	3,075	2,959,100
1982	334	682,300	2,872	3,000,500
1983	328	708,500	2,751	3,489,700
1984	336	723,700	4,350	5,148,500
1985	342	772,500	5,564	6,570,400
1986	355	1,410,500	993	11,994,200
1987	389	3,102,300	5,943	26,172,200
1988	502	8,541,300	3,038	64,543,700
1989	626	19,014,000	3,398	95,476,800
1990	669	2,418,300	3,162	79,019,700
1991	686	2,150,400	4,094	73,117,900
1992	688	1,741,200	7,064	84,711,900
1993	693	1,485,900	10,398	112,665,200

Note 1: The number of shares traded drops significantly in 1964. This has to do with the stock mergers that took place in May 1963. 10,000 shares of Korea Stock Exchange have been merged into 1 share. 1,000 shares of Korea Securities Finance Corporation have also been merged into 1 share.

Note 2: Since 1978, KSE started to count the number of beneficial owners. This led to a big jump in the number of shareholders between 1978 and 1979. Also, since 1990, KSE started to consolidate same shareholders appearing in duplicates in the shareholders' roster. This led to a sharp drop in the number of shareholders between 1989 and 1990.

Source: Rhee et al. (2005)

Original Source: Securities Market Yearly Statistics

Table A-3 | The Chronology of Major Events

1953		
	Nov. 25	Korea Securities Dealers' Association (KSDA) established
1956		
	Feb. 1	Daehan Stock Exchange (DSE) established
	Mar. 3	The first trading day at DSE
1959		
	Feb. 5	Korea Securities Dealers' Association proposes to transform Daehan Stock Exchange into a stock company
	Jul. 1	Securities firms split regarding their position on the legal form of DSE, between those supporting a membership organization and others supporting a stock company.
	Jul. 9	KSDA urges the National Assembly to deliberate on the bill enacting the Securities and Exchange Act
1960		
	Apr. 1	KSDA adopts a proposal that DSE should be transformed into a stock company
	Nov. 12	DSE proposes to the government to sell government owned SOE shares through the stock exchange
1961		
	Jul. 1	Korea Electric Power Corporation (KEPCO) lists on DSE
	Jul. 18	The government announces its plan to enact the Securities and Exchange Act
	Dec. 6	The government sells shares held by Korea Development Bank
1962		
	Jan.15	The Supreme Council for National Reconstruction enacts the Securities and Exchange Act
	Apr. 1	DSE transforms into a stock company
	Apr. 14	The government sells KEPCO shares by auction
	Jun. 1	DSE closes due to the May stock market bubble-burst (reopens on Jun. 7)
	Jun. 11	DSE closes due to currency reform (reopens on Jul. 13)
	Aug. 16	DSE closes (reopens on Sep. 4)
	Sep. 15	DSE closes (reopens on Sep. 20)
	Dec. 4	DSE closes (reopens on Dec. 18)
1963		
	Jan. 14	DSE transforms into a non-profit organization
	Feb. 25	DSE closes due to share price collapse of DSE shares (reopens on May 9)
	May 3	DSE renamed as Korea Stock Exchange (KSE)
	Jul. 23	Korea Securities Finance Corporation (KSFC) lists on KSE

1964		
	Dec. 31	National Assembly passes the bill revising the Securities and Exchange Act (3rd revision), allowing the government to purchase KSE investment securities by making payments with government-owned SOE shares
1965		
	Jan. 27	Mr. Nam-June Lee and 52 other National Assemblymen submits a bill enacting the Stock Investment Security Act
	Apr. 7	The government submits a bill enacting the Stock Investment Promotion Act
	Sep. 30	The government allows the interest rate to rise to a realistic level
	Oct. 29	The government purchases KSE investment securities from financial institutions by making payments with government-owned SOE shares
1968		
	Nov. 22	National Assembly passes the Capital Market Development Act
	Dec. 16	Korea Investment Development Corporation (KIDC) launched
	Dec. 31	National Assembly passes the bill revising the Securities and Exchange Act (4th revision)
1969		
	Feb. 1	The government repeals the clearing transaction system and adopts the regular way transaction system.
	Jul. 18	MoF allows the settlement day under the regular way transaction to be extended by 60 days
	Oct. 26	MoF lowers the margin requirement for regular way transactions
1970		
	Mar. 10	KIDC announced its plan to begin securities investment trust business
	May 20	KIDC establishes the first securities investment trust and sells the first beneficiary certificates
	Sep. 26	MoF urges KSE to discipline firms disguised as public firms
1971		
	Jun. 3	MoF requires all stock transactions be settled on its fifth day
	Jun. 14	Securities firms files two injunctions in response to the June 3rd Measure, one against the Ministry of Finance and another against the Korea Stock Exchange
	Jun. 23	The civil district court of Seoul accepts the injunction filed by the securities firms against the Korea Stock Exchange
	Jul. 29	The government revises the Enforcement Decree and stipulated that stock transaction must be settled on the fifth day of contract. The effective date set to be December 1st

1972		
	Feb. 14	The government revises the Enforcement Decree requiring stock transactions to be settled on the 3rd day of contract
	Aug. 3	The government announces an emergency measure freezing all the exiting private loans extended to business
	Dec. 30	The Emergency State Council enacts the IPO Promotion Act
	Dec. 31	The Emergency State Council revises the Capital Market Development Act
	Dec. 31	Korea Investment Development Corporation (KIDC) renamed as Korea Investment Corporation (KIC)
1973		
	Feb. 6	The Emergency State Council revises the Securities and Exchange Act (5th revision)
	Mar. 22	The IPO Review Committee holds its first meeting
	Jul. 23	The IPO Review Committee holds its second meeting
	Dec. 18	Korea Listed Companies Association (KLCA) established
1974		
	May 29	President Park issues the "Five Special Orders on Firms' Public Offerings and Corporate Culture" to the cabinet
	Jun. 7	MoF announces the Capital Market Preparation Measures (including measures on securities savings , securities investment trust, and employee stock ownership plan)
	Jun. 29	KSE investment securities delist from KSE
	Jul. 11	MoF announces detailed plan on firm commitment underwriting by a syndicate of financial institutions
	Jul. 13	MoF announces a package of measure strengthening employee stock ownership plans
	Oct. 1	KIC starts securities valuation business
	Nov. 15	KSFC stocks delist from KSE
	Dec. 6	KSE establishes the Korea Securities Settlement Corporation (KSSC)
1975		
	Jul. 7	MoF mandates to settle all secondary market transactions by book-entry transfers
	July 15	KSE delegates securities settlement business to KSSC
	Aug. 8	MoF announces the IPO Supplementary Measures shifting to a new set of target firms
	Oct. 6	MoF makes public the first list of qualified firms (105) and their public offering schedules

1976		
	Jan. 20	KSE strengthens the disclosure rule
	Mar. 31	National Assembly passed the bill enacting the Law Stimulating Savings and Supporting Worker's Property Accumulation
	Apr. 1	MoF starts the new savings program supporting worker's property accumulation
	Jul. 1	MoF makes public the second list of 101 qualified firms and their public offering schedules
	Dec. 22	National Assembly passes the bill revising the Securities and Exchange Act (7th revision)
	Dec. 31	National Assembly passed the bill liquidating KIC
1977		
	Jan. 18	Daehan Investment Trust Company established
	Feb. 19	Securities Management Commission (SMC) and Securities Supervisory Board (SSB) established
	Arp. 13	MoF introduces mandatory registration and disclosure of financial statements prior to stock exchange listing
	Sep. 20	Korea Securities Computing Corporation established
1978		
	Jan. 25	SMC urges 139 blue-chip firms to go public
	Jul. 27	Yearly trading volume surpasses 1 trillion won
	Aug. 23	MoF decides to introduce securities transaction tax
	Dec. 5	National Assembly passes the bill enacting the Securities Transaction Tax Act
1979		
	Jan. 4	KSE increases the number of constituent firms from 35 to 135
	Jul. 2	KSE opens the Yeouido stock exchange market
	Jul. 13	MoF tightens the public offering eligibility requirement by excluding firms with debt-to-equity ratio above 700 percent
1980		
	Jan. 4	KSE revises the constituent firms in the composite stock index
	Jan. 4	KSSC starts centralized securities deposit
	May 31	MoF announces its multi-phased capital market liberalization plan
	Dec. 31	National Assembly passed the bill enacting the Act on External Audit of Stock Companies
1981		
	Jan. 14	MoF announces long-term plan for capital market liberalization
	Aug. 3	MoF announces the plan on beneficiary certificates exclusively for foreign investors
	Oct. 3	MoF announces the plan establishing Korea Fund

1982		
	Jan. 11	MoF decides to establish Korea Fund in the U.S.
	Mar. 29	National Assembly passed the bill revising the Securities and Exchange Act (8th revision)
	Jun. 22	Kookmin Investment Trust Company established
1983		
	Jan. 4	KSE shifts to a composite stock index based on market capitalization
	Jan. 8	MoF mandates centralized securities deposit
	Jul. 18	MoF announces the Measures Expanding the Role of Capital Market (including measures expanding the primary market and gradually allowing share offerings at market prices)
	Dec. 16	SMC allows share issuance at market price
1984		
	Feb. 20	MoF announces the Money Market Promotion Plan (including measures raising the cap on corporate bonds and commercial papers issuances)
	May 15	Korea Fund established
	Aug. 22	Korea Fund stocks list on NYSE
1985		
	May 1	KSSC begins the continued depository system
	Jun. 11	MoF announces the Capital Market Development Plan (including measures boosting the investment demand of institutional investors for stocks)
1986		
	Mar. 7	MoF announces the IPO and SEO Promotion Plan (including measures aimed to increase public offerings)
	Apr. 2	MoF announces the Measures to Enforce Equity Financing (including measures linking firms' public offerings with the credit management system)
	Apr. 29	SSB makes public the first list of firms recommended for IPO
	Oct. 25	POSCO makes public an outside consulting project assessing the possibility of adopting PSOP
	Nov. 28	SSB makes public the second list of firms recommended for IPO
	Dec. 1	Stock merger program to make par value 5,000 won starts
1987		
	Jan. 15	EPB makes public the idea of privatizing 3-4 SOEs with a year
	Mar. 28	The government announces the plan to gradually privatize 25 SOEs in phases
	May 6	The government makes public the need of enacting a special law that imposes individual share ownership limit on newly privatized firms
	Jun. 10	Financial Development Review Committee announces the measures to strengthen the foundation of capital market (this led to revise the Securities and Exchange Act and the Capital Market Development Act)
	Jun. 18	The SOE Privatization Committee (chaired by the Vice Minister of EPB) announces SOE privatization plan of seven SOEs

	Aug. 19	KOSPI hits the 500 level for the first time
	Aug. 29	Stock merger program to make par value 5,000 won completes
	Sep. 1	MoF announces measures to strengthen ESOP (allow ESOA to purchase up to 15 percent of IPO stocks)
	Nov. 3	Tae-Woo Noh announces a plan outlining the basic structure of PSOP
	Nov. 28	National Assembly passed the bill revising the Securities and Exchange Act (9th revision) and the Capital Market Development Act
	Dec. 2	MoF announces the plan on PSOP
1988		
	Apr. 1	Subscription to POSCO PSOP shares starts
	Apr. 11	Subscription to POSCO PSOP shares ends
	Jun. 10	POSCO shares list on KSE
	Jul. 23	MoF mandates employees to deposit their ESOA shares at KSFC until their retirement
	Dec. 23	The number of listed firms on KSE hits 500
1989		
	Mar. 31	KOSPI hits the 1,000 level for the first time
	May 27	Subscription to KEPCO PSOP shares starts
	Jun. 5	Subscription to KEPCO PSOP shares ends
	Aug. 10	KEPCO stocks list on KSE
	Oct. 5	SSB mandates prior notice of public offering plans
	Nov. 9	MoF announces measures to stabilize the stock market (including stock investment of 2.4 trillion won by institutional investors)
	Nov. 24	MoF grants SMC the power to make adjustments in IPO and SEO plans
	Dec. 12	MoF announces measures to stabilize the stock market (including the adjustment of IPO and SEO plans and the increase in investment trust companies' stock investment)
1990		
	Jan. 9	KLCA establishes the Paid-in Capital Increase Coordination Committee
	Apr. 6	Paid-in Capital Increase Coordination Committee announces a plan to deter paid-in capital increase
	May 8	MoF announces measures to stabilize the stock market (including financial support for investment trust companies, lower tax rate on securities transactions, and enlargement of securities market stabilization fund)
	May 8	MoF indefinitely postpones any new PSOP offerings
	Jul. 25	MoF indefinitely postpones any new public offerings

Table A-4 | The List of Acronyms

Acronyms	Unabbreviated expression
BW	Bonds with warrant
CB	Convertible bonds
DSE	Daehan Stock Exchange
EPB	Economic Planning Board
ECOS	Economic Statistics System
ESOA	Employee Stock Ownership Association
ESOP	Employee Stock Ownership Plan
FKI	Federation of Korean Industries
HCI	Heavy Chemical Industry
IBK	Industrial Bank of Korea
IPO	Initial Public Offering
KDB	Korea Development Bank
KDI	Korea Development Institute
KEB	Korea Exchange Bank
KEPCO	Korea Electric Power Corporation
KIC	Korea Investment Corporation
KIDC	Korea Investment Development Corporation
KLCA	Korea Listed Companies Association
KOSPI	Korea Composite Stock Price Index
KRX	Korea Exchange
KSD	Korea Securities Depository
KSDA	Korea Securities Dealers Association
KSE	Korea Stock Exchange
KSFC	Korea Securities Finance Corporation
KSSC	Korea Securities Settlement Corporation
KT	Korea Telecom
MoF	Ministry of Finance
POSCO	Pohang Steel Corporation
PSOP	People's Stock Ownership Plan
SEO	Seasoned Equity Offering
SOE	State Owned Enterprise
SMC	Securities Management Commission
SSB	Securities Supervisory Board
USAID-K	United States Agency for International Development-Korea
USOM	United States Operations Mission

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