

# Politics of State-led Microcredit under the Lee Myung-bak Administration: State Autonomy, Capacity, and Outcomes<sup>\*</sup>

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## Abstract

In the 2000s, financial exclusion of low-income people emerged as a major social problem in South Korea. Microcredit business was first introduced by NGOs to help the poor overcome poverty while the Korean government soon chose to initiate microcredit policies to assist financially marginalized low-income people as a key policy measure to alleviate social inequality and revitalize economy. Unlike the initial expectation that state intervention in microcredit industry would be more effective, the outcome has been much less impressive. This paper aims to examine the poor performance of state-led microcredit in South Korea during the period of Lee Myung-bak administration by employing the concepts of state autonomy and capacity. It finds that the state autonomy, a key characteristic of a developmental state, was high in the sense that the funds had been raised in the face of strong resistance from private financial institutions. Lack of state capacity such as low technocratic expertise and politicization of microcredit policy, however, turned out to be a major stumbling block to the state-led microcredit in South Korea. This study shows that although the Korean government still has strong willingness to intervene in the financial market even in the face of interest groups' opposition, the eventual success of state action largely depends on its capacity to effectively implement financial policies.

## Keywords

microcredit, microfinance, developmental state, state autonomy, state capacity, South Korea

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## I. Introduction

Financial exclusion, which refers to those processes that prevent poor and disadvantaged social groups from gaining access to the financial system, has become a global phenomenon (Leysdon and Thrift, 1995). Although it was expected that financial consumers would have better and easier access to financial services at lower costs thanks to financial globalization, characterized by massive cross-border financial activities by transnational actors and intense competition among them, the financial services industry in the world has in fact become increasingly exclusionary (Choi and Jung, 2013; Jung et al., 2018).

Similarly, financial exclusion has become a social problem in South Korea since the late 1990s. While the 1997 Asian financial crisis and post-crisis financial reform further integrated the Korean economy into global finance along with the adoption of international best practices and growing foreign participation, this integration also exposed the Korean economy to the vicissitudes of global finance. In this process, those who had collaterals and high credit ratings were able to enjoy lower interests and better financial services although a large number of low-income people, many of whom became credit defaulters, were unable to get access to financial services at affordable costs. This so-called social exclusion in finance became not only a social problem in itself but also an obstacle to Korea's economic performance (Jung et al., 2018).

In order to help those in financial needs and revitalize domestic consumption, the Korean government initiated microcredit policy in the midst of 2008 global financial crisis and a growing income disparity.

Microcredit business, small loans to low-income people, was first introduced in the early 2000s by non-governmental organizations (NGOs) although it became a signature policy of the Lee Myung-bak administration (Choi and Jung, 2013). In the beginning, it was expected that this state-led microcredit would systematically distribute more resources to the poor and eventually lead to poverty reduction thanks to a strong presidential willingness for the success of state-led microcredit and the use of dormant savings as its major source.

The performance of state-led microcredit in Korea, however, ended in disappointment. While microcredit policies were swiftly initiated by the Korean state, the actual implementation and outcome show that this state-led microcredit policy was unable to reduce poverty, resolve the problem of income disparity, and revitalize economy. Why did the state-led microcredit under the Lee administration fail to achieve its policy goals? Despite the favorable conditions such as strong political will and social support, what factors affected the underperformance of the microcredit policy? This paper takes a closer look at the ways in which the microcredit policy had been initiated and implemented to answer these questions.

These questions are of great significance both in practical and theoretical senses. In a practical sense, the answer would help us devise better policy tools to help those in financial needs. Theoretically, it would enable us to re-examine the role of the state in financial market. While financial globalization was expected to force the state to retreat from the market, financial exclusion might require a renewed role of the state. In retrospect, the very success of post-1997 financial reform that had led to the decline of the state in the financial market “brought the state back in” to manage the negative consequences and revitalize the economy by

resolving financial exclusion problem. In this sense, the underperformance of the microcredit policy may show that the Korean state failed to find its renewed role in this niche market. This paper finds that, despite initial success in raising funds and distributing credit to low-income people, the state-led microcredit in Korea had little effects on borrowers' poverty reduction because of the lack of state capacity to achieve its policy goals. It argues that a high level of state autonomy was instrumental in microcredit policy initiation while the lack of capacity to assist poor people to make the most out of the credit eventually resulted in poor performance. Increasing delinquency rate, reliance on collaterals in micro-loan decisions, and bribery scandals are indicators of low capacity to evaluate applicants' business proposals, provide appropriate business consulting, and monitor applicants' business performance.

This paper is organized as follows. First, prior studies on developmental state and microcredit will be examined. Second, it will closely examine how the use of dormant accounts as a major source of microcredit during the Roh Moo-Hyun administration had been politicized. Third, the initiation, implementation and performance of microcredit policies during the Lee administration will be analyzed from the perspective of state autonomy and capacity. Finally, it concludes with policy implications.

## **II. Literature Review**

South Korea's economic miracle had been explained by proactive state intervention in the market with developmental purposes (Johnson, 1982; Wade, 1990; Haggard, 1990; Evans, 1995; Woo-Cumings, 1999; Deyo, 1987).

According to the developmental state thesis, Korea's economic success in the past largely owed to state autonomy and capacity based on elite economic bureaucracy and to effective industrial policies through preferential credit allocation (Amsden, 1989; Choi, 1993; Woo-Cumings, 1995). Dramatic changes since the late 1980s, however, undermined the Korean developmental state: these changes included democratization, vibrant civil society, economic globalization, and the 1997 East Asian financial crisis followed by financial and corporate restructuring (Lim, 2010; Pirie, 2005; Lee and Han, 2006; Lim and Jang, 2006; Ha and Lee, 2007; Kalinowski and Cho, 2009). These changes had been regarded as what had transformed the Korean state-society relations in fundamental ways.

Although most agree that post-1997 neo-liberal reforms made the state step down from "the senior partner" position in its relations with private sectors, the nature and implications of post-developmental state in Korea are still hotly debated. On the one hand, some scholars maintain that the developmental state model became anachronistic as a regulatory state replaced the former due to unbridled market forces (Minns, 2001; Pirie, 2008). They argue that Korea's post-developmental state seems to be losing the bureaucratic coherence and autonomy, which may indicate the weakening of its core developmental features (Park, 2012). On the other hand, other scholars assert that the key characteristics of Korea's developmental state that had made possible the compressed economic growth continue to exist despite, or because of, globalization and economic crises. According to them, the Korean state can be better understood as one having characteristics of both developmental and neoliberal regulatory state as the legacy of developmental state still exists (Weiss, 2005; Hundt, 2009).

Recent studies reconcile these different views by stressing the unevenness in degree and scope of the demise of developmental state and the emergence of a neoliberal model across different sectors in the society (Wong, 2004; Stubbs, 2011; Lew and Wang, 2007; Wade, 2000; Lim, 2010; Stubbs, 2009). What these arguments have in common is that the retreat of the state is more noticeable in the financial sector than in any other sectors.<sup>1)</sup> The unprecedented financial crisis in 1997-1998 was a watershed event that weakened the role of the state in finance because Korea had little choice but to widely open its financial market and the growing presence of international actors—IMF and foreign investors—constrained financial policy-making autonomy to achieve policy goals. Decreasing state autonomy in financial sector was accompanied by declining state capacity as a result of the separation of financial supervisory agencies from the Ministry of Finance.

Unlike the previous works, however, a great deal of variation exists in terms of degree and scope of state intervention in the financial sector and its effectiveness if the financial sector is disaggregated into various types of financial services and examined separately. While direct state intervention in the first-tier commercial banks has mostly disappeared,<sup>2)</sup> the Korean state still plays key roles in some financial sectors, especially

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- 1) Unlike other developmental states in East Asia, Korean state intervention in financial sector had been so extensive as to effectively allocate scarce capital for developmental purposes even by nationalizing all commercial banks from 1961 to the early 1980s. Despite the crucial role of financial policies in Korea's economic growth, the same policies turned out to be the major source of market distortion as evidenced by the 1997 financial crisis.
  - 2) Some may argue this is not the case. However, if we compare the state intervention in the banking sector in pre-1997 period to that in post-1997 period, there exists a clear difference.

where foreign participation is low. The effectiveness of the financial policies in these sectors, that has been largely under-explored, might provide us a better understanding of the continuity and change in the state-society relationship in financial sector. One of the key financial policies in these sectors includes the microcredit policy.

Microcredit (also known as microfinance) refers to small loans given to the poor, who have no or little access to traditional financial institutions due to poor credit history, no loan guarantee, and no collateral, to establish or expand income generating activities, and therefore supposedly helps them escape from poverty (Bateman, 2011). Microcredit, part of microfinance, has a long history and encompasses a diverse range of institutional formats (Bateman and Chang, 2012).<sup>3)</sup> Modern microcredit is generally considered to have originated with the Grameen Bank founded in 1983 by Dr. Muhammad Yunus in Bangladesh (Bateman 2010). After microcredit gained worldwide attention with the success of Grameen Bank, microfinance institutions (MFIs) were established in most developing and some developed countries to help low-income people fight poverty and get resources to break vicious cycle of poverty (Yunus, 1998; Hermes and Lensink, 2007). From 1990s to 2000s, microfinance industry had become internationalized, commercialized, and sophisticated. As of the early 2010s, it was reported that more than 100 million customers of worldwide were borrowing small loans from MFIs (Ahlin et al., 2011).

In Korea, microcredit was introduced by NGOs such as Social Solidarity

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3) Institutional formats of microfinance range from individual money-lenders through to more formal institutions, such as village banks, credit union, friendly societies, financial cooperatives, building societies, state-owned banks for small and medium-sized enterprises (Bateman and Chang 2012).

Bank and Joyful Union in the early 2000s. The Korean government started its own microcredit business in the mid-2000s with more financial resources in the context of growing income disparity and poverty. Unlike most countries where microcredit industry were society-initiated and operated without substantial state intervention though receiving state subsidies, the Korean government soon played a leading role in the microcredit industry. This state-led model of microcredit was expected to bring forth positive outcomes in terms of poverty reduction and economic revitalization given the past record of the Korean state intervention in finance. However, there are very few works to analyze the role of the Korean state in microcredit business.

In this regard, this paper employs the analytical framework of the developmental state thesis to better understand the initiation and implementation of microcredit policy in South Korea. First, the concept of state autonomy is used to examine how the Korean government was able to initiate microcredit policy by utilizing dormant savings in commercial banks in the face of the latter's resistance. Second, a careful attention is paid to the state capacity to implement microcredit policy or lack thereof to analyze policy outcomes. This attempt to analyze the state's role in microcredit business with the concepts of state autonomy and capacity can also help us see if these concepts still are relevant in understanding the Korean state-society relationship.

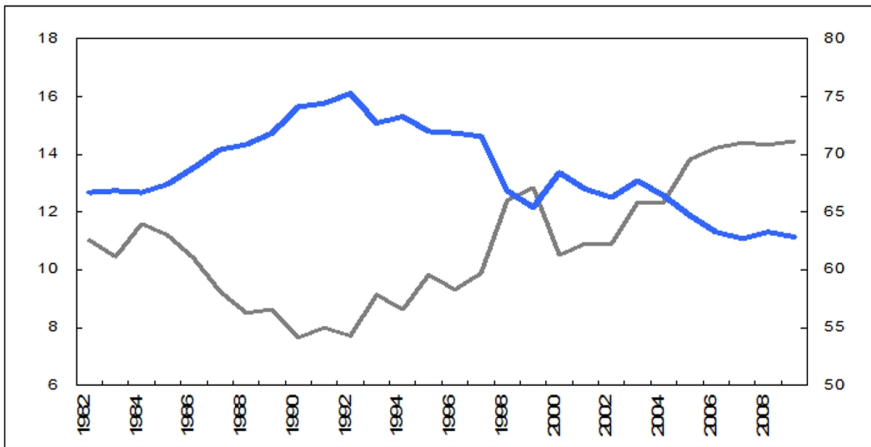
### **III. Microcredit in the Korean Context**

The unprecedented economic recession during and after the 1997 Asian financial crisis hit the poor hardest and income disparity worsened in the 2000s. Banks and other financial institutions were very reluctant to extend loans to the poor because they themselves were under pressure to reduce non-performing loans (NPLs) and maintain proper capital adequacy ratios. Meanwhile, low-income people had access to private money-lenders, but only with the risks of being involved in predatory lenders. As a result, an increasing number of people began to be denied access to credit due to job loss, income reduction, and bad credit history.

It was in this context when the first microcredit providers, the Joyful Union (the Korean branch of Grameen Bank) and the Social Solidarity Bank, were established to help those who could not get bank loans but had strong will to overcome poverty. Most funds were raised with corporate and individual donations, membership fees, government subsidies, and interest payment from borrowers. Microcredit business had been mostly done by NGOs in the early 2000s. In the mid-2000s, however, the Korean government started to play a leading role in microcredit business. From the beginning of the 2000s, worsening poverty, income disparity, and collapse of middle class had become social problems as well as major economic stumbling blocks to economic revitalization and recovery. Both liberal and conservative administrations alike—the Roh Moo-hyun administration (2003-2008) and the Lee Myung-bak administration (2008-2013)—took seriously the growing income gap and the worsening economic status of low- and middle-income groups. Old-style

direct state intervention, however, was not a viable option due to the existence and growing influences of international financial institutions and private actors, especially foreign investors in the financial sector.

Figure 1. Share of Middle-Income and Low-Income Group in South Korea



Note: low-income group (gray line), middle-income group (blue line)

Source: Korean Statistical Information Service (<http://kostat.go.kr/portal/korea/index.action>)

In this context, microcredit was an attractive option as it would serve policy goals in more direct ways: poverty reduction and economic recovery. The state intervention in microcredit business could directly distribute financial resources to the needy, opt for specific policy beneficiaries, and gain their political supports. In other words, microcredit policy was desirable both economically and politically. As a result, microcredit policies were initiated and implemented with a new policy direction from welfare to financial approach (Yim and Park, 2010).

The problem in this state-led microcredit was how to finance it without

imposing fiscal burden. As will be explained more in detail below, the Korean government utilized dormant savings as a major financial source for microcredit in the face of strong resistance of private financial institutions. Dormant savings or dormant claims are savings accounts that have shown no activity over a long period, other than posting of the interest and/or service charges. Financed with dormant savings and corporate donations, the Dormant Savings Management Bank was established as a public foundation in March 2008 to implement state-led microcredit, renamed the Smile Microcredit Bank (SMB) in September 2009.

Since its establishment, SMB extended loans through its affiliates and NGOs. In fact, microcredit business was implemented by four different loan providers. First, SMB established thirty-three local branches to conduct microcredit business under its direct supervision. Second, six conglomerates (Samsung, Hyundai, LG, SK, POSCO, and Lotte) established their own corporate foundations and local branches to conduct microcredit business independently. Third, five leading commercial banks (Kookmin Bank, Shinhan Bank, Woori Bank, Hana Bank, and Industrial Bank of Korea) also established their own foundations and their local branches and took part in microcredit business. As of June 2013, six corporations had 78 branches and five banks maintained 53 branches respectively. Finally, SMB provided funds to 445 welfare-related private organizations and supervised their activities including microcredit NGOs such as Joyful Union and Social Solidarity Bank (refer to the Table 1 and 2 below).

**Table 1. Microcredit Organizations, 2009–2013 (by region)**

|                         | 2009 | 2010 | 2011 | 2012 | 2013 |
|-------------------------|------|------|------|------|------|
| Total                   | 15   | 106  | 145  | 162  | 164  |
| Seoul metropolitan area | 1    | 48   | 63   | 70   | 71   |
| Local area              | 14   | 58   | 82   | 92   | 93   |

Source: Financial Service Commission ([www.fsc.go.kr](http://www.fsc.go.kr))

**Table 2. Microcredit Organizations, 2009–20139 (by purpose)**

|                                  | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|----------------------------------|------|------|------|------|------|------|
| Total                            | 29   | 172  | 214  | 352  | 426  | 445  |
| Support to establish own company | 2    | 5    | 7    | 8    | 8    | 8    |
| Support to credit recovery       | 2    | 2    | 2    | 2    | 2    | 2    |
| Social enterprises               | 1    | 3    | 5    | 5    | 3    | 3    |
| Traditional market               | 24   | 161  | 200  | 337  | 413  | 432  |

Source: Financial Service Commission ([www.fsc.go.kr](http://www.fsc.go.kr))

This state-led microcredit fundamentally reshaped microcredit industry in South Korea. While most microcredit industries in the world were initiated and implemented by private actors, microcredit business in South Korea was led by the government with private microcredit institutions and NGOs playing only ancillary roles. Of great significance was that there were high expectations that this state-led microcredit would be more effective in poverty reduction and distribution of financial resources to the underprivileged given the strong presence of the Korean state in the financial market. From the perspective of developmental state thesis, this involvement of the Korean state in microcredit industry was a clear indicator that the state enjoyed high level of independence from the

societal actors — microcredit NGOs and financial and corporate actors — as financial resources were mobilized successfully and channeled through the state-sponsored SMB.

Unlike the initial expectation, however, actual performance of microcredit policies was much less impressive. Rather, the rapidly increasing NPLs questioned the sustainability of state-led microcredit. In addition, state-led microcredit did not succeed in achieving its primary goal of microcredit: poverty reduction. Of greater importance is the fact that little data on the performance of those who were financially supported by SMB were generated and accumulated, indicating that post-loan monitoring and consultation had been very limited.

The not-so-impressive outcome of the state-led microcredit requires us to carefully examine how this policy was initiated and implemented especially when strong willingness of the top executive — the president — is taken into consideration. This is so since policy initiation and implementation take place in different contexts where state autonomy and capacity play central but differentiated roles (Haggard and Kaufman, 1992). In the following sections, we investigate the political dynamics in initiating and implementing microcredit policies.

#### **IV. Initiation of State-led Microcredit in Korea: State Autonomy vis-à-vis Societal Actors**

When microcredit was first introduced in the early 2000s, only a few societal actors, most of whom were NGOs, took part in this new industry. While funds were mostly raised through corporate donations, microcredit

was available only for the selected poor due to insufficient amount of funds. It was in the mid-2000s when the growing income disparity and worsening poverty brought in state action. Moreover, the very success stories of microcredit in developing countries made the Korean government take seriously microcredit as a viable policy option.

The biggest hurdle was how to raise funds sufficient for microcredit. When the idea of utilization of dormant savings to help the poor emerged, private financial institutions vehemently opposed it (Jung et al., 2018). The estimated total amount of dormant savings was more than 800 billion KRW (about \$750 million USD). Until then, banks and insurance companies had regarded dormant savings as miscellaneous revenues. Financial institutions maintained that the state utilization of dormant savings would infringe upon depositors' property rights, compromise the independence of financial institutions, and complicate management of dormant savings. Instead, they strongly suggested that they would establish their own foundations to make the use of the funds to help the poor.<sup>4)</sup> After two-year long debates on how to manage dormant savings, the "Bill on Establishment of the Dormant Savings Management Bank" was promulgated in August 2007.

Once the financial sources for microcredit were secured, the newly-elected president Lee Myung-bak swiftly moved to grasp the opportunity seen from the previous Roh administration. In 2008, the Lee administration initiated a series of policies to financially assist low-income people as part of its "active welfare" policy strategy.<sup>5)</sup> The Lee admini-

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4) *The Naeil Shinmun*, July 27, 2005.

5) The five policy strategies of the Lee administration were 'government serving the people,' 'lively market economy,' 'active welfare,' 'country rich in talent' and 'contributing member of the international community.'

stration coined many notions such as “shared growth,” “fair society,” and “symbiosis society” to define its welfare policies, which were summarized into “active welfare” or “welfare through the work” (Lee et al., 2012).

**Table 3. Development of Microcredit Policy in Korea**

| Period                | 2000 ~ 2005                 | 2005 ~ 2008   | 2008 ~                                   |
|-----------------------|-----------------------------|---|--|
| Primary Actors        | Non-profit organizations    | The government  | Public-sponsored foundations             |
| Funding and Operation | Funded by private donations | Funded by the government (dormant savings and donation) | Funded by the government operated by SMB |

Source: Choi and Jung (2013)

In the context of global financial instability and worsening external economic circumstances, Lee Myung-bak proposed projects to help the recovery of financially-difficult people by raising funds from dormant savings and surplus of Non-performing Loans Resolution Fund of Korea Asset Management Corporation (KAMCO). Acknowledging and taking seriously the social consequences of income disparity and credit defaults, the Lee administration made a series of microfinance policies such as microcredit (Smile Microcredit), Sunshine Loan (*hatsalron* in Korean), New Hope Seed, and so forth. Soon microcredit policies became one of the Lee administration’s signature policies.

In the very beginning of the presidential tenure, SMB was established as a key institution to implement microcredit policies by expanding and restructuring the previous Small Microcredit Bank, renamed the previous “Dormant Savings Management Bank.” SMB was the overarching institution,

making key policy decisions regarding the direction of microcredit policies, setting the project guidelines, and manage consulting, education, and information. SMB's major projects were as follows: (1) microcredit to help the poor to start new businesses or to get new jobs; (2) microinsurance to support the poor to make contracts and to maintain basic insurance; and (3) public welfare projects to relieve the burden of the expenses of tuition and medical services for the children of low-income families (Yoon, 2010).

From the perspective of the developmental state thesis, the Korean state intervened in the microcredit business in a manner highly reminiscent of the Park Chung-Hee's developmental statism (Chang, 2010). The swift initiation of state-led microcredit policies indicates that the Korean state still enjoyed relative autonomy vis-à-vis the society, especially in the fact of resistance of private financial institutions such as banks and insurance company which preferred independence in managing dormant savings.

This high level of state autonomy was possible thanks to three factors. First, social consensus on the need of assistance for the poor emerged in the context of global financial crisis and widening income gap. The Lee administration claimed to be a "pragmatic" administration and made policies to help the poor in order to revive the economy as a key policy objective. Especially, as the widening income gap became a main social problem that might prohibit economic revitalization and successful cases of MFIs in other countries began to be known, there was an emerging social consensus around the need for microfinance policy options.

More importantly, financial institutions made massive profits through interest differentials even during the economic downturn, which were heavily criticized by media, politicians and the general public. Their

profit became a burden, not an asset. Therefore, they found cooperation with the state would help them cope with criticism when the state twisted the arms of banks to donate funds to SMB and to make their own MFIs. This situation helped the Korean state exploit the opportunities in eliciting private cooperation with the state-led microcredit. Despite the fact that the balance had been tipped in favor of financial institutions as a result of financial liberalization, reform, and presence of international investors, it shows that the Korean state had sufficient extractive capacity while it was questionable whether it had transformative one (Weiss, 1998).

Second and related, one of the key aspects of SMB was that it was primarily financed by dormant savings in financial institutions and donations from conglomerates. According to the “Microfinance Project Plan,” SMB would secure 700 billion KRW from dormant savings and 1,500 billion KRW of donations from business community until 2019 and provide funds to 200 to 250 thousands of low-income and financially-excluded individuals and households. The fact that SMB financed itself from unclaimed dormant savings meant that SMB was able to autonomously devise microcredit policies and make loan decisions. Securing dormant savings as a main financial resource indicates high level of state autonomy in microfinance. As dormant savings are created on annual bases, the financial independence enabled flexible utilization of the funds for political and social purposes.

**Table 4. Financial Source of SMB Loans**

|                                       |                              | Amounts<br>(billion KRW / million USD) | Percentage |
|---------------------------------------|------------------------------|--|------------|
| Smile Microcredit                     | Bank                         | 415.4 / 389.1                          | 54%        |
|                                       | Enterprise                   | 305.0 / 285.7                          | 38%        |
|                                       | Etc                          | 65.4 / 61.2                            | 8%         |
|                                       | Total                        | 785.8 / 736.1                          | 100%       |
| Donation from<br>welfare organization | Bank                         | 398.4 / 373.2                          | 65%        |
|                                       | Life insurance company       | 169.4 / 158.6                          | 27%        |
|                                       | Nonlife insurance<br>company | 50.4 / 47.2                            | 8%         |
|                                       | Total                        | 618.4 / 579.1                          | 100%       |

Source: Financial Service Commission ([www.fsc.go.kr](http://www.fsc.go.kr))

Finally, the relative weakness of non-state actors in microcredit business made it possible for the state-sponsored microcredit agencies to play a dominant role in the business in a short period of time. The history of South Korea's MFIs shows that it was only in the early 2000s when a couple of NGOs began microcredit business to assist low income groups with seed money and training in management and marketing. Despite their active roles in helping the poor, private MFIs had limited and unstable financial resources. They had been dependent on the government and corporate donations only with limited human resources to provide training and education for the people. Once the government made a decision to take part in the microfinance business, non-state actors began to become more dependent on the government. In the absence of strong non-governmental MFIs, the state could enjoy more policy autonomy to achieve its policy goals.

While this swift initiation of microcredit policies under the Lee administration was possible due to high level of state autonomy, it did not mean that they were at odds with Lee's pro-business or pro-*chaebol* policies. Rather, it was more likely that microcredit policies were chosen because they were expected to strengthen political support of these beneficiaries for Lee Myung-bak and then ruling conservative party as low-income people had tended to support conservative parties in Korea. In this regard, while his economic policies in general favored big business, the initiation of microcredit policies was a strategic choice to show off his allegedly pro-*seomin* (ordinary people) policies and garner their supports because these policies that entailed relatively low budgetary burden were cost-effective from Lee's perspective.

In sum, microcredit policies were adopted by the Korean government in the context of the global financial crisis, a growing social consensus on the need of these policies, and strong presidential leadership. Microcredit policies were expected to help the poor overcome poverty and to revitalize economy. The swift initiation of microcredit policy with utilization of dormant savings against societal resistance was an indicator of high level of state autonomy. In the following section, whether state-led microcredit was successfully implemented as expected and what affected the policy outcome will be examined.

## V. Implementing Microcredit Policies: Lack of State Capacity and Underperformance

While the high level of state autonomy vis-à-vis society made possible the swift initiation of microcredit policies, the actual implementation and policy outcome clearly showed that this state-led microcredit failed to achieve its primary goal: poverty reduction and self-help of independent businessmen. Poor performance of microcredit policies such as rapidly-rising delinquency rate of borrowers, reliance on collaterals in loan decisions, and financial scandals indicated that state autonomy and strong political volition, if any, failed to achieve policy goals in the absence of state capacity.

First of all, increasing NPLs were a key indicator of poor performance of SMB. Some might argue that the very nature of microcredit necessarily relates to high share of NPLs. While this might be true, the speed of NPL's accumulation was very alarming, constraining the very core business of SMB. While the share of NPLs was only 1.6% by the end of 2010, it increased to 5.7% in two years. It was reported that delinquency rate of microcredit extended by some social welfare NGOs was as highly as 50%.<sup>6)</sup> Also, given the fact that the amount of outstanding loans increased rapidly, the increasing share of NPLs implies that NPL problem would be very critical soon and the entire state-led microcredit would come to an end.<sup>7)</sup> [Figure 2] shows that the delinquency

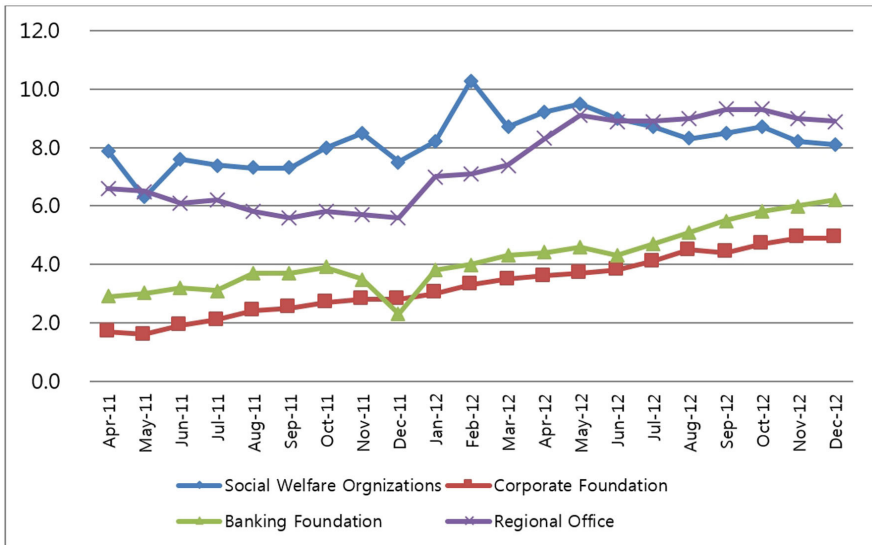
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6) *Maeil Kyungjae Shinmun*, (*Daily Economy*), December 4, 2012.

7) *Hankook Kyungjae Shinmun*, December 27, 2012.

rates increased rapidly, especially those of branches of SMB and social welfare organizations.

Figure 2. Delinquency Rate by Microcredit Providers



Source: Financial Service Commission ([www.fsc.go.kr](http://www.fsc.go.kr))

This increase of delinquency rate was closely related to the lack of capacity to evaluate feasibility and profitability of applicants' business projects, provide proper consulting, and monitor post-loan performance and continuously engage in these borrowers. This lack of capacity exacerbated moral hazard problems. Faced with the rising delinquency rate and lack of capacity, SMB had little choice but to rely on the conventional way to hedge against risks involved in their loans: collaterals.

In fact, SMB increasingly extended loans to those who could provide collaterals such as cars and trucks although microcredit policy was

adopted to help those without collaterals. It indicates that the state-sponsored SMB lacked the capacity to evaluate creditworthiness of those in need and monitor their performance. In the middle of 2011, half of loans extended by SMB went to those utilized their cars and trucks as collaterals. Collateralized loans are much easier to manage the risks compared to credit-based loans, again exemplifying the limited state capacity.

**Table 5. Amount and Ratio of Collateral Loans and Credit Loan (Non-Collateral) in SMB**

|                  | 2 <sup>nd</sup> half of 2010 | 1 <sup>st</sup> half of 2011 | 2 <sup>nd</sup> half of 2011 | 1 <sup>st</sup> half of 2012 |
|------------------|------------------------------|------------------------------|------------------------------|------------------------------|
| Collateral loans | 231.2                        | 735.8                        | 767.3                        | 407.4                        |
| (Ratio)          | (24.2%)                      | (49.9%)                      | (47.0%)                      | (30.8%)                      |
| Credit loan      | 723.6                        | 739.6                        | 863.7                        | 915.7                        |
| (Ratio)          | (75.8%)                      | (50.1%)                      | (53.0%)                      | (69.2%)                      |
| Total            | 954.8                        | 1,475.4                      | 1,631.0                      | 1,323.1                      |

Source: Financial Service Commission ([www.fsc.go.kr](http://www.fsc.go.kr))

Second, implementation of microcredit policies largely depends on relationship managers (RMs). RMs are those who evaluate project feasibility and creditworthiness of borrowers, provide technical and practical assistance, build relationship with them, and monitor their performance over time.<sup>8)</sup> It is not an overstatement that the long-term success of microcredit business depends on how RMs are trained and how capable they are. The very success of microcredit in other countries shows this is

8) RMs are responsible for the recruitment of clients, administration and maintenance of clients' files, the delivery of the financial education and disbursement of the matched funds (Cabraal et al., 2006).

the case (e.g., Grameen Bank). The SMB tried to foster capable RMs only to fail.

The lack of RM's expertise in SMB and other government-sponsored MFIs turned out to be a major problem.<sup>9)</sup> One of the key components of microfinance projects was to assist the poor with management and marketing supports. In the early 2000s, microcredit NGOs such as SSB and JU provided low-income low-credit people who planned to start up businesses with non-financial, technical, and even emotional supports such as selection of business location and items, business plan and management, continuing relations with them, and so forth.

Despite the significance of pre-screening and post-management, however, SMB focused mostly on financial supports and undersupplied non-financial supports. Most RMs in SMB were retired bank officials who were able to evaluate credit-worthiness of loan applicants but not to provide business consultation. Especially, local SMBs had very few capable RMs (Jung et al., 2018). This resulted in the rapidly increasing NPLs in local SMBs relative to other microcredit providers. Social welfare organizations also had high delinquency rates primarily because they extended loans to those who began their own businesses without collaterals, which was riskier than other borrowers. The fact that the delinquency rate of local SMB became higher than that of social welfare organization was a clear indicator of lack of capacity of RMs in local SMBs.

More specifically, local SMBs lacked their independence in implementing tailored microcredit policies. In other words, local branches had little

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9) Moreover, SMB is under supervision of FSC. Despite the fact, there were only few financial regulators who oversaw SMB.

independence from the central SMB, not being able to meet local needs. One of the key positive aspects of state-led microfinance was that regional disparities could be reduced as the state could provide universal microcredit services regardless of the localities. Also, standardized screening process and management were expected to help reduce regional differences. However, highly standardized loan products could not meet the various needs specific to different localities (Kim, 2010). Moreover, the amount of operation expenditures of a local branch was distributed based on the amount of loans it made to the poor, not based on other performance criteria such as the share of NPLs. In addition, local branches, legally independent from the central SMB, were de facto dependent on the latter on every aspect, not being autonomous in making locally-initiated loan policies. As a result, local SMBs were disincentivized to build their own capacity.

More problematic was that long-term sustainability of state-led microcredit. Due to the low interest rates and growing NPLs, SMB and other state-sponsored MFIs had to increasingly rely on donations and other governmental subsidies. Especially, this lack of financial resources discouraged private welfare providers and capable RMs from playing more active roles in microfinance projects. In fact, the yearly amount of loans by SMB indicates that actual amount distributed by microcredit and social welfare organization declined substantially as shown in Table 6.

**Table 6. The Yearly Amount of Loans by SMB/Private MFIs/Distribution to Traditional Market**

|                                      |                                    | 2008             | 2009             | 2010                | 2011                | 2012                | 2013.6              |
|--------------------------------------|------------------------------------|------------------|------------------|---------------------|---------------------|---------------------|---------------------|
|                                      |                                    | 241.0<br>(7,505) | 371.3<br>(8,305) | 1,144.2<br>(15,192) | 3,106.4<br>(28,022) | 2,746.1<br>(29,542) | 1,280.5<br>(14,036) |
| SMB                                  | Amount<br>(the number<br>of loans) | 0<br>(0)         | 0<br>(0)         | 795.6<br>(7,770)    | 2,547.8<br>(16,489) | 2,158.8<br>(17,803) | 1,075.7<br>(9,890)  |
| Private<br>microcredit<br>foundation | Amount<br>(number of<br>loans)     | 231.0<br>(6,878) | 268.1<br>(6,092) | 215.1<br>(4,466)    | 202.1<br>(3,797)    | 157.7<br>(2,990)    | 9.9<br>(134)        |
| Traditional<br>Market                | Amount<br>(the number<br>of loans) | 10.0<br>(627)    | 103.2<br>(2,213) | 133.5<br>(2,956)    | 356.5<br>(7,736)    | 429.6<br>(8,749)    | 194.9<br>(4,012)    |

Source: Financial Service Commission ([www.fsc.go.kr](http://www.fsc.go.kr))

Third, the embezzlement and bribery cases in state-run microcredit agencies showed that the implementation of microcredit policy had been politicized. In 2011, it was reported that some social welfare organizations that had little experiences with microcredit projects were selected to extend loans to low-income people on behalf of SMB only because they had political connections.<sup>10)</sup> One representative of a social welfare organization was imprisoned in charge of embezzlement of 2,500 million KRW. Politicized distribution of funds led to the general ineffectiveness of microcredit policies.

As a result of these problems, South Korea's state-led microcredit could not achieve what it was expected to do. Rather, the state intervention stifled societal actors such as microcredit NGOs that had

10) *Kyunghyang*, December 2, 2011.

been successful prior to the state involvement. It is hard to definitely measure the success or failure of state-led microcredit. However, the very fact that state-led microcredit failed to reduce poverty, help low-income people have easier access to financial services, resolve the problem of income disparity, and revitalize economy is indicative of its ineffectiveness. In this regard, the microcredit policy was not taken seriously by the subsequent Park Geun-hye administration whose economic policies were made in the context of a growing social consensus for “economic democratization.”

Some might argue that the underperformance of state-led microcredit in South Korea was due to the lack of the willingness not due to the lack of capacity. While this is a reasonable argument, we argue that there had been sufficient volition for the government to be successful in this project. First, if the Lee administration would not take this microcredit project into serious consideration, this project had not been included in the six major policy priorities by the Lee administration. Second, there was a political burden for the government to take initiative to use the dormant savings account in the face of private sector’s resistance. The Lee administration wanted to be a “business-friendly” government and this microcredit project could undermine the image of “business-friendly” government. The very fact that the Lee administration took the risk of being regarded as “anti-business” verified that the government really wanted to make it successful. In fact, the Lee administration stressed the microcredit policy as “the ultimate policy of mid-way pragmatic policies.”<sup>11)</sup> Therefore, the lack of state capacity in implementing the

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11) *The Chosun Ilbo*, September 18, 2011.

state-led microcredit in South Korea, though autonomous and resolute in making decisions, became a stumbling block to its success.

## **VI. Concluding Remarks**

This paper aims to understand what went wrong with the state-led microcredit policy in South Korea under the Lee administration. It takes a closer look at the initiation and implementation of state-led microcredit by taking seriously state autonomy and capacity to better understand whether and how Korea's developmental state had been transformed as expected by scholars. It finds state autonomy, a key characteristic of a developmental state, was high in the sense that the funds had been raised in the face of strong resistance from private financial institutions and the state's own MFIs had been established to distribute the funds to politically-chosen groups of people. This state autonomy played a key role in the prompt initiation of a series of policies to achieve politico-economic goals. Despite the successful fund-raising and initiation, longer-term poor performance of state-led microcredit shows it failed to achieve its policy goals.

This paper argues that this unsatisfactory outcome had been resulted from weak state capacity such as low bureaucratic cohesiveness and technocratic expertise in microcredit. Since the 1997 Asian financial crisis, the Korean government had to comply with international best practices in the context of financial market openness and growing foreign participation. Therefore, although financial policy options were increasingly

constrained, the Korean state found opportunities for policy intervention in financial sectors where domestic financial actors were less interested and international presence had been low. State intervention in microcredit policy was decided as the state was more autonomous and it was expected to take more prompt effects in alleviating income inequality and gaining political supports. This study, however, shows that although the Korean government had strong willingness and capacity to intervene in the financial market even in the face of interest group's opposition, the eventual success of state action largely depended on its capacity to effectively implement financial policies. From a perspective of the developmental state thesis, this state-led microcredit and its outcome show that although the Korean developmental state was not working in the ways as it used to be, old practices and legacies of the state interventionism, even in the financial market, still affected behaviors of major societal actors and their interaction.

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