Economic Crisis and Chaebol Reform in Korea

Phil-Sang Lee

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Phil-Sang Lee
Dean, School of Business Administration
Korea University

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1. Introduction

The restructure of the Chaebol has been regarded as a prerequisite for restoring the global competitiveness of the Korean economy. After barely recovering from the IMF crisis, the domestic economy found itself facing a structural dilemma caused by the Chaebol.

During the rapid course of economic development in Korea, the role of Chaebol was justified as an economic energizer despite the sacrifices of small-medium sized enterprises and the average tax payers. It is the Chaebol that pushed the economy onto the track of fast growth. It is, however, also the Chaebol that pushed the economy into the turmoil of the IMF crisis. The conglomerates, in fact, had grown so large that they reached the point where they could exploit the national economy for their own benefit. They had grown strong enough even to place the financial industry under their control. The Chaebol enjoyed unrestrained market power and expansion, which caused enormous damage to the Korean economy. These harmful effects included: excessive and illegal debt financing; boundless expansion of capacity; charging excessively high prices; driving rival firms and small industries out of business through predatory tactics; suppressing technological improvements; persuading government to restrict new entry or open market policies; speculation in real estate and the stock market; and illegal inheritance or transfer of property. This led to the ruin of the national economy and eventually heralded the IMF crisis.

This paper analyzes the Chaebol problem and evaluates government policies in conjunction with the IMF crisis in 1997. In addition, the paper discusses the new role of the Chaebol in Korea's business and economic system, suggesting appropriate policy measures for enhancing competitiveness and the constructive role of the Chaebol.

2. The Chaebol Economy

2.1 *Engine for growth*

In the initial stage of economic development in the 1960s and 70s, big firms worked as an engine for fast economic growth. With exclusive government support and protection, these big firms grew to be the Chaebol. The Chaebol led fast industrial growth via monopolistic access to resources. The government gave the right to engage in certain businesses exclusively to the Chaebol. The government continuously employed an expansion policy favoring the Chaebol in the form of financial assistance, low interest rates, tax benefits, foreign exchange allocations, import and export licenses and foreign investment incentives. In addition, small and medium sized firms, whose existence were heavily dependent upon the Chaebol, provided them with quality parts and components at the lowest cost possible in order to maintain a working relationship with the Chaebol. The extraordinarily beneficial treatment by the government drove the Chaebol to develop the relatively primitive economy at a fast rate, achieving an annual growth rate averaging 8% over the last 40 years. Per capital income rose approximately 100 times from eighty dollars to eight thousand dollars since 1962. In terms of gross domestic product, the Korean economy now ranks 12th in the world.

However, Korea's Chaebol-driven economy could not sustain growth. In 1997, the domestic economy found itself impotent in surviving a harsh international market and could not help but collapse from its own self-contradictions, resulting in the so- called "IMF crisis".

Figure 1: Chaebol and Economic Growth

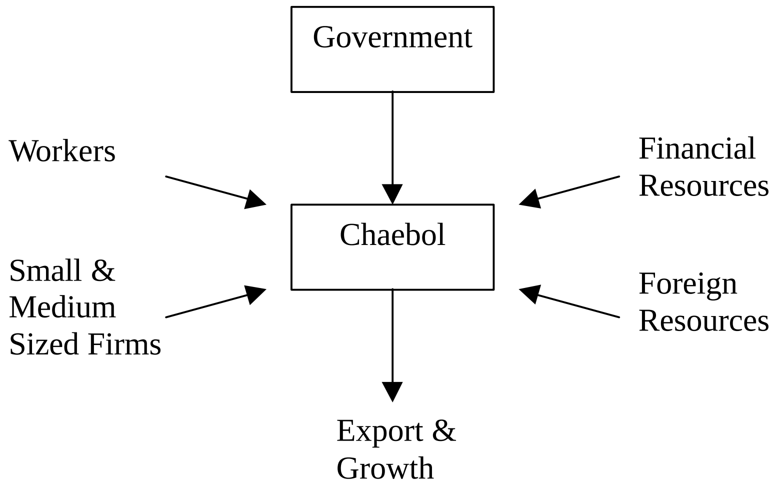


Table 1: Chaebol Influence in the Korean Economy

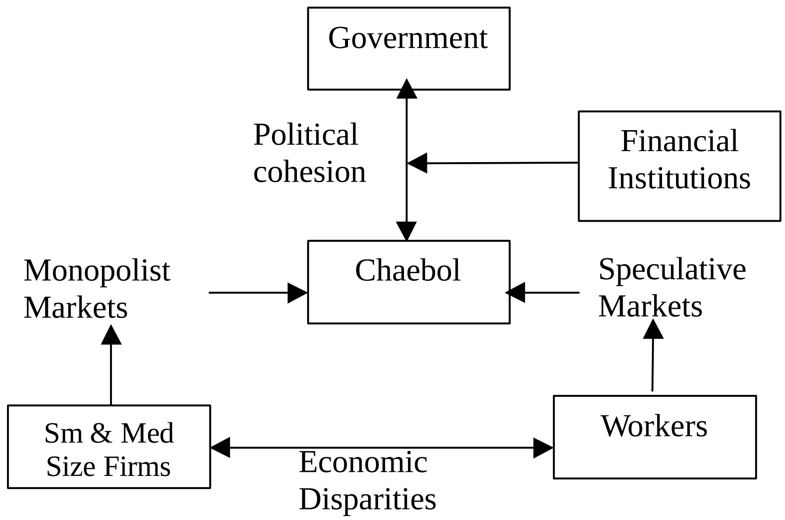
	Total Volume	Top 5 Groups (%)	Top 30 Groups (%)
Assets (billion won)	910,044	29.22	46.25
Liabilities (billion won)	736,584	29.79	47.94
Revenues (billion won)	875,156	32.29	45.94
Employees (thousands)	21,048	2.70	45.86

Source: The Korea Center for Free Enterprise – An Affiliate of Federation of Korean Industries, 1998.12

2.2 *Entrenched System*

The Korean economic crisis was born of an entrenched system of government-business collusion. For the past 40 years, political power and the Chaebol have existed in symbiosis, linking preferential treatment and political funds. The politically powerful have exercised their authority by handing over major projects and concessions to the Chaebol, which, in return, have provide the slush funds politicians have needed to maintain their political positions. Under this corrupt structure, the domestic economy has experienced fast growth, but this has been merely an expansion of external structure without increasing core strength. Further, the formation of this "food-chain" structure was accompanied by the concentration of income in a high-ranking, vested-interest class. There has been little accumulation of solid technology. The basic framework of industrial development in Korea has consisted of assembling imported components and equipment using low cost labor for exports. Accordingly, the Korean economy has the character of a subordinated economic system, one augmenting the benefits of advanced industrial countries rather than that of the Korean people. Thus, the Korean economy, contrary to its proclamation of promoting fierce competition following the entry to the WTO in 1995, in fact lost its competitiveness. Due to a lack of technology, the Korean export base has crumbled and the economy has undergone structural stagnation; at the same time, Korea was targeted by foreign investors and faced a critical shortage in the foreign exchange reserve needed to fight back. The economy was caught in crisis.

Figure 2: Government - Chaebol Collusion



The serious dilemma in Korea is that despite changes in government, the Chaebol remain the same, and their influence grows ever stronger. Whenever a new regime steps in, the Chaebol demonstrate their power to control this new environment. There has been no political regime that did not require Chaebol help to win election. Accordingly, these regimes, could not help but take a humble posture toward the Chaebol, granting them the special treatment that, in the end, got the Chaebol what they wanted. The public protested continuously and ultimately defeated the dictatorship government, and the civilian government was finally born in 1993. Naturally, the civilian government was expected to disperse the economic power of the Chaebol. Yet, Chaebol power has continued under the new government. While promoting globalization as the goal of its administration, the civilian government placed its economic policy focus on the revitalization of the Chaebol. Its simple economic logic was that strengthening national competitiveness must inevitably be entrusted to the Chaebol.

Even if we set aside exposure of government-business collusion, it is clear that in order to ensure technological predominance, establish a high value-added economic system and lead the way to balanced economic development, there must be a diversification of economic power. This means that instead of big business groups aiming at “octopus style” external growth, Korea should strengthen the development of small and medium sized “grassroots” companies. The civilian government, nevertheless, while making international competitiveness its new policy target, had neglected to sever the government-business links, and has returned to the same Chaebol revitalization policy routinely used by governments in the past.

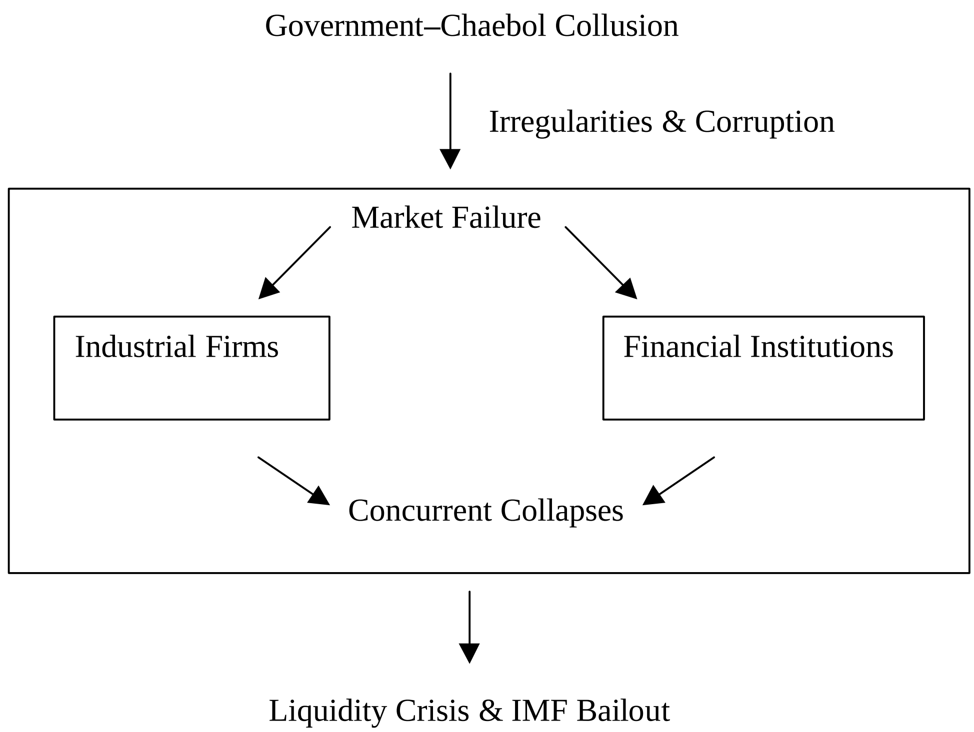
3. The IMF Crisis

3.1 *Overall*

The fragile, Chaebol-structured economy was hit hard by the financial and currency crisis of 1997 and 1998, the so-called IMF Crisis. Few had expected the currency crisis to impact so harshly on the domestic economy. The financial crisis has virtually forced the collapse of industries in both the financial and real sectors of the economy. During the turmoil, asset prices plunged as much as 40% to 60%, worsening the financial status of domestic firms and financial institutions, leading to market failure and a domino effect of bankruptcies. The concurrent falls of industrial firms and financial institutions led many to fear the collapse of the economy. Worst of all, national foreign exchange reserves were depleted to 3.9 billion dollars, pushing the country into an economic standstill.

Foreign debt exceeded 150 billion dollars, or four thousand dollars per capita. It had almost quadrupled during the period 1993-1997 from some 40 billion dollars, making the country nearly insolvent. Given this excessive foreign debt, the depletion of the foreign exchange reserve resulted in a virtual national liquidity crunch. The economic crisis also triggered a social crisis, with the rising unemployment of 2 million workers or 8.6% of the total work force. Social instability mounted with a sharp decline in growth rate from 7% to -5.8%.

Figure 3 - The IMF Crisis



3. 2 Overinvestment

Overinvestment was the core problem for the Chaebol economy. For the fast growing economy, highly leveraged investment was regarded as a necessity to exploit growth potential. However, in retrospect, too much investment was channeled to areas facing excessive competition, speculative activities, and a poor return of the investments. The average annual return on assets of manufacturing firms were below 1% during the 1990s, and the average return on equity was just over 5%. The EBIT-to-Sales ratio was –0.3%, which showed a sharp contrast with 8.3% in the U.S., 5.1% in Taiwan, and even with 3.4% in Japan.

Table 2: The IMF Shocks (Dec. 1997) , Before and After

	Before IMF Shocks 1997.6	IMF Shocks 1998.12	After IMF Shocks 1999.12
GDP growth rate (%)	7.00	- 5.80	13.00
Unemployment (%)	2.10	8.6	6.30
Interest Rate (%)	11.45	31.32	4.74
Exchange Rate(W/$)	888.10	1,964.80*	1145.40
Stock Market Index	765.20	280.00*	984.50
Foreign Reserve(billions)	33.30	3.9*	74.10

Source : Bank of Korea, *Monthly Bulletin*, 1997.1-1999.12

*indicates highest or lowest records after breakout of IMF crisis in December 1997

High investment rates are not a problem as long as domestic savings can support such levels of investment. However, savings as a proportion of GDP remained 2 to 6% below the rate of investment, and the gap widened during the 1990s. As Stiglitz(1998) argues, the marginal productiveness of an economy at this rate of investments cannot be so high as to justify the foreign debts incurred to fill the investments-savings gap.

The quantity and quality of investment in Korea was not the only concern; how the investment was funded was another matter that affected the course of the crisis. Most private sector investments relied on debt-form financing either from domestic or foreign sources. Korean Chaebols maintained debt ratios over 400% and their interest payment costs out of sales exceeded 6% as compared with 2 to 3% of competing firms in other countries.

Huge non-performing loans provide further evidence of inefficient investment. As of June 1998, the Non-performing Loan (NPL) ratio for Korea was 21%. Large portions of loans by non-bank financial institutions were extended to failing conglomerates. Even before the financial crisis, five of the 30 largest conglomerates went bankrupt, creating $2 billion in bad loans, amounting to almost two thirds of the total capital of commercial banks in Korea.

3.3 Corporate Governance

The crippled corporate governance structure in Korea is a critical source of mismanagement. The management of large corporations was controlled largely by a few monopolistic owners who were usually connected to political leaders. Investment decisions were based not on economic feasibility, but on the private interest of the owners. The management of a large corporate was monopolized by the founder and /or his family, who alone appointed the members of the board of directors. Minority shareholders were generally silent and ignored partly due to their lack of concern for the long-term performance of their firms, and to prohibiting legal procedures against mismanagement. Externally, the market for corporate control was still in an early stage of development due to the government's policy to protect the existing management, low labor market flexibility, and the traditional corporate culture of identifying firms with their founding fathers.

In addition to the extreme conflict of interest between owner-managers and minority shareholders, flimsy accounting standards and poor auditing systems also lowered the level of management transparency, and hindered the sound development of capital markets. The underdevelopment of capital markets increased firms' dependency on banking credits as the major source of funds, and increased instability in the economy.

3.4 Financial Crisis and Foreign Debt

The problem of overinvestment in the real sector would not have occurred had the financial sector had shown some discretion in credit allocation. The driving force supporting overinvestment was credit expansion, either through domestic financial institutions or through foreign sources. High liability ratios verify this fact. (Table **III)**

The lack of discretion on the part of financial institutions as resource allocators was partly attributed to government's involvement in the management of financial institutions and implicit safety nets. The government was directly involved in allocating financial resources and maintained strong control over both on the financial and real sector until the crisis emerged. It controlled interest rates, specified the business scope of financial institutions, and even specified their manpower, branch networks and capital, for example. Despite the extensive financial reform process of the 1990s, the government still maintained its influence over these institutions through implicit guidance channels.

There was also an incentive problem on the part of the government officials dealing with financial institutions. They benefited from the control and red tape while incumbent and even after retirement, as they could safely land management jobs in the financial institutions they used to control. To perpetuate these benefits, control over financial institutions tended to persist and financial reform measures were superficial in content. Therefore, it is not surprising that the extensive financial reforms implemented during the 1990s turned out to be a failure, leading to the financial crisis. Not only were these reform measures perfunctory, but they also underestimated critically the importance of supervisory functions and prudential regulations that should accompany any financial deregulation.

Existing prudential regulations usually aimed at restricting specific behavior of financial institutions, but did not amount to maintaining a sound level of capital adequacy to protect the institutions. Furthermore, these prudential regulations were based mostly on ex-post approaches so that authorities intervened in problematic institutions only after their financial conditions became out of control. The result of the paternalistic policy of the government was the mounting non-performing loans of financial institutions, including commercial banks. Under the government safety umbrella, financial institutions pursued high-risk-high-return strategies, and did not worry much about the credit worthiness of their corporate customers.

Excessive intervention by the regulatory authorities injured the governance of financial institutions. Political connections usually played an important role in the

Table 3: Characteristics of the major business groups

		July 1997				
	Group	In-group Ownership (%)	*of which*; Family Ownership(%)	No. of Subsidiaries	Total Asset ($ bill.)	Liability Ratio (%)
1	Hyundai	56.2	14.6	57	53,597	436.7
2	Samsung	46.7	4.2	80	51,651	267.1
3	LG	40.1	6.1	49	38,376	346.5
4	Daewoo	38.3	7.1	30	35,455	339.5
5	SK	44.7	14.6	46	22,927	383.8
6	Ssangyong	42.0	4.5	25	16,457	409.4
7	Hanjin	41.4	21.1	24	14,309	555.8
8	Kia	30.6	21.0	28	14,287	519.0
9	Hanwha	33.0	6.3	31	10,967	751.4
10	Lotte	22.8	3.4	30	7,774	192.2
11	Kumho	40.1	2.3	26	7,468	481.8
12	Halla	49.5	19.0	18	6,640	2,065.4
13	Dongah	54.2	12.0	19	6,458	354.7
14	Doosan	49.7	13.8	25	6,370	688.2
15	Daelim	34.2	9.1	21	6,177	423.2
16	Hansol	37.3	4.1	23	4,346	291.9
17	Hyosung	44.9	14.2	18	4,131	370.1
18	Dongkuk	51.0	18.5	17	3,956	218.4
19	Jinro	45.8	17.5	24	3,951	3,075.0
20	Kolon	45.1	8.6	24	3,910	318.0
21	Kohap	39.4	8.6	13	3,690	590.5
22	Dongbu	47.8	14.6	34	3,677	251.5
23	Tongyang	50.1	6.1	24	3,445	307.8
24	Haitai	30.9	6.0	15	3,398	658.5
25	Newcore	98.7	36.4	18	2,798	1,225.6
26	Anam	42.0	10.0	21	2,659	478.5
27	Hanil	37.4	12.2	7	2,599	576.8
28	Keopyung	59.0	17.5	22	2,477	347.6
29	Miwon	52.5	16.3	25	2,238	416.9
30	Shinho	36.9	13.6	25	2,158	489.3
	Average	43.0	9.3	819		
	Total				348,364	386.7

In-group ownership is the average, weighted by capital, of family ownership (shown in second column) in each company in the group plus the shares of subsidiaries. *Source*: Fair Trade Commission appointment of the management of financial institutions, and managers, thus, were obliged to offer loans to the firms connected to those protégés. Such misconduct was closely related to the government's exclusion of shareholders in the governance of commercial banks. Shareholders were also excluded from exercising their ownership rights. In Korea, it was only in 1997 that outside directors representing shareholders could influence the appointment of board members. In the absence of shareholder monitoring, bank management was generally obliged to provide 'policy-directed' or 'politically favored lending' to corporate customers.

Nor were depositors worried about their savings, since there existed a general belief that financial institutions would never be permitted to fail. They even shifted their funds into failing financial institutions, which offered high interest rates to avoid liquidity problems after the financial crisis broke out. Such a lack of market discipline also worked to bolster moral hazard in the management of financial institutions, leading to the pursuit of high risk investment.

Another problem that increased economic risk is the sticky exchange rate system. Korea has maintained a floating rate system with a band since 1990. Under its Market Average Exchange Rate (MAR) system, the Korean won has supposedly been allowed to move freely against the U.S. dollar according to market forces, with a maximum movement of plus/minus 2.25% against the previous day's closing price. However, the economic policy that placed the first priority on the competitiveness of its export sector forced the monetary authority to intervene frequently in the market and to maintain stable exchange rates. During the first half of the 1990s, the real effective exchange rate of the Korean won depreciated unlike other countries facing the crisis, partly due to the appreciation of the Japanese yen during the period, but mainly due to the government's determination to support the export sector. The mounting balance of payments surplus due to the increasing exports forced the monetary authority to engage in a massive sterilization operation by issuing the Monetary Stabilization Bonds (MSBs) on a large scale, leading to a vicious circle of higher interest rates and large inflow of foreign capital. The overflow of liquidity helped to cause asset bubbles in the economy and increased overall risk with rising debt dependency.

The foreign reserve of a country versus its foreign debt has a kind of built-in safety mechanism since the government's effort to maintain a stable exchange rate, usually pegged to the U.S. dollar, renders the central bank to accumulate foreign reserves as capital inflows increase. However, in Korea, such a system did not work, as the weakening competitiveness of the real sectors tended to depreciate the currency, reducing the needs for currency purchases. The accumulation of foreign reserves did not match the increase in foreign debt.

Korea presented a very interesting case in that it had posed as an example of how an underdeveloped economy could become an economy with the 11th largest GDP and trading volume in the world (prior to the crisis). Korea was recognized to have world-class competitiveness in semi-conductors, shipbuilding, car manufacturing, and chemicals. Its highly educated, hardworking labor force and sound social infrastructure, having also made a smooth transition from a military to a democratic government worked to make it an OECD member country in 1996. However, it could not avoid the financial crisis that swept the East-Asian countries mainly due to its rising foreign debt, evaluated at over 150 billion U.S. dollars, including a short term debt of some 60 billion US dollars. Of course, a major portion of the foreign debt had been acquired by the Chaebol. Unlike the other economies facing the crisis, there was no massive currency attack on the Korean won by currency speculators, partly due to Korea's underdeveloped foreign currency market. It was rather the financial institutions making up a shaky financial structure, particularly foreign debt structures, that triggered the financial crisis. Beginning in mid-October 1997, a several merchant banks and commercial banks faced a severe liquidity crunch in firing accounts, partly due to the frozen investments in East-Asian countries, and they were unable to rollover short-term debt. With limited foreign reserves, the Korean monetary authority could only expand the daily band for currency movements from +2.25% to 10%.

Table 4: Short-term Foreign Debt & Foreign Reserves

($ billion)

	1997.12	1998.12	1999.12	2000.6
Short-term Foreign debt(1)	63.9	30.7	38.1	47.5
Foreign Reserves(2)	8.9	48.5	74.1	90.1
(1) / (2)	716.6%	63.3%	51.5%	52.7%

Source: Bank of Korea, *Monthly Bulletin*, 1997.12-2000.6

Insolvent financial institutions, including commercial banks of substantial scale and non-bank financial institutions such as finance companies and securities firms had been closed or were under the process of recapitalization. The restructuring of financial institutions naturally has been followed by the bankruptcies or recapitalization of highly leveraged, high risk industrial firms including the Chaebol. Most surviving financial institutions and industrial firms have been also going through a painful process of organizational restructuring. In the meantime, shareholders, debtors and management as well as employees have paid for their share of mistakes, which has been unprecedented in the financial sector.

4. Chaebol Reform

4.1 IMF Rescue Program

Restructuring was no easy task. The program loans, evaluated to be around 150 trillion won or some 20% of total domestic credits, were 1.5 times more than the government's total annual budget. Thus, fiscal policy turned out to be unviable. Financial markets were also no help. The stock markets had virtually collapsed. The bonds markets were not developed enough to absorb bond issues of unprecedented scale. Allowing foreign capital to own and manage the ailing domestic financial institutions and industrial firms was another option, but fair deals rarely occurred because foreign investors feared the uncertain economic prospects. Inevitably, the IMF became involved in the Korean crisis as it did for other countries in trouble. The IMF has promised to extend 57 billion dollars in rescue loans to bail out the economy. The IMF rescue loans, however, were not without price. The IMF's conditions for financial support ranged from macroeconomic policy frameworks to structural policies, including both financial and real sector reforms.

First, the IMF demanded lower growth rates, budgetary austerities, high levels of interest rates, and reduced current account deficit, whose main purpose was to enforce swift structural adjustment while providing an environment to recover foreign investors' confidence. Second, the IMF demanded comprehensive financial and industrial restructuring, including closure of troubled financial institutions and industrial firms, and improving accounting and disclosure rules. Third, the IMF demanded elimination of unfairness in business and trade, including complete market opening both financial and real, elimination of trade related subsidies, and promotion of labor market flexibility.

The IMF conditionality has incurred substantial costs. The fact that the Korean economy experienced a more severe contraction than even the IMF had expected at the time of its assistance casts doubt on the appropriateness of the program. Under the IMF program, the economy observed a steep rise in interest rates, a negative growth rate, and a series of corporate bankruptcies of unprecedented scale. The control on domestic credit growth was especially dubious considering that the economy had already begun to contract even before the crisis, and many firms with sound financial prospects faced credit crunches after the onset of the crisis. The precipitated asset prices made it harder for the private sector to restructure through the sale of their business lines. As the economy observed a series of bankruptcies, increasing social instability due to increasing unemployment also threatened the political system, further delaying the implementation of any reform plans devised by the government.

Criticism of the IMF is based on the argument that Korea had maintained sound budgetary policies, unlike those of Mexico or some European countries. In other words, the Korean economy was basically suffering from private debt and microeconomic problems, not from public debt or macroeconomic problems, and the IMF's conditionality was of no point in the short run, and could be, in fact, detrimental in the longer run.

After experiencing extraordinary hardship, the Korean economy has survived the crisis successfully, with the inflow of IMF rescue funds and foreign liquidity. The Korean economy, stricken with a huge foreign debt, has struggled to attract foreign capital. Korean business firms, which borrowed heavily from foreign institutions, was forced to sell off assets or subsidiaries to raise foreign currency and repay debt. Korean firms also had been required to downsize their operations in order to remain in business on a sound basis. As a result, a growing number of foreign companies have penetrated the domestic market through direct investment or the takeover of existing firms. The trend has forced Korean firms to speed up their restructuring in order to stay afloat.

Total direct foreign investment in Korea now reaches some 15 billion dollars, while indirect foreign investment through securities markets reaches 60 billion dollars. The share of foreign investment in securities market counts for more than 30%. The foreign equity holdings of leading firms in Korea, including Samsung Electronics, Daewoo Motor, Citizens Bank of Korea, Korea Housing Bank etc. exceeds 50%. Inflow of foreign capital has helped raise the foreign exchange reserve to 90 billion dollars, and has contributed to the fast recovery of the Korean economy from the liquidity crunch.

The massive lay-off and drastic cut in wages, too, has been a major contributor to revitalize the collapsing economy. Some 1.8 million workers, or 8.6% of all workers, lost their jobs. The huge cut in labor cost has helped the economy decisively to recover its high growth rate. In 1999, the Korean economy recorded a high growth rate of 10.3% . Due to this high growth, the unemployment rate has fallen from 8.6% to 3.5%. The nationwide frugality campaign has also significantly reduced the consumption of foreign goods and services, thus helping the balance of payment restore a surplus. In 1998 and 1999, the Korean economy recorded an unprecedentedly high trade surplus, exceeding 40 billion dollars and 25 billion dollars, respectively.

4.2 Restructuring Chaebol

The Korean economic crisis is far from over, although Korea seems to have avoided the worst case scenario. The Chaebol have been always at the core of the economic problem. Thus, unless the Chaebol are reformed, the economy can hardly restore international competitiveness. The IMF has strongly called for the reform of the Chaebol. The Kim Dae-Jung government followed immediately IMF demands to streamline the Chabols' ever-expanding businesses acknowledging that they had been principally blamed for the nation's economic crisis. The government has imposed five rules for Chaebol reform — ①business consolidation into core competence areas ②capital structure improvement ③elimination of cross-debt guarantee ④enhancement of management transparency ⑤improvement of management accountability. The government stipulated that the five rules are pivotal in inducing a full recovery from the country's economic crisis, and that they will be a platform for the corporations' transformation into globally competitive companies.

Later, the government added three more rules to correct undesirable Chaebol practices — ①Reduction of indirect cross ownership ②prevention of anti-competitive intragroup transactions and unlawful insider trading ③prevention of the evasion of inheritance and gifts taxes. Thus, the so-called "five plus three rules" have been imposed for Chaebol reform by the government. Two and a half years into the government driven reform, however, the Chaebol's problematic structure, blamed for the 1997 foreign exchange crisis, remains virtually unchanged. On the surface, the Chaebol and the government have claimed remarkable accomplishments in terms of reduction in the number of affiliates, debt ratios and foreign capital attraction.

However, statistical evidence indicates little has come of the top conglomerate's efforts to weaken inter-unit dependence and end internal cross financing and control by founding families, which defy fundamentally the government's eight point reform rules. The degree of inter-subsidiary dependence at the top Chaebol has, in fact, deepened over the last years, indicating that their much-criticized fleet-like, sprawling structures remain intact. According to consolidated financial data for fiscal 1999 released by the government in August 2000, cross-subsidiary transactions accounted for more than 30% of total sales in 16 local Chaebol. The Samsung Group showed the highest ratio of inter-unit trading. Samsung's 159 units reported 148.17 billion won in total sales, of which 61.73 trillion won, or 41.7%, came from intra-group transactions. Internal trading by the Hyundai group stood at 38.1%, followed by the LG group at 38.0% and the SK group at 36.1%. The average ratio of intra-group transactions to total sales by the second-tier Chaebol was lower at 13.4%.

At the end of last year, the nation's top four family-controlled conglomerates, or Chaebol, reduced their debt-to-equity ratios below 200% at the order of the government. The debt-to-equity ratios of the four business groups – Hyundai, Samsung, LG and SK – averaged 172.9%, a remarkable improvement from a year earlier when the figure hovered above 300%. According to the combined financial statements, however, the low debt-to-equity ratios achieved are quite misleading.

Of the top four conglomerates, Hyundai Group affiliates' debt-to-equity ratio stood at 296% at the end of 1999, but fell to 229.71% without its financial units. Samsung showed

443.77% with financial units and 194.04% excluding them. LG's overall debt ratio stood at 357.60%, falling to 273.15% excluding its financial units; while SK's marked 254.87% with financial units and 227.59% without them. The combined financial statement merges the assets, liabilities, net worth and operating accounts of all companies under the effective control of a group owner-chairman, meaning that nonexistent equities and turnovers created through inter-unit transactions evaporate. Imposition of tough accounting rules is part of the government's broad effort to enhance Chaebol financial transparency and dismantle their family-controlled governance structure.

4.3 Bureaucratic Approach

The government continues to maintain its influence over the economy, contrary to president Kim's original call for a market-oriented economy. The Chaebol reform plan undertaken by the government is fundamentally flawed, in that it is a bureaucratic order. Rather than forcing reform based on political considerations, the government's task should be to establish a fundamental framework that will allow market forces to bring reform autonomously.

The government's goal of fortifying competitiveness by reducing debt ratio below 200% is a worthy object. The reduction of debt ratios may force the conglomerates to sell off subsidiaries and assets or attract equity capital, domestic as well as foreign, to pay back the debt, thus bringing about business streamlining, risk reduction and improvement of management accountability. To meet the deadline for the uniform debt ratio requirement, however, the conglomerates have engaged in all kinds of irregularities. Paradoxically, the conglomerates' mishaps have destroyed the reform.

On the whole, companies in Korea have had high debt ratios. Not only were bank loan interest rates low, but banks were unwilling to close down insolvent companies and instead provided additional relief funding. Furthermore, by increasing borrowing, major shareholders could hoard profits and also retain management rights over the company. Considering the low interest rate environment and a system where relief funds are provided when trouble arises, it is natural that a high debt corporate structure is created.

As Korea's industrial development was oriented toward large conglomerates, debt ratios of companies were extremely high. The borrowing proclivity made it appear as though banks were simply private cashboxes owned by the Chaebol and this led to the monopolizing of profits by the Chaebol. Inevitably, an industrial structure where competitiveness was concentrated among the Chaebol was erected. With the opening of Korea's economy and efforts to compete globally in this state of high debt, the corporate-oriented lending practice by the banking sector caused a weakening of the banks themselves. The economic liberalization and heightened competition diminished the competitiveness of banks and in turn they lost the capacity to keep companies afloat. The corporate and financial sector arrived at a situation where both could collapse and in the process, owing to the insufficient foreign currency holdings, the IMF crisis ensued. Ultimately, a structural problem was the main culprit with both banks and companies almost going bankrupt.

Table 5: Chaebol Intragroup Transactions

(unit: trillion won)

	Total sales			Intragroup sales		
	Total	Domestic	Overseas	Total	Domestic	Overseas
Hyundai	112.98	83.33	29.65	43.04 38.1%	41.27 49.5%	1.78 6.0%
Samsung	148.17	111.21	39.96	61.73 41.7%	45.56 41.9%	15.17% 6.0%
LG	83.48	62.28	21.20	31.76 38.0%	25.96 41.7%	5.80 27.3%
SK	51.72	38.39	13.34	18.68 36.1%	11.46 29.8%	7.22 54.1%
Top-four Chaebol	396.36	295.21	101.15	155.21 39.2%	125.24 42.4%	29.97 29.6%
Hanjin	19.95	14.9	2.05	1. 15 6.8%	0.67 4.5%	0.48 23.3%
Lotte	10.12	10.11	0.01	1. 09 10.8%	1.09 10.8%	- -
Hanwha	6.95	6.07	0.88	0. 75 10.7%	0.75 12.3%	- -
Ssangyong	12.44	11.24	1.21	1. 07 8.6%	0.9 8.15%	0.17 13.6%
Hansol	5.25	4.9	0.34	1.32 25.2%	1.25 25.5%	0.07 21.2%
Doosan	4.78	4.58	0.19	0.40 8.3%	0.37 8.2%	0.02 12.3%
Dongbu	6.56	6.44	0.12	0.51 7.8%	0.48 7.5%	0.03 23.3%
Kolon	4.84	3.94	0.90	0.41 8.6%	0.37 9.5%	0.04 4.4%
Tong Yang	6.02	5.6	0.42	0.40 6.6%	0.29 5.1%	0.11 26.3%
Saehan	2.34	1.77	0.57	0.56 23.8%	0.52 29.5%	0.04 6.4%
Halla	2.41	2.41	-	2.41 3.9%	24.1 3.9%	- -
Kangwon	1.66	1.63	0.02	0.37 2.5%	0.37 22.8%	- -
2nd-tier chaebol	77.8	71.17	6.72	10.43 13.4%	9.48 13.3%	0.95 14.2%
Total	474.25	366.38	107.87	165.64 34.9%	134.72 36.8%	30.92 28.7%

Source: The Financial Supervisory Service (FSS), Aug. 2000

Financial and corporate structural reform has been implemented in order to correct this structural deficiency and overcome the IMF crisis. Companies that have been overly dependent on banks should reduce their debt to acceptable levels while introducing a prudent management policy. From this standpoint, the government's debt ratio reduction policy is a sensible one. However, the problem is why 200% and why by the end of last year? Setting a uniform 200% debt ratio criterion and forcing companies to observe this requirement does not follow economical rationale and can only be explained as being a bureaucratic show of strength. The more pressing issue is why force the reduction by the end of last year?

There are many ways to reduce the debt ratio, but one of the most feasible methods is to issue shares in the stock market and, at the same time, raise foreign capital. The proceeds generated will, of course, be used to repay debt. However, demanding that all companies satisfy the debt ratio criterion by the year's end generates a predicament wherein the market cannot support itself. Yet, the government has pushed for the deadline to be met and naturally, companies must endure a very difficult situation.

As a result, rights issues were carried out under unfavorable conditions and healthy companies were sold at dirt-cheap prices, even to foreign entities, and this has become a problem. In sum, the objective was well-intentioned but the approach was wrong. As Chaebol companies could not satisfy the original 200% debt ratio criterion for each affiliate, the Chaebol protested; and this led the government to change its requirement and apply the ratio to the group as a whole. This has also caused a serious problem.

Obviously, there is no persuasive reasoning for forcing groups to satisfy uniformly the 200% guideline, as each Chaebol group is different, both structurally and business-wise. The more serious problem is basically, that the message here is to meet the 200% criterion by making healthier companies buy up weaker ones. This, in fact, legitimizes the collective, extended management system. Efforts are now being made to break up the web-like Chaebol business system, introduce professional management and bring sweeping reform; but conceptually the government is retrogressing.

The government's obstinate attempt to lower the debt ratio within the deadline has led the Chaebol to use false tactics, so-called, circulatory investments. Circulatory investment occurs when company A invests into B, B into C, C into B and B into A. Under this scenario, no actual investment has been made but capital appears to have increased on the books. While internal ownership ratios are soaring and solidarity among Chaebols' affiliated companies is strengthening, the effect may be to give Chaebol chairmen even stronger control of their kingdoms. In the process, minority stockholder rights, even for publicly listed companies, have been ignored without hesitation. Today, it is feared that pressure on the Chaebol is weakening and they will be able to act with impunity. This will allow the current insular management and ownership structure to continue and bring on greater possibilities for Chaebol control.

With respect to small and medium sized companies, the most essential goal of Chaebol reform is to encourage competitiveness and allow them to survive on their own. Yet, since the restructuring process, the economic concentration of the top four Chaebol has rather increased. In terms of revenue, compared with past levels of total revenue, the Chaebol portion has grown larger. Subsequently, the small and medium sized companies are losing ground, and the disarray of the Chaebol may further aggravate difficulties. It is understandable that the government had no choice but to use strong-arm tactics to push for Chaebol reform; however, no matter how difficult or pressing the matter is, one should tighten the girth before riding the horse. Chaebol reform must be implemented for economic reasons, not political ones.

4.4 Public Price

Given the failure in Chaebol restructuring how could the economy survive the financial crisis and restore the high economic growth rate? One major tool used by the government for fast recovery was the injection of public funds. At the outbreak of the IMF crisis, the government estimated bad debts of financial institutions to be 118 trillion won or some 110 billion US dollars, which was nearly 1.3 times the national budget at that time. Then, the government issued 64 trillion worth of government bonds to be used for resolving bad debt and restructuring financial institutions, proclaiming that the bond issue would be enough to rebuild a sound financial industry. Actual injection of public funds, however, has reached 107 trillion won, far exceeding the target. Nevertheless, the financial industry remains fragile and continues to be haunted by the spectre of the financial crisis. In fact, despite the huge price paid by the public, there exist virtually no sound banks, merchant banks, investment companies, or securities dealers in Korea. As a result, the real sector of the economy remains unstable.

The fall of the Daewoo group provides evidence that improper Chaebol reform has caused enormous public loss. By injecting 107 trillion won of public funds into the ailing financial institutions, the government could have pushed ahead reform plans, including the shut-down of unhealthy institutions, downsizing of organizations, dismissal of idle workforce, institution of foreign investment incentives, improvement of capital structure, merger & acquisitions, etc,, thus helping the economy recover soundness and competitiveness at a faster rate than expected.

However, the sudden fall of Daewoo group, which was the second largest in Korea in terms of asset size, has ruined the restructuring efforts. There is not a single Korean financial institution unaffected by Daewoo. Domestic investment, trust, and investment trust management companies have been especially hard hit as a substantial volume of Daewoo paper was incorporated into their financial products. The fall of Daewoo group has produced bad debts estimated roughly to be equal 90 trillion won. Hurt by the Daewoo fall, most of the incumbent financial institutions returned immediately to the state of insolvency experienced during the IMF crisis. It is a pity that the government did not disband Daewoo right after the IMF crisis. By delaying the reform for nearly two years, the government has actually nurtured the Daewoo disaster.

No matter how difficult or how long it takes, restructuring should take place under market mechanisms between financial institutions and companies. In actuality, however, the government has injected public funds into distressed financial institutions and this makes them state-operated entities. Chaebol reform is being implemented through those financial institutions. The fact that financial institutions are implementing corporate reforms and that those institutions are controlled by the government illustrates the continued bolstering of a government-dominated system. If corporate reform is to be achieved through the financial sector, financial institutions should be left alone, as this will lead them to demand Chaebol reform. The government should not interfere in the financial sector and should leave financial institutions accountable for credit management and reduction of corporate debt. Most importantly, the government should not continue to inject public funds. If the injection of public funds is continued, financial institutions and companies will try to evade restructuring. Nor should the government give orders on whether or not to dispense funds. If possible, the government should preserve public funds and instead, construct a legal and systemic framework, which will push financial institutions and companies to implement corporate reform in order to survive. Conversely, however, the government is directing the reform process and this only means the return to a government-directed economy. Financial institutions and companies are interlinked. Once the groundwork to force financial institutions to conform to the principle of survival of the fittest is laid, the financial sector will have no choice but to demand the corporate sector shape up in order to survive.

5. New Economic Paradigm

When designing a new economic structure, social and political influences should also be accounted for comprehensively. Until now, the political sector had a very negative influence in the economy. Because the economy was controlled by the government, there was collusion between the corporate and political sectors, which fostered rampant corruption. Consequently, political authorities and the Chaebol “scratched each other’s backs,” with the Chaebol being provided financial assistance, tax breaks and other benefits, while political funds were given to the incumbent leadership. This led to the belief that instead of earning profit from business endeavors, particularly technological and product development, it would be more lucrative to provide political funds and receive special favors in return. This led the Chaebol to become bloated, and this is why fundamental surgery is necessary in order to sever the link between money and politics. A decisive overhaul of the political system is urged to guarantee clean elections.

In order to sever government-business collusion at its root, the most urgent task is governmental reform. The Korean government does not act as a public institution working for the economy, but reigns as a powerful agency controlling the economy to serve political ends. The government has mass-produced administrative rules as a means to control the economy and companies are now so tangled up in the spiderweb of regulations, they can hardly move. Worse, through devices such as tax investigations, administrative sanctions and financial restrictions, the government threatens companies at every turn, making free and creative business activities impossible. Viewed from the standpoint of competitiveness, the government of our nation looks like the most backward, improperly run enterprise. It is urgent that the government reform and correct its shortcomings.

The government has designed an improvident device to control the economy. Under a government-directed economic system, the economy cannot develop properly and government control prohibits the market from manifesting its genuine function. Hence, regulations should be drastically reduced. Not only should the government trim its organization, but a fundamental change in the government’s mind-set is crucial so that the government exists to serve its citizens. Only then will the government cease its intervention in the economy. The government’s influence and organization should be trimmed and an economic climate created that ensures fair and open competition.

As for reorganization of the government, the separation of money and administrative powers is a precondition. No matter how it is reorganized and specialized, the administrative structure, if it has the power to issue and distribute money as it wishes, will develop inextricable links with the business sector, reinforcing the sort of vicious circle which already exists. Should this happen, the economy will become hostage to the vested interests class and suffer once more.

From this standpoint, it is important to develop an independent central bank with the authority to issue money. Often the central bank has been compared to the heart in the human body; the central bank supplies money, the blood of the economy, to enable the healthy growth of the national economy. If the central bank is misused, the economy pays a high price as the victim of bureaucracy and political fraud.

The Bank of Korea (BOK), Korea's central bank, was deprived entirely of autonomy, beginning with the military dictatorship of the 1960s. For 40 years, the BOK was degraded to the status of a printing company, churning out money at the command of the government. The natural outcome of this kind of government control was the excessive issuance of currency and poor execution of economic policy. It led also to unbalanced economic growth and structural corruption. In the end, the BOK drove the national economy to collapse. Under these circumstancs, even if government structure is reorganized efficiently, the roots of corruption remain intact and bureaucratic society becomes a hotbed of irregularities.

In addition to the independence of the central bank, financial market function must also be enhanced. Korea's financial institutions have been vassals of the authorities and have acted as the private cashbox of the Chaebol. In capitalism, money is crucial. Just as the human body depends on how well blood is refined and distributed, a healthy financial industry requires money to be provided to healthy organs via well-maintained distribution functions. In Korea, government influence in finance is becoming stronger. Although distressed financial institutions are being closed, merged and sold overseas in homage to financial reform, government influence is, in fact, being fortified. The advent of the omnipotent Financial Supervisory Commission, in particular, is enlarging the source of non-performing elements. The government should sever its chains of control.

As stated previously, the Chaebol must also change. The Chaebol are operating in many businesses via substantial debt accumulation and this octopus-like approach has reached a state where the Chaebol have become too big to manage effectively. A truly specialized affiliate system, a lower debt ratio and the securing of competitiveness in relevant sectors are important remedies.

The core of Chaebol policy must be the dispersion of ownership and the separation of ownership and management. Since the Chaebol companies' ownership has been concentrated in the hands of the founder and his family, company activities have stressed the maximization of private interests. If ownership is dispersed and ownership-management separation is enforced on the basis of open and public Chaebol policy, the perception of a company as its owner's cash box will be erased. Only then can companies concentrate their attention on healthy, productive activities for consumers and shareholders, rather than on the monopolistic activities of the company owners.

It is urgent to preserve small, medium sized and venture industries, as the base of a competitive economy. The survival of small and medium sized companies depends on their functioning as sub-contractors to the big companies. Under this system, it is difficult to save them merely by creating an office providing some limited kinds of support. The Korean Chaebol companies have concentrated on the pursuit of their monopolistic interests through the development of goods-assembly production. They have systematically blocked the development of capital resources and basic materials and knowledge based industries and deprived other industries of a place in which to stand. Consequently, the Korean economy faces the loss of its international competitive power. The fundamental way to solid growth is to change the method of industrial development to that of a decentralized system with small companies and big companies involved in a complementary relationship. In this way, the environment must be secured and small companies must be free to engage in creative activities. A prerequisite to this is the blocking of Chaebol companies' domination.

Figure 4 - Chaebol Reform

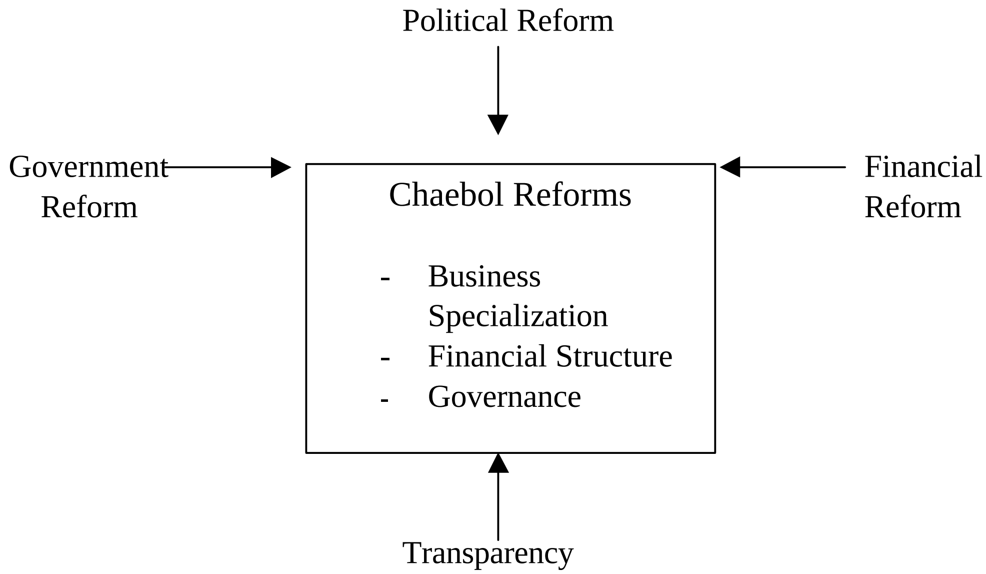
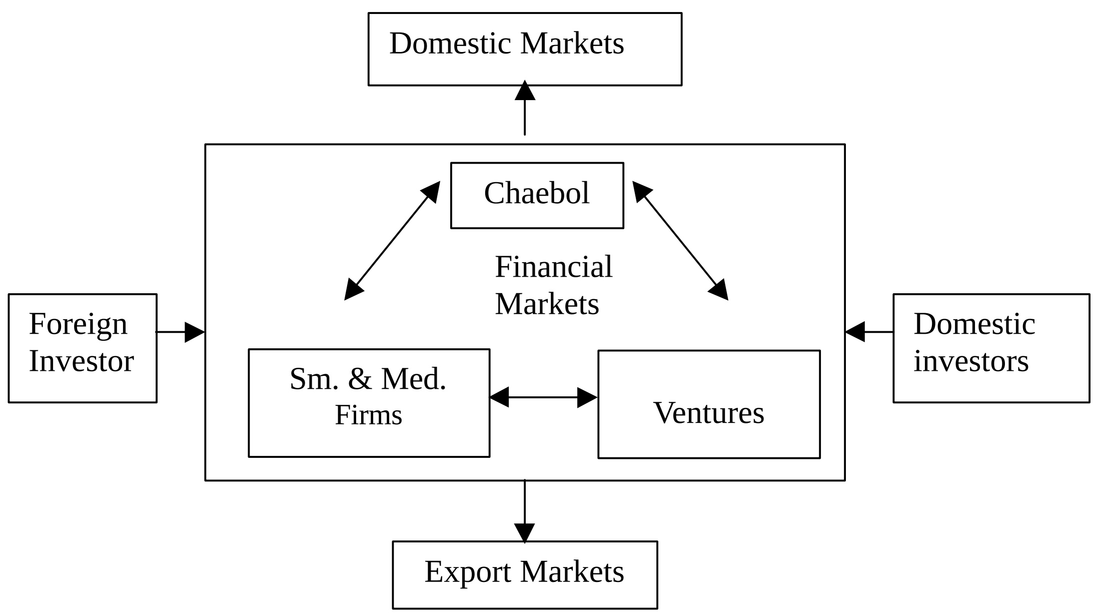


Figure 5 - Decentralized Economic System



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