THE EVOLUTION OF KOREAN CHAEBOLS AFTER 1997 IMF CRISIS

by

Martina Sipkova

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Submitted to
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ABSTRACT

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The Korean Republic is an example of a successful state-led industrialization, which has brought the country among so-called Korean Dragons. This remarkable evolution was allowed for by the existence of chaebols, local business organization forms, which the government used as a main tool to achieve its economic goals during industrialization. However, successful economic development was abruptly disturbed by an IMF crisis hitting the economy in 1997. IMF and WB identified chaebols as the major cause of the crisis, thus the post-crisis economy reform included high portion of measures focused on corporate sector and with special attention paid to chaebols. According to an Anglo-American free market ideal, the measures were aimed at dismantling chaebols, as they were regarded harmful for the economy *per se*. This paper discusses post-crisis corporate sector reform in view of two different doctrines – free market ideology and traditional Korean model. It argues that the reform was ill-managed and its results are ambiguous, as it neglected traditional Korean business and industrial policy practices. Furthermore, after the analysis of the reform is provided, alternative suggestions about how it should have been conducted are offered and the future necessary adjustments for chaebols to operate successfully in globalizing world are discussed.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF CHARTS AND QUOTATIONS

I. Introduction

A lot has been written about the economic achievements the Korean Republic has been able to realize since the end of Korean War in 1953 until now, that the country belongs among so-called Asian Dragons, with the GDP per capita amounting to 15,700$[1] in 2006, which it rose to from 65$ after the war. Apart from the role of SME and the government (so called developmental role of the state typical for countries which started their industrialization relatively late), one of the main factors which allowed for the "Miracle of the Han River" were Korean typical business organization forms – chaebols. These huge conglomerates have led Korean economy through several stages during its development up to an International Monetary and Financial Crisis (henceforth IMF crisis), which hit Korea and other Asian countries in 1997. The crisis was a crucial moment in Korean development, as Korea experienced an abrupt collapse unprecedented in its history. Numerous scholars and professionals tried to identify the causes of the crisis to find a proper remedy, so that Korea could continue on its way towards high living standard and economic prosperity. In doing so, many of them (including the IMF representatives) agreed on the fact that they are chaebols, and specifically their inflexibility and inability to respond to rapidly changing and globalizing international environment, which lie beyond the crisis. Consequently, following reform aiming at the renewal of economic growth and trust in heavily crisis-hit economy, consisted not only of the attempted market and business environment reform but was specifically focused on the generally believed crisis cause, chaebols.

As the title suggest, this paper is going to deal with the post-crisis evolution of chaebols, with the main focus lying on the reform which chaebols were forced to

[1] www.econstats.com

undergo along with its results as we can see and evaluate them at present. As I feel it goes beyond the scope of the paper, not much space is dedicated to the financial crisis itself, neither special attention is paid to the evolution of chaebols before the year 1997. **The goal of the paper** is to analyze the reform in view of two different doctrines – the "western" and the "eastern" one as they are described in the following chapters, and suggest, whether the measures were the proper ones to address the main weaknesses of chaebols and Korean economy. Furthermore, as I am convinced that the reform was ill-managed and based on inappropriate principles unsuited for Korean economic environment and business culture, a suggestion of more appropriate chaebols' treatment follows.

Implied by the previous text, the **working hypothesis** is that the Anglo-American market system attitudes which were applied to Korean economy and chaebols are inappropriate and can only work in the short-term. Measures implied by this approach did not remedy the main weaknesses of the chaebols and rather destroyed features that constituted chaebols' main competitive advantage. Consequently, different strategies, based upon more traditional Asian model of economy and business structures, are needed to ensure further economic development of Korea and chaebols as a major part of its business environment.

The paper is divided in six different chapters. After the main hypotheses and the goal of the thesis are stated in chapter I, chapter II focuses on the definition of chaebols along with their main features so that the ideas expressed in the thesis can be later further developed. Chapter III analyses the post-crisis reform together with its causes, main chaebol features which were subject to the reform as well as particular measures taken to address specific weaknesses of chaebols. In chapter IV, the results of the reform are evaluated, separating the reform successes and reform failures. The core chapter is Chapter V, which is aimed at comparison of the way so-called "Western view" and "Korean view" perceive the crisis, following reform and its results. After short discussion on the underlying factors and further implications of the "Korean view", some recommendations on alternative measures which should (could) have been taken implied by the "Korean view" are provided, followed by conclusion in chapter VI.

As the most recent data is not available in English, the latest development of chaebols is not discussed in the paper. Rather, I tried to examine the **chaebols' features** along with the **assumptions** and **theoretical background** lying behind their post-crisis reform as factors, which bore serious implications for the particular measures taken as well as their results. Although lacking the current data, I still hope I can offer a fresh viewpoint and that the conclusions of the paper will be helpful in better understanding of the unique Korean business environment realities together with chaebols as a major agent in the economy.

II. Chaebols

Before we can proceed to the analysis of the measures taken to tackle the IMF crisis and conduct chaebol restructuring, it is necessary to define what a chaebol is and understand its major features as well as functioning. It is only logical, that the post-crisis chaebols reform was meant to address chaebols' weaknesses and enhance their strengths so that they could successfully recover from the shock and assume a redefined role in opening and globalizing economy, for which previous thorough understanding of chaebols and their characteristics is needed.

II.1.Definition

What is a business group?

Various forms of business groups exist in many countries. As chaebol is one of their specific type particular to Korea, let's first define a business group itself and see what the main reasons which economically justify its existence are.

By definition, a **business group** is understood as "a set of firms which act in different product markets under common entrepreneurial and financial control"[2]. In contrast to a **diversified firm**, firms operating within such a group are legally independent entities, while they transact with each other through a non-market mechanisms such as hierarchy and intra-group transfer. The rationale behind their existence is competitive advantage created by synergies achieved through resource sharing and coordination at the group level, diversification among member firms under centralized coordination being a key element of their functioning.

Economically, there are 3 major reasons for which business groups are created. First, they provide a **mechanism to increase the amount of capital** by mutual shareholding, fictious capital creation and exploitation of debt leverage. Second, a business group provides an environment of "mini-capital market", where financial resources can be mobilized due to direct subsidy, corporate lending and loan guarantees, so-called **intra-group mobilization**. Third, centralized decision-making at the group level allows for saving entrepreneurial resources due to intra-group transfer ("**central-office effect**"). According to management theories, **3 main motives** lie beyond large conglomerates: 1. pursuit of growth, 2. risk aversion and 3. economies of scope and scale; the first two motives being sometimes considered as dubious.

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[2] Shin, Jang-Sup: *Restructuring Korea, Inc.*, New York, Routledge Curzon, 2003, 155 p., ISBN 0-415-27865-1, p. 26

<u>What is a chaebol?</u>

The expression "chaebol" comes from Chinese and stands for a money clique, i.e. a group with vast fortune. Korean Fair Trade Commission definition as of "Monopoly Regulation and Fair Trade Act" states that chaebols affiliates are those of which "**either more than 30 % of whose issued shares are owned by one person, his relatives, or a company controlled by him, or whose management such as appointing its officers is substantially affected**"[3]. This definition is critically important from the economic perspective of chaebol functioning, because every year government issues a list of biggest conglomerates and based upon the above mentioned definition different measures and restrictions are imposed on organizations recognized as chaebols.

Apart from this "government working definition", in the attempt to grasp their ownership structure and internal functioning relationships, we might try to develop a "functional definition" listing the most typical features of chaebols. According to this approach, chaebols can be defined as "**large vertically integrated paternalistic hierarchical organizations with authoritarian rule and the management consisting mainly of members of one family**"[4].

<u>II.2.Common features</u>

Various papers dealing with this topic can be found in available literature, but what they all have in common are the following three features cited as distinctive for chaebols:

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[3] Chang, Sea-Jin: Financial *Crisis and Transformation of Korean Business Groups: The Rise and Fall of Chaebol Business Groups*, New York, Cambridge University Press, 2003, 364 p., ISBN 0521814359, p. 6

[4] Burns, R.: *Doing business in Asia: a cultural perspective*, Malaysia, Addison Wesley Longman Australia Pty Limited 1998, 308 s. ISBN 073390193X, p. 258

1. *Corporate governance*: Family ownership

2. *Business structure*: Diversification of activities

3. *Capital structure*: High debt proportion

Now, let's have a look at them in detail.

1. As for **corporate governance**, chaebols are typically owned by members of one family, while the head, whose position is passed from the father to the eldest son following traditional patriarchal pattern, is called Chairman. Management and control is exercised by the owner, who is at the same time the major stockholder, and who widely intervenes not only in the issues related to the original parent company, but also decision making of affiliated firms and thus virtually controls all the group (See Appendix 1, Table 1 and Table 2). His formal as well as informal control is hierarchical and centralised, which is often cited as one of the factors contributing to the fact that chaebols lack professional management and expertise. Typical decision making pattern is from top down, with concentration of decision-making at upper levels of managerial structure and horizontal concentration of functional control. As chaebols do not usually use exact job descriptions or specifications, responsibilities are not clear and many overlaps exists. This fact implies that promotion is based on the seniority principle, level of loyalty and devotion to the company rather then skill or job performance.

In most chaebols a group of people who have been in the organization from its early stages do still hold their powerful positions; so called "tobagi" [5] - "natives or aborigines". This fact is often regarded as an obstacle to restructuring and process

[5] Kang, Myung-Hun: *The Korean Business Conglomerate: Chaebol Then and Now*, USA 1996, 254 p., ISBN 1557290512, p. 112

modernization needed to be conducted for chaebols to stay competitive in global changing environment. It is also often argued that the original owner was personally engaged when the chaebol was created, but blood succession principle leads to the situation that when the ownership is passed to the eldest son, second or third generation owners do not necessarily prove to be as good managers as their fathers. Typically, the founder of chaebol was possessed of entrepreneurial spirit and gave momentum to the business; but when certain level of development with larger scope of activities was reached, management should have been handed over to professionals. Another problem is that later on many original owners established affiliated companies, which diluted the energy they could devote to their original business and thus unition of control and ownership in the same person became a major problem. Such a practice also led to a homogeneous company culture and managerial style implying inertia and lack of incentives for a change.

2. In terms of **business structure**, chaebols are usually engaged in various activities throughout many industries pursuing the strategy of unrelated diversification. Apart from spreading across industries, chaebols also display the tendency to acquire financial institutions and companies in their value chain. As vertical and horizontal integration reduces existing competition and leads to distortion of natural market mechanism, chaebols are often blamed for enhancing inefficiency of the economy as a whole. Due to their expansionary policy, chaebol conglomerates usually operate under excess capacity decreasing profitability indicators. However, it is often argued that the main business of each chaebol, which usually lies in one or two fields, is profitable enough in comparison to other companies and unfavourable profit situation is reported due to other unrelated operation activities, where the chaebol proves to be

less competitive. Another issue connected to high diversification is mutual shareholding. As mentioned before, the owner (founder) of the original company often established new companies in different fields, this feature being sometime described as a "passion for growth" and heavily criticised. In literature this phenomenon is referred to as "octopus" tendency of chaebols, as their "tentacles" can be seen throughout all the economy (See Appendix 1, Table 3). To justify this behaviour, we may say that to a certain extent this approach was just an act of self-defence and the result of the effort to tackle the conditions in the market – economically, diversification of activities led to lower risk and better chances to obtain financial resources.

3. **Capital structure** of chaebol conglomerates is characterized by high debt proportion; a fact caused by circumstances under which most biggest chaebols were founded. In time of their creation no capital resources were available and the only possible way of obtaining funds was through borrowings either from banks or using the money provided by the government. For many years, chaebols enjoyed preferential behavior of the state, which enabled them to access loans more easily and at a lower expense than existed in competitive environment. This fact was even strengthened by lack of supervision which would require conglomerates to hold lower proportion of debt in their capital structure or keep debt and efficiency indicators at specified level (See Appendix 1, Table 4). Capital structure was also influenced by mutual guarantees which different chaebol affiliates offered to each other, and thus created fictive capital. Buyouts of non-banking financial intermediaries were also widely used for capital provision for the parent company. Due to these factors funds were accessible more easily and without sufficient attention being paid to efficient

capital management, which is believed to be a factor that largely contributed to 1997 IMF crisis. As a result of this experience, after 1997 government in cooperation with IMF imposed regulations allowing maximum debt proportion to be 200%, a level which had to be achieved by 1999[6]. Following this rule, many chaebols maintain their leverage at the level of 199% nowadays. Nevertheless, their debt proportion ratio is often still higher than average level in most non-chaebol companies operating in the particular industry.

Apart from the major three features listed above, other common characteristics can be found if chaebols are examined in detail. These comprise for example prevailing authoritarianism, strong bargaining power or close relationships with the government, further description provided in the literature listed at the end of the paper.

III. Post-crisis reform

Up to 1997 chaebols went through various stages of development, but their evolution was suddenly disrupted by IMF crisis in 1997. In this chapter, we are going to analyze the measures which were taken to restructure chaebols to tackle their major weaknesses as one of the alleged causes of the crisis. As the measures suggested and the tools employed are based on the **Anglo-American free market view**, which regards any major market mechanism disturbance as harmful and strongly emphasizes free market and free competition, the main approach taken in this chapter is going to reflect this ideological background. However, an alternative approach, which I

[6] Lee, Kwon-In; Jwa Sung-Hee: *Korean Chaebol in Transition: Road Ahead and Agenda*, Korea, Korea Economic Research Institute, 2000, 451 p., ISBN 8980311826, p. 52

personally consider much more relevant in Korean reality, is going to be applied later and further suggestions based upon it also follow.

III.1.Alleged causes of the crisis

There are several causes to which the IMF crisis is mainly attributed. Here, we are going to focus on those identified on the side of chaebols, as they imply the attitude the government as well as the IMF took to them in their attempt to remedy the crisis-hit economy. Post-crisis restructuring of the economy, which represented the biggest restructuring of the Korea's economic system in its history, was mainly driven by liberal free market ideal with little intervention of the government in the economy and the restored functioning of natural market mechanism as well as free competition.

According to conventional neoclassical model, the main cause of the crisis was the fact that the government stopped performing its crucial economic functions, such as regulation of financial markets, control over cross-border financial flows and overall supervision of the business environment, which was supposed to ensure competition and equal conditions for all market agents. The most obvious form this government-function failure took was so called "**government-banks-chaebols nexus**". Due to special attitude and protectionism of chaebols' by the government, domestic financial resources were concentrated in the hands of a few large chaebols (See Appendix 1, Table 5). However, although chaebol was an organization form which was able to create huge synergies especially due to its ability to concentrate and share resources and information and provide capital, all its benefits were wasted by operating inefficiencies due to overall low profitability and resource transfer towards less productive affiliates to keep them going. Government industrial policy favorizing chaebols led to the increase of **moral hazard**, quite clearly seen e.g. in government

too-big-too-fail (henceforth TBTF) approach. Inflexible industrial policy promoting particular industries and chaebols resulted in neglecting SME, which would have been able to respond more quickly to rapidly globalizing international environment due to their higher flexibility. Thus, according to this view, the **crisis happened due to long-term structural problems of Korean economy**, closely tied to the existence of chaebols and their increasing inefficiency of operations (See Appendix 3, Quotation 1), which were mainly financed by external debt (As we can see in Table 5, it is only alarming that 30 largest chaebols' debt represented almost 80% of all debt in the economy).

IMF bailout which Korean government had to ask for was conditioned by overall economy reform including the chaebols. **Crisis treatment** consisted in 3 main elements - **macroeconomic retrenchment, market opening, and structural reform** (See Appendix 1, Table 6). The main issues defined as subject to reform were labor market, public and financial sector, the role of the state and its relation to banks and corporate sector as well as the corporate sector itself. For this purpose, various measures such as the creation of Bank for International Settlement (BIS) and Financial Supervisory Commission (FSC), introduction of capital-adequacy ratio or forward-looking criteria (FLC) were taken. While the reform of financial sector was seen as a way to reform the corporate sector, it was aimed at dismantling the chaebol as a phenomenon of Korean economy the way it had existed prior to the crisis.

III.2.Chaebol features subject to reform

The key features generally perceived as weaknesses of chaebols and thus defined as a subject to the reform were the same ones which had helped them survive and thrive in the Korean economy before the crisis. Namely, they were **monopoly power of**

chaebols, expansion strategies used to ensure further growth, **vertical and conglomerate structure** resulting in peculiar **corporate governance** and **special treatment by the government** generally considered as undesirable and pathological. As a result, five main areas were specified to be addressed by the reform measures.

1. The first area needed to be reformed was **financial structure** of chaebols. Chaebols' operations were financed by large portion of external debts, mostly of overseas origin. High debt proportion was reflected in high debt-equity ratio, which averaged 519% in 1997 (for debt-equity ratio of 30 biggest chaebols see Table 4), significantly high level in comparison to the average debt-equity ratio of conglomerate type of organization in other countries. In international comparison high gross corporate debt level was even worsened by unfavorable debt structure of chaebols characterized by short-term obligations and long-term investment with long horizon of return and large portion of non-performing loans. Thus, chaebols were financially vulnerable to changes in external as well as internal business environment and were substantially exposed to investors change of attitude and financial outflow in case of loss of credibility (which is exactly the thing that happened during 1997 crisis and through snow-ball effect even deepened the initial economic downfall and further spread the crisis in the economy).

2. Secondly, chaebols were believed to face serious **efficiency** problems. Measured by ROA, the productivity of chaebols was low compared to other businesses in the same field. This fact is closely related to huge diversification of chaebols, which owned and ran many businesses in unrelated fields. Just to illustrate the problem, in 1997, 30 largest chaebols owned business in on average 20 different industries, with 27

affiliated companies [7]. Such a range of activities meant that chaebols proved operational efficiency and realized profits only in few core activities, while the other non-profitable areas decreased the overall efficiency of the group and wasted efficiency gains created by conglomerate-chaebol structure synergies as described above.

3. Third main problem specified on the side of chaebols was **lack of transparency**. Insufficient transparency was caused by several factors, the most important of which were family ownership, internal transfer, mutual shareholding and debt guarantees. In 1997 ownership structure of an average company of top 30 chaebols was composed of 43% of inside ownership share, 8,5% of family share and 34.5% of affiliates share[8]. Although the direct family ownership is relatively low in proportion, in reality the family members exercised much more control through family relations and relatives holding important posts in affiliated companies. Low transparency was enhanced by high ratio of affiliates share as we could see above. Such ownership structure led to suppression of minority shareholders' rights and the fact, that corporate governance dependence of chaebols' on the criteria of profitability and shareholders' gain was once again suppressed. Another issue connected to this problemacy is the fact that up to 1999 the accounting and financial statement of chaebols were prepared for particular firms and affiliates, while they did not offer aggregated numbers for the conglomerate as a whole (as stated in previous chapter, chaebol does not exist as a legal entity and its affiliated firms are legally independent). Followingly, profitability, capital adequacy and other measures of weaker affiliates were seriously distorted by

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[7] Shin, Kwang-Shik: *Competition Policy and Corporate Restructuring in Korea*, Korea, Korea Development Institute, 42 p., 2001, p. 4

[8] Shin, Kwang-Shik: *Competition Policy and Corporate Restructuring in Korea*, Korea, Korea Development Institute, 42 p., 2001, p. 4

internal resource transfer and the chaebols seemed to own e.g. much more assets than physically really existed.

4. The fourth group of unfavorable chaebols' features is related to their **business structure**. As chaebol problem was often regarded as problem of concentration of economic [9] rather than market power with structural weaknesses and political implications, chaebols' main advantage – size and diversity – turned into a major weakness in government viewpoint. As explained above, buoyant diversification original needed for survival undermined chaebols' profitability, while concentration and economic power exercised by chaebols through horizontal linkages and links to the authorities including the government distorted competitive environment and natural market functioning

5. Last but not least, the so called "**chaebols-government-banks nexus**" was viewed as deeply problematic. Preferential treatment by the government along with its TBTF approach has been mentioned many times, so we are not going to dwell on this issue again. However, apart from the government, chaebols also enjoyed preferential treatment by banking as well as non-banking financial institutions, due to which they had substantially easier access to capital resources relatively to other non-chaebol businesses. One of the reasons was that many chaebols had links to bank or became owners of prominent financial houses in Korea (See Appendix 1, Table 7). As of 1997, the 70 largest chaebols owned a total of 114 financial affiliates, which makes the average of 1.6 affiliates per chaebol. Correlation of this indicator with chaebol size is clear, as the same indicator averaged 5 financial affiliates per chaebol for top 5

[9] For example, in 1996 30 largest chaebols stood for 40% of shipment, 18.1% of employment and 38.% of value added in the mining and manufacturing sector. Reference the same as 7 above.

chaebols (See Appendix 1, Table 8). Another reason is that Korean financial sector was underdeveloped and lacked the ability to assess properly the real financial situation of large businesses, as the capital providers followed the same logic as the government and believed that large conglomerates were more trustworthy and thus less risky.

III.3.Reform measures

Korean government has been trying to control chaebols by so called "chaebol policy" with more attention paid to them already since the 1980s. The main regulatory document used for this purpose is **Monopoly Regulation and Fair Trade Act** (further MRTA), was first enacted in December, 1980. Since that time there have been several revisions strengthening control over chaebols. As chaebols are often regarded as being unique to Korea, under MRFTA Korea pursued non-traditional competition policy which was own of its kind. It lacked systematic measures as we are used to in most Western economies, Korean government approach being often described as "cocktail approach". Although MRFTA has **two main purposes –** promotion of **fairness** as well as promotion of **competition**, it did not pay sufficient attention to conventional competition concerns. It tried to limit chaebols behavior by direct control instead of enhancing overall competitive environment, which proved inefficient. Consequently, the MRFTA underwent a major revision in 1997, in line with the government goal of developing a better framework for corporate governance and enhancing firm specialization. As a result, the following changes appeared in the revised MRFTA.

In response to identified crisis causes, the reform package involved measures focused on generally believed main weaknesses of Korean corporate governance system. As we can see in See Appendix 1,Table 6, corporate sector reform was involved in the group of system reforms of the crisis management package introduced by the Korean government. To tackle main chaebol weaknesses, corporate government reforms were aimed at **4 main areas**: fair **trade regulation, introduction of new accounting standards, ensuring financial market discipline and improving efficiency and transparency of internal governance**. Overall, the reform measures contained components which were designed to improve chaebols' performance in short-term (produce immediate results in treatment of urgent symptoms of the crisis and unfavorable profitability and financial indicators), mid-term (financial structure revision) and long-term (strengthening corporate governance system to enhance stability and continuous growth). In the following lines we can see in more detail which reform tools were used to tackle the main chaebols' weaknesses as specified above (See Appendix 1, Table 7).

1. Financial structure:

As for financial issues, the reform was aimed at two kinds of economic agents. The first group of measures was targeted directly at chaebols, whereas the other group focused on the recovery of the whole financial sector.

To improve financial structure of **chaebols**, revised MRFTA introduced an obligatory **debt-equity ratio** level. Effective as of February, 1999, it stated, that a holding company may not have a debt-equity ratio higher than 200%. In comparison to 1997 top 30 chaebols level of the ratio at 516.4%, it meant substantial reduction in this indicator, which indeed fell significantly by the end of 1999, as we can see later.

Second, the 1998 amendment of the Act required **complete elimination of intra-group transactions** along with debt-guarantees, while all outstanding guarantees had to be cleared by the end of March, 2000. Provision of "unreasonable assistance to specially related persons or other companies by providing loans, assets and manpower free or at preferential term" was prohibited and the supervisory role of the KFTC (Korea Fair Trade Commission) was strengthened. Consequently, from 1999 KFTC was given special power for 2 years to investigate bank accounts of 30 largest chaebols' affiliates, which was extended for another 3 years in 2001. Also, from April, 2000, ten biggest chaebols were obliged to obtain a Board of Directors approval and issue a public notice before large-scale in-group transaction were to be conducted[10]. For the 6th to 30th largest chaebols, a **workout program**[11], a banks sponsored restructuring process was one of the ways to conduct debt restructuring and thus, apart from other effects, improve their financial indicators. The main tools used in a corporate workout programs were interest rate reduction, interest expense write-offs and debt-equity swaps, which led to debt reduction and was supposed to provide an incentive for recovery process.

For the regulation of **financial sector**, **Financial Supervisory Commission** (FSC) and **Bank for International Settlements** (BIS) were established. As accumulation of non-performing loans (NPLs) was an immediate cause of the crisis and there is no doubt that financial institutions were largely responsible for this fact, financial sector underwent the biggest reorganization in its history. Due to the underdevelopment of financial sector and the inability of financial institutions to asses properly the soundness of creditors and clear preference towards larger companies under the

[10] Since April, 2001, this regulation was expanded to 30 largest chabols.

[11] A corporate workout program by definition means that "financially weak firms negotiate with their creditors to restor their financial health by restructuring their debt profiles before they have to file for bankruptcy and be liquidated", reference the same as 7) above.

commonly held view that the larger the company the more trustworthy one, **forward looking criteria** (FLC) were introduced. Though their main purpose was to restrain possible over-investment by the corporate sector, they regulated functioning of financial institutions. FLC required that "financial institutions set aside provisions against the loans even though interest on which are regularly paid, if borrowers' management conditions, financial status, future cash flow, and so on are regarded inadequate[12]" (until that time, provisions were required to be set aside only on those loans on which interests were not actually paid). Moreover, to ensure soundness of financial institutions, a **minimum capital adequacy standard** ("BIS" ratio), which actually represented a limit on loan provision resulting in less corporate lending[13], was imposed. Due to stricter control and the inability of financial institutions to keep new standards, many unviable commercial banks as well as non-banking financial institutions were closed.

2. Efficiency and business structure improvement

Operational inefficiency of chaebols is closely tied to all the aspects of their functioning mentioned here. Especially, it is related to large diversification and existence of numerous peripheral businesses decreasing profitability of the group as a whole, although the main business of a particular company might have been successful. Thus, it was the aim of Korean government to make chaebols focus more on their core activity and concentrate on limited number of areas. To reduce over-capacity along with diversification and consolidate industries, the government introduced so called "**Big Deal**" program, the plans for which were ready by the end

[12] Shin, Jang-Sup: *Restructuring Korea, Inc.*, New York, RoutledgeCurzon, 2003, 155 p., ISBN 0-415-27865-1, p. 97
[13] BIS ratio used to control financial and capital structure in case of financial institutions is similar in nature to debt-equity ratio regulating financial structure of chaebols.

of 1998. This program focused of 5 biggest chaebols and consisted in business swaps among the chaebols in industries with over-capacity, imposed by the government. It included 8 major business sectors (semiconductors, petrochemicals, aerospace, railroad vehicles, power generation machinery, ship engines, oil refining, automobiles and electronics) and 17 companies of top 5 chaebols (For detailed list see Appendix 1, Table 10). Generally considered not very successful, BD resulted in market concentration increase (See Appendix 1, Table 11, Table 12). Along with Big Deal, chaebols were required to **decrease the number of their affiliated companies**, which, as we can see in Appendix 1,Table 13, indeed started falling, beginning in 1997. Revised MRFTA also stated that a holding company may not include second-tier subsidiaries and may not own both – financial and non-financial subsidiaries. Another measure, which strongly influenced chaebols' business structure, was liberalization of capital market and full liberalization of hostile M&A by foreigners.

3. Lack of transparency

While financial risk reduction and enhanced trustworthiness of Korean economy together with its corporate sector were major targets of the reform, they could not be achieved without improvement of transparency supported by **stricter accounting standards and better supervision of accounting practices**. It was especially KFTC, which became much more active in application of new standards. As one of the assumptions lying behind the reform was that the chaebol structure has no more benefits and transactions between chaebols and their affiliates perpetuate market distortions and unfair trading, KFTC tightened its supervision and between the years 1998 – 2000 levied fines worth 234.3 billion won (195.2 million USD) on 30 largest chaebols. Apart from other, chaebols were mainly punished for transfer prices, so the amount of the fine was based upon the gap between market and internal prices. The trend of increasing number of legal actions raised against KFTC (See Appendix 1, Table 14) proves unpopularity of tighter control and increased activity of KFTC.

Reforms meant to ensure better transparency of chaebols' actions were conducted under liberal doctrine reflecting shareholders viewpoint. In line with this approach, the **rights of minority shareholders were strengthened**. Minimum proportion of shares needed to bring a lawsuit against a misconduct of managers changed from 1% to 0.01% and the proportion needed for accounting books inspection decreased from 3% to 1%, while cumulative voting system was introduced. At the same time, institutional investors' rights were also enhanced when investment trust companies and bank trust accounts were given voting rights. **Managerial transparency and accountability** was encouraged through **revision of commercial law** stating that listed companies are obliged to appoint at least 25% of directors from outside of the firm and people with common interest with effective managers of the group were banned from any executive positions. **Chaebol owners bore more legal responsibility** as they became liable for public prosecution and civil lawsuits (although this change was only recommended and not strictly imposed by the government, the overall economy atmosphere and public opinion was as such that the chaebols virtually did not have an option and had to follow the government's "recommendation"). Apart from strengthening the roles of outside directors, the government also demanded that **group level staff organizations** as well as the Chairman's Office be **abolished**. Although chaebols had to keep the letter of the regulation, such a requirement from the side of the government was rather naive and ineffective, as the need for coordination of the business group activities on the group level still existed and chaebols were thus only forced to find different ways how to do so. Furthermore, transparency was also enhanced by **revision of external audit law** according to which top 30 chaebols must report consolidated financial statements for the whole group due to which overlapping transactions are eliminated and the overall financial situation of the group as a whole is revealed. To ensure the objectivity of outside auditors, establishing an election committee for their assignment became obligatory. Another thing, already mentioned it the previous text, was abolition of intra-group transactions and debt guarantees, as they had previously allowed for unfair expansion.

4. Breaking "Chaebols-government-banks nexus"

It is a generally held opinion that another factor playing important role in the outburst and progress of the crisis was insufficient attention which Korean regulatory bodies paid to the problem of **chaebols' market power**. During their history, as explained above, chaebols enjoyed preferential treatment by the government as it used them as a tool to achieve its economic goals and thus gain legitimacy, which it would have otherwise lacked. Such an attitude, reflected by the fact that government decisions, loan provision, license distribution etc. were not based on operation efficiency criteria, continued until the crisis. Another point was that chaebols became owners of numerous banks and non-banking financial institutions, 1997 in resulting in the **attempt of the government to decrease chaebols ownership of financial institutions** of any kind. However, it was not successful as the ownership of non-banking financial institutions actually increased. Nevertheless, the collusion with the state and corruption in general was reduced and even managers themselves consider present business environment much more ethical. Enhanced supervision and especially tightened control of KFTC is generally believed to be the main reason for this positive development.

IV. The results of the reform

As the reform tried to solve problems of the economy which had been cumulating for a long time it was not entirely successful. Some measures led to positive results, whereas in case of others we must be very careful when trying to evaluate them. The following text provides summary of reforms which brought intended results as well as those where the desired effect was not achieved or was even the opposite. Summary of main economic indicators within the period of 1995 – 2005 is provided in Appendix 1,Table 17, also see Appendix, 2, Chart 1.

IV.1. Successes of the reform

First, I would like to point out that the reform mainly succeeded in those areas where "hard" measures or ratios were imposed. It is clear that such limit required by the law or imposed by various government acts must be kept and chaebols thus did not have any ways how to avoid meeting them. On the other hand, if an economic or financial indicator is kept at a specified level, it does not necessarily mean that all the underlying factors move in the desired direction. The perfect example of such a statement is **debt-equity ratio**. As we can see from Appendix 1, Table 15, the ratio was significantly reduced between the years 1997 – 1999 that the revised MRFTA level about the maximum of 200% became effective. While in 1997 the ratio stood at 472.9% for 5 largest chaebols and even 616.8% for the top 30, it fell to 148.7 % and 498.5 respectively (See Appendix 1, Table 15). Based upon the numbers, it is a positive results and it seems that the chaebols even overshot. However, while the main purpose of imposing a limit on the ratio was to decrease chaebols leverage in their operations and consequently reduce the risk involved in their operations, it did not actually happen. The indicator was manipulated by **financial and accounting management**. The ratio fell due to increase in the denominator through new stock issue, asset sales and asset revaluation, while the numerator did not actually decrease. Moreover, such asset revaluation resulted in new costs such as transaction and especially depreciation costs without any reduction in interest payments (the fact that the amount of total debt in manufacturing sector even increased in the respective period proves that the goal of debt reduction did not materialize[14]). As a result, the financial situation of chaebols even worsened, with further consequences influencing their liquidity in a negative way.

Another aspect of the reform was **debt-guarantee removal**. In this case, as Appendix 1,Table 16 suggests, loans with in-group guarantee indeed fell from 39.5% in April, 1998 to 4.3% at the and of 1999 and zero in 2000, as required. As guarantee provision was seen as a fact allowing for uncontrolled expansion, from the Anglo-American perspective the result is regarded strongly positive. However, it has not been proved that the high leverage was the real cause of the crisis, rather, it might be that the causality is reversed and leverage reduction and guarantee provision elimination worsened the position of chaebols in the economy and seriously threatened their existence.

In contrast to the previous ones, a result, which can be considered positive without any doubt, is **introduction of international accounting standards**. Apart from harmonization with international environment and thus improvement of transparency as well as facilitation of joint-ventures and entry of foreign capital in Korean

[14] Shin, Jang-Sup: *Restructuring Korea, Inc.*, New York, RoutledgeCurzon, 2003, 155 p., ISBN 0-415-27865-1, pg. 86

companies, the major achievement in this area is consolidated statements reporting. These newly obligatorily contain information for the whole group and not only separate firms, which makes it much easier to judge the real financial situation of the chaebols including the distribution of their assets, profit or debts. Along with the obligatory disclosure of information, this measure significantly improved trustworthiness and overall corporate sector transparency in view of domestic as well as international investors.

Enhancement of minority shareholders rights along with the rights of institutional investors is also a positive reform result. Such a step promotes better management of chaebols due to strengthened external control mechanisms. Family owners of chaebols could no longer make decisions independently off other shareholders' interests and had to pay more attention to economic performance of the group as well as particular affiliates.

In terms of **corporate governance**, the positive impact of the reform is **professionalization of chaebols' management**. In many cases, family owners had to resign from their positions and instead of them external managers and professionals were appointed, supported by the required 25% of directors originating from outside of the company. Correspondingly, while new accounting standards and information disclosure weakened existing asymmetry of information, due to improved corporate governance **moral hazard was significantly reduced**.

As for **diversification** and the **number of affiliates** (Appendix 1, Table 13) we can see that average number of subsidiaries started falling since 1997. Within the year 1997 to 1999 it dropped from 27.2 to 22.9, correspondingly to the total of subsidiaries of 30 largest chaebols, which fell from 819 in 1997 to 544 in the year 2000. Interestingly, despite Big Deal and asset sale-off, the average number of industries was 19.8 in 1997 and stood at 19.6 in 1999, which does not show any significant change. Moreover, it proves a slight increase in contrast to the years before the crisis, so the diversification itself was not reduced. In fact, the failure to meet the goal of diversification reduction was a lucky one, as it was empirically found that the degree of chaebol diversification is negatively correlated with bankruptcy during and after the crisis (this fact was further proved by the outcomes of Big Deal program).

IV.2. Reform failures

Reform measures which can be rather considered as unsuccessful or even became a failure are explained in this chapter. The first issue falling in this category is **intra-group ownership**. Although the reform attempted to reduce its level and bring more external capital, it did not happen. In fact, internal shareholding **increased** from 43.2% in 1997 to 50.5% in 1999, as chaebols wanted to protect against the possibility of hostile takeover (See Appendix 1, Table 13). Moreover, such an evolution contributed to chaebols **liquidity difficulties**, as more cash was tied in shares of other affiliates and transaction costs were involved. In response to M&A liberalization the government also expected that chaebols would have to conform to harsher discipline in corporate sector, as they would be forced to focus on their core activity and improve their efficiency. Nevertheless, on the account of overall business environment atmosphere, these expectations never materialized either. Hostile takeovers were not regarded well by the population and economic agents were highly cautious due to existing cultural constraints as well as lack of funds. As equity financing was not able to provide sufficient resources for chaebols to operate, the total level of debt of top 30 chaebols increased from 269.9 trillion won to 267 trillion, i.e. by 36%. It is alarming to see such an evolution, as the total assets increased by 36%

as well, but considering the fact that the increase in asset value largely happened due to accounting management practices as explained above, total debt increased much more quickly (See Appendix 1, Table 13).

Although the previous part stated that internal **corporate governance reform** proved partially positive results, some effort was made in vain. In terms of abolishment of Chairman's Office and group level staff offices, chaebols were actually deprived of any legal possibility how to manage and control the group as a whole. Even though the reform attempted to dismantle chaebol and many chaebols were coercively made to split into several independent legal entities (e.g. chaebol Hyundai was later imposed to divide into 5 independent companies) by the government, they still needed to coordinate their activities. If we consider the fact that horizontal and vertical integration of activities is one of the ways to tackle uncertainty (e.g. integration of suppliers makes chaebol less dependent on the change of conditions in their supplier market) as well as to increase organizational efficiency, such a deed meant that synergy effect was more difficult to be achieved and risk was increased. Moreover, prohibition of internal transactions and abolishment of intra-group transfer prevented chaebols from economizing of resource sharing, which had allowed for long term planning in the previous period. Instead, they were forced to focus on short-term profitability and became more dependent on changeable business conditions.

The reform also had negative effect on the companies' **financial situation**. As the measures required corporations to maintain high level of liquidity (debt-equity ratio) while the financial institutions were pushed to withdraw liquidity from corporate sector (forward-looking criteria), corporation found themselves facing a serious credit crunch. Furthermore, as the provision of capital within the chaebols was abolished (intra-group transfer was prohibited) and mutual debt-guarantees were no longer possible, many companies went bankrupt just because of **lack of liquidity in the short-term**. This situation was made more difficult by the fact that foreign investors lost trust in the crisis-hit Korean economy and their resources had been quickly withdrawn even before the reform measures could take effect. The **corporate workout program** which was originally intended as a form of help for chaebols with serious indebtedness also turned out not to bring desired effect. Before the program was initiated, liquidation of 55 bankrupt companies was announced in June 1998. In 1999 54 affiliates of 17 chaebols and 39 other independent companies operated under the program. However, many of them were not performing well and in November, 2000, 29 of them were liquidated. In fact, the corporate workout program only extended the agony of already unviable organizations.

In terms of the effort to break special **relations between banks, chaebols and the government**, the reform was successful only partially. It is true that due to increased transparency, the ties were more difficult to maintain. However, despite the fact that reduction of intervention of the government in the economy along with chaebols' functioning was one of the conditions required by the IMF for the bail-out agreement, government intervention was not entirely eliminated. Government still controlled the activities of chaebols, both, indirectly through financial sector, and directly through specific measures such as Big Deal program. The result of BD was on the one hand decrease of chaebols diversification, on the other hand it led to economically unsatisfactory outcomes and many chaebols put under the program faced economic difficulties. The main problem of **BD was that it was motivated politically** rather than economically and Korean government once again applied its direct intervention within corporate sector. As many times before, it turned out that the government planned steps are not any more efficient than those taken without its influence.

To conclude the chapter about reform results, it is important to say that assessing the success of any reform or steps undertaken with certain expectations is always a complex task. **Corporate governance reform in Korea contained 3 types of components** – those, which were supposed to **treat immediate symptoms** of the crisis and could be seen in the short-run (accounting standards harmonization etc.), **mid-term horizon measures**, the results of which take some time to be seen (e.g. financial structure measures – debt-equity ration, loan-guarantees abolition, capital adequacy ratio etc.) and finally reforms, which need **long horizon** to be fully exploited (internal corporate governance reform – structural changes in the corporate sector such as focus of profitability criteria and shareholders' viewpoint in the management of chaebol, competitive behavior of chaebols, internal transfer abolition and market orientation etc.).

It is my belief that the most difficult task - "**soft**" part of the reform – is changing the traditional attitudes and beliefs of the general population as well as chaebols owners towards chaebols. Even though hard criteria were mostly achieved and chaebols' management became much more transparent, "soft" features such as traditional communication patterns, vertical and hierarchical management with rigid structure, lack of initiative at the lower level of company structure or seniority principle and respect enjoyed by senior colleagues with their negative implications, cannot be easily uprooted, as they are all examples of corporate governance mechanisms which are embedded in Korean style of thinking and local culture. In this view, the reform has produced an "organizational hybrid". On the one hand, effort was made to force chaebols manage their activities along liberal free-market ideal requiring a lot of flexibility, quick response to changing conditions and the necessity to operate under short-term horizon. On the other hand, the employee attitudes and traditional Confucian thinking is changing very slowly. So, at present we have come up with a chaebol as a company full of tension. For example, it is supposed to be driven by competition and free market, but the staff is still afraid of taking initiative and has to learn how to voice their opinions in front of senior colleagues or their bosses[15]. Such a situation presents a controversy, as the much needed flexibility and western patterns of management coming to Korea with FDI, joint-ventures and globalizing world require the very initiative and free thinking which has so far been culturally constrained in Korea and regarded as undesirable and bad manners. Unless and until these things change, the implementation of western models in eastern society will not work and many, especially human, resources are going to be wasted. However, in this place we can ask a question, whether this western paradigm can really work in unique Korean context and whether it is desirable at all. It is not necessarily true that the western liberal model is the only one and the best suited one for any world economy, and where else should we be more open towards different paradigms and economic models than in Korea, where economic agents take different role in comparison to Europe or North America. Next chapter provides the assessment of the reform in view of two different doctrines – a "western" free market ideology and a more traditional model reflecting unique Korean reality, which I call "Korean view" due to lack of any better name.

V. Contrasting viewpoints of chaebol reform

As it is true for any reform, transactional costs must be set against the results the reform brings. As I believe that the reform of Korean economy did not reflect the

[15] It is only one example of what is meant by soft features and what controversies may arise.

principles which are suited for the economy, this chapter summarizes the assumptions and approaches of "Western" paradigm and contrasts them with "Korean" paradigm of the reform. Concise summary can be found in Table 18.

V.1. "Western view"

To begin with, the Western view is based on several crucial assumptions, which implied the treatment of the crisis as well as the attitude towards chaebols. As stated many times, the basic paradigm was Anglo-American liberal free market ideology.

First, chaebols restructuring was conducted under the conviction that **chaebols are a pathological phenomenon** *per se* and as such are harmful to the economy. According to this view, chaebols lead to natural market mechanism distortion, enhance monopoly or oligopoly structure of the market and as such go against free competition principle. Moreover, since they have already used up their growth resources, their existence is no more economically justified as they cannot bring any more benefits. Consequently, since their further development and existence would be only possible at the expense of other market agents, they should be dismantled, letting their position be taken by other agents of the economy. Instead of chaebols, FDI and PME become new engines of growth, supported by strengthened free-market system with free competition and market-based resource allocation and well as decision making systems. This development will be allowed for by removal of regulations against exit and entry into industries, in which chaebols will lose their monopoly or oligopoly power.

Table 18: Different aspects of "Western" and "Korean" view of chaebols' reform

Item	"Western view"	"Korean view"
Source of growth:	• FDI, PME	• Modified chaebols and PME
Crisis cause:	• Chaebols – allowed for by the fact that government stopped performing its basic functions	• Developmental state decline • Mismanagement of financial liberalization • Failure of chaebols to meet the challenges of globalization
Hidden assumption	• Chaebols no more economically justified, their growth sources have been used up • Chaebols harmful and pathological by nature • Free market and free competition the best system for economy efficiency • Little government intervention desired	• Chaebols performed efficiently under given conditions • Chaebols' behavior was rational and justified • As an organization form, chaebols reflect unique market and cultural conditions and as such cannot be easily dismantled or eliminated from the economy without negative effects • In a modified way chaebols can continue to function profitably in Korean economy
Free market	• Regarded as basic ideal, necessary for successful functioning in the economy	• Can work in the long run, so far culturally difficult to be released, initiative difficulty
Free competition	• Desired as one of the basic principles of functioning market mechanism	• Needed to induce more efficiency in the system
Minority shareholders' rights	• Need to be promoted	• Need to be promoted
Management accountability	• Must be enhanced	• Must be enhanced
Capital adequacy ratio	• Successful, desired effect achieved	• Failure, ratio reduced artificially through accounting management
Leverage in chaebols' operations	• Bearing too much risk, must be decreased	• Does not necessarily have to be harmful, in Asian modes high leverage is traditional, also due to smaller proportion of equity financing
Staff-level offices	• Must be abolished, contribute to lack of transparency and go again free competition principle	• Are much needed for chaebols to operate efficiently and realize synergies through resource sharing
Family ownership and management	• Should be weakened, management must be professionalized and become accountable for their mistakes	• Should be weakened, management must be professionalized and become accountable for their mistakes
Major restructuring	• Absolutely necessary	• Not needed, moderate adjustments respecting traditional model are sufficient

Reference: Own writings of the author.

Transition from state-controlled economy toward free-market economy is possible due to less state intervention, based upon **second important assumption** – that **less**

government intervention is desirable and can bring more prosperity to Korean economy. In classical catching up model, chaebols represent a substitute to underdeveloped market and up to a certain point are helpful for the latecomer Korea to catch up with the forerunners. However, from a certain moment it becomes possible that the dominance of business groups deters the development of the market and thus they are no more desirable. As they suffer from rigidity and their size makes it difficult for them to be responsive enough to the changing environment, they become outdated and should cede their role to more flexible enterprises. The role of the government is to ensure conditions for smooth transition towards market-based economy, while keeping its supervisory and regulatory function. As chaebols are often considered a result of active market interference by the government and they are also believed to have caused the crisis, the fact that government stopped performing its crucial functions (esp. supervision and regulation) and had kept special relation and preferential attitudes toward chaebols is one of the crisis causes according to neoclassical model supporters. Consequently, it was demanded from the government by IMF and World Bank to withdraw from the economy, which happened much too quickly in comparison to other countries, leaving a lot of empty space without any systematic policies as substitutes. On the other hand, even after the crisis the government still tried to keep its control over chaebols both indirectly through financial sector as well as directly through e.g. Big Deal program.

In term of chaebols themselves, their corporate governance system was believed the biggest problem. The **third assumption** was made was about the **efficiency of corporate governance system and its measures**. As the Western view is based on separation of 3 types of power – executive, judiciary and legislative - the fact that in Korean chaebols separation of ownership from control did not exist was regarded as a major weakness. Agency problem along with lack of accountability stood behind many reforms trying to reduce moral hazard. This perspective also resulted in the effort to enhance shareholders' viewpoint and institutional and minority shareholders' rights.

Finally, several assumptions were made about the **functioning of the chaebols themselves**. High leverage and high degree of diversification were regarded as harmful by nature, along with homogeneous group culture inducing rigidity and inertia. It was believed that ineffectiveness of group-level strategy cancelled out any positive effects of group existence and overinvestment, excessive diversification, family dominance with all other negative aspect mentioned above resulted in rapidly declining competitiveness of chaebols in opening Korean economy.

V.2. "Korean view"

While in many areas even this approach holds the same viewpoint, in contrast to the previous attitude, it believes there are still reasons for the existence of chaebols. The **underlying assumption** is that **chaebols behaved rationally** during their development and that business group represents a response to its environment. Consequently, they reflect the circumstances which existed during their creation and later evolution and represented an efficient way of organizing economic resources in particular conditions. Thus, they are **not pathological by nature** and prove beneficial for economic development of a particular country.

Chaebols are not considered as the cause of the crisis, which is believed to be of structural as well as cyclical nature. The real causes of the crisis in this view are the decline of the developmental state without the existence of any institutions which could substitute its role, consequent mismanagement of financial liberalization (long-term capital flows were liberalized after short-term flows) as well as the failure of chaebols to fully meet the challenges of globalization. The view acknowledges the fact that the traditional Korean model has certain flaws but denies the statement that chaebols would be the main phenomenon responsible for the crisis. Moreover, it states that although Korean economy recovered relatively quickly after the reform measures were taken, the "causal nexus" between the reform and the recovery as well as between the crisis outburst and chaebols can be doubted. **Major mistakes in the crisis management happened due to the controversy between suggested measures and prevailing business ethics along with practice of industrial policy**. Risk involved in adjustment was underestimated and the measures were rather of "ad hoc" nature lacking systematic long-term strategy.

In terms of chaebols' generally alleged weaknesses, in this viewpoint it is argued that much criticized unrelated diversification was a tool of pursuing long-term profit maximization and should be understood as an effort to find future resources of profits. Due to lack of capital in Korea, it was only such a large corporation which could afford to make long-term investments or put significant resources in R&D or large-scale projects, thus, withdrawing liquidity from the corporate sector and banning intra-group transactions actually deprived chaebols of much needed capital resources. Moreover, imposing a debt-equity ratio, as mentioned before, meant further liquidity constraint and went not only against the interest of chaebols, but Korean economy itself, as there is no relevant substitute for chaebols' innovative and research role. Similarly, internal transactions elimination resulted in loss of synergies while abolishment of staff organizations made it much more difficult to manage the entire group. As a result, chaebol was made to assume role of a group consisting of smaller relatively independent firms focused on short-term profitability. Positive effects of horizontal and vertical integration were lost to a certain extent, while the reality in Korea was that vertical integration was necessitated by the absence of domestic supporting industries.

Some more reflections on the "Korean view"

Examining the factors lying behind the Korean view, we cannot but acknowledge that there are **risks and drawbacks** involved. For example, moral hazard risk certainly does exist. Looking back at traditional Confucian culture which is a major source of Korean business culture along with chaebol governance system (according to conventional theories on business groups, business groups such as chaebols are "socially and culturally embedded in the specific countries, where they operate[16]") it used to be the morality of the ruler or the person in change which represented a "**supervisory role**" and if the morality was broken rules "Mandate of Heaven" was taken away. As function of moral constraints no longer exists in this form, other **mechanisms of control** are needed as a substitute. However, such mechanisms were not sufficiently developed in Korea and resulted in **agency problem** and other moral hazard. So, even in "Korean view" enhancement of minority shareholders' rights and transparency of corporate governance is regarded as beneficial. In the same way, introduction of international accounting standards and appointment of outside directors is certainly considered a change for the better.

Nevertheless, as stated many times, reform itself was ill-conceived and represented huge transaction cost which were not balanced by the benefits (from the discussion above about the positive and negative outcomes of the crisis we already know reform

[16] Chang, Sea-Jin: Financial *Crisis and Transformation of Korean Business Groups: The Rise and Fall of Chaebol Business Groups*, New York, Cambridge University Press, 2003, 364 p., ISBN 0521814359, p. 30

results) and with a bit of courage it is possible to claim that Korean economy recovered not in response to the crisis treatment, but **despite the measures** which were taken. In many cases it happened due to the fact that a particular measure even worsened existing condition instead of any positive effect (e.g. debt-equity ratio). As a result, the reform addressed immediate crisis symptoms with short-term effect, while only long-term view based upon unique Korean reality could lead to sustainable growth in the long run.

The main reason for ill-management of the crisis was the fact that the connection between economic and social aspects was neglected. It is very naive to think that bringing Western patterns and principles to an Asian economy can work well enough, let alone without any time for adjustment. Moreover, although external forces such as globalization are driving economies towards convergence and harmonization of their corporate governance practices by various formal as well as informal institutes, underlying belief and values are not so easy to change. If we accept the view that "enterprise structure represents a situational adaptation of preexisting organizational forms to specific political and economic conditions[17]", chaebols are just a reflection of political and business culture in Korea and thus of deep-set values and attitudes, which cannot be changed over night.

V.3. Recommendations

Based upon the traditional model, complete and fundamental restructuring was not needed, but only modifications of traditional model would have sufficed to remedy the economy and chaebols. However, before proceeding to the specific measures, the main purpose of the reform must be stated. In my view the main issue of the reform

[17]Chang, Sea-Jin: Financial *Crisis and Transformation of Korean Business Groups: The Rise and Fall of Chaebol Business Groups*, New York, Cambridge University Press, 2003, 364 p., ISBN 0521814359, p. 80

should have been **structural adjustment** of Korean economy to help it **overcome not only the crisis, but the transitional period** before a liberalized free market economy system can be fully functional. It is also important to say that the **free market economy ideal in Korea** represents a **different quality of the system** in comparison to Europe or the USA. In other words, the main aim is to ensure that Korea becomes able to cope with the demands of internal as well as external pressures introduced through globalization, while it keeps some of its traditional features. To be able to do so, economic and business agents **must first be educated and taught** to understand and incorporate some foreign principles in their everyday life[18], which is a gradual process that takes time. For this purpose, a certain level of government intervention must be kept and would be higher than in case of liberal reform as required by the IMF, since (as mentioned above) the traditional control mechanism represented by morale and cultural constraints is no longer functional, while the new one has not developed yet. The new control mechanism needn't necessarily be the e.g. free market and its "invisible hand", but it may take any form which is going to be unique in the Korean context. Before such a system evolves, the role of the government cannot be easily done without for a certain time.

In the next lines, I am first going to state a specific problem as discussed above, followed by alternative suggestions as to what measures might have been taken to overcome it, while these suggestions comprise solely my own opinions and viewpoints. It is also necessary to state the list is not exhaustive and that I am going to focus on selected points only, as the reform is a very complex system, and in this paper they are chaebols which lie in the centre of the attention.

[18] In this place I would like to state that it does not mean blindly accepting anything coming from the abroad, rather, I perceive this change as the effort to blend the new and the traditional without directly contradicting each other. In Asian terminology it might be described through the analogy of yin and yang principles, which cannot exist without each other and constantly change mutual proportion while seeking balance and harmony.

1. Financial structure

In contrast to the reform, the **main flaw** of chaebols financial structure was not high leverage, but **debt structure** in my opinion. Thus, the crucial issues in this area were 1. **unfavorable time structure**, 2. **non-performing loans proportion**. As in my understanding the real purpose of the financial structure reform was to increase the efficiency of chaebols' capital flows along with balancing their capital needs with profitability, introduction of debt-equity ratio did not meet the purpose. High debt does not necessarily translate into lower efficiency of the business, while the risk caused by high leverage can be managed. Consequently, it might have been more effective to **set strict limits on non-performing loans** and **tie any loan provision to profitability** of a particular affiliate or group where the funds would go. Thus, risk involved in borrowing funds would be reduced through reduction of non-profitable businesses while efficiency would be enhanced by supporting profitable fields. The main problem of this approach is that the decision about fund provision would be made upon existing situation (tackling the time structure problem to a certain extent), which at the same time suppresses development of new industries or investment in R&D with long term investment return. This could be made up for by allowing for a certain ratio of funds to be used for these purposes instead of strictly controlling all capital. Such a provision would also solve the problem of the inability of financial institutions to evaluate realistically the risks involved in particular transactions, as I expect that the number and capital requirements of high-risk projects would exceed the available resources, and thus would have to be distributed upon competition principle. By allowing a higher debt proportion, chaebols would still be exposed to the risk of investors' decision to withdraw its capital. Nevertheless, as one of my other suggestions is that chaebols should have been **allowed to keep financial institutions ownership**, I suppose that the proportion of capital coming from different sources would be lower.

As for the financial institutions ownership, financial institutions owned by chaebols would be allowed by the laws to provide capital within their chaebol group only under the same criteria as independent institutions. To tackle the problem of corruption and the risk of power abuse, the same **transparency measures** (e.g. international accounting standards, reporting financial statements of the whole group etc., see III.3.) would be taken. By engaging such measures, I believe that post-crisis chaebols' credit crunch would have been released, while the financial structure of chaebols would have significantly improved and their risk-taking ability would have been preserved.

2. Efficiency problems and business structure

Problems with low business efficiency would have been partially solved by the above mentioned measures, as according to the scheme funds would automatically go to the more profitable fields. I share the opinion of reform creators that the number of fields should have been reduced for chaebols to **focus more on their core** activity, for which again the above mentioned scheme would represent one of the driving forces, as the less-profitable businesses would obtain fewer funds. But at the same time I do not think that obligatory business splits (e.g. Hyundai) should have been imposed or that a Big Deal program represented a solution to the problem of industry over-capacity; rather I fancy the idea of **using a financial sector as a tool** for chaebols control by the government. Thus, for a temporary period, government might have handicapped or favored certain industries through financial management similarly to the years before the crisis, but on much a smaller scale.

Closely tied to business structure is the issue of corporate governance and managerial methods. It is the feature of the American system to promote decentralization and low power distribution along with suppressing hierarchy and inequality. Based upon this ideal, chaebol decentralization was attempted, moving the decision making and power from group-level organizations towards affiliates and lower levels of management. However, as Korean culture is hierarchical with strong inequality existing among its members[19], classical hierarchical top-down decision making pattern is more natural. Nonetheless, as in the past power was distributed and manager were appointed according to seniority principle, kinship etc., I think that not the fact of **unequal power** distribution but **power distribution criteria** should have been changed. Thus, introduction of professionalized management along with the fact that the power became to be distributed and exercised through expertise, instead of other "merits" is in line with this statement.

The **capacity of chaebols to introduce and absorb modern and more flexible managerial methods** is given by the readiness of its **employees** to accept them. The fact that South Korea belongs among the countries with high uncertainly-avoidance index[20] and that hierarchy is one of social institutes employed to tackle uncertainty, represents the rationale to keep hierarchical structure in chaebol management and governance, while it should be released only gradually with increasing willingness of employees to face more uncertainly and their growing familiarity with especially post-modern managerial techniques, as they are brought by globalization.

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[19] Hofstede's Power Distance index standing at 60, see http://www.geert-hofstede.com/

[20] Hofstede's Uncertainty Avoidance index standing at 85, http://www.geert-hofstede.com/

3. Lack of transparency

As for the lack of transparency, the **same measures as mentioned above should have been taken** (See Chapter III, Lack of Transparency). Enhancement of minority shareholders' as well as institutional shareholders' rights, managerial accountability, introduction of new accounting standards and new systems of financial reporting were certainly beneficial and finally regarded as positive by any business agents touched by the reform. Management professionalization and appointing outside managers, which strengthened management accountability also helped to solve agency problem and moral hazard.

However, I do not agree with the abolishment of group level staff organizations and offices. As in my view, **chaebols can still function as a group**, corporate-level strategy requiring overall coordination supported by group-level management and cooperation is highly needed to preserve chaebols synergy effects. I agree that **intra-group transfer** should have been **limited**, but **not completely abandoned**. One of the ways how to enforce this limitation could have been allowing such kind of transfer only within the fields or affiliates with similar level of profitability indicators, making it more difficult for less profitable affiliates to obtain funds which they would not possibly get from financial institutions through intra-group transactions. On the other hand, certain level of flexibility making it possible to respond to e.g. geographical changes in demand for certain products or temporary supplier deficiency would be kept.

4. Chaebols-government-banks nexus

I also agree that **special ties** between chaebols and government and banks should have been **disrupted** and **preferential treatment** of chaebols should have been

abandoned. As the issue of banks would have been partially solved by management professionalization (see (3) above) and transparency enhancement along with introduction of profitability criteria for fund provision as in (1), another part of the problem lies in tackling the corruption, nepotism and favoritism on the side of the authorities, which lies beyond the scope of the paper.

Nevertheless, a serious issue falling in this category is the **monopoly or oligopoly power** of chaebols. By the above measures this problem might be slightly reduced but definitely not overcome as the monopoly (oligopoly) power of chaebols would stay. The rationale for this statement is as such. As the main purpose of the anti-monopoly and competition policy is to prevent the situation that other economic agents and mainly the consumer become much less powerful in relation to the producer, who limits their choice and sets the price independently off the market, the fact that chaebols would become more efficient would result in lower cost and less pressure on consumers' dead-weight cost. Thus, in microeconomic perspective, there would be more space for the producer, i.e. chaebol, to set a lower price. However, it would still keep its monopoly (oligopoly) power to set a higher price than the cost and normal profit. This situation means that the chaebol would have more space for their price decision, but could set the price as they wish. Again, the entry into particular industries needs to be enhanced, which can be done by standard competition policy tools such as setting limits on maximum market share, limiting M&As etc..

Summary

To summarize the main ideas it can be said that the major flaw of the reform was that risk-taking ability of Korean corporate subjects was significantly reduced. Links to the banks and government which had helped chaebols bear the entrepreneurial risk in the past were destroyed and no other agents were able to assume similar role. Thus, investment in large scale long-term projects was prevented. Consequently, the measures should not have immediately broken all ties and should have kept the possibility of cooperation between the state and financial institutions under strengthened control and supervision mechanisms. It is only good that more attention was paid to SME; nevertheless, it does not mean complete abolishment of chaebols. Rather, the government should have spent its energy on ensuring equal conditions for all economic agents and preparing mid-term and long-term adjustment schedule under which it would slowly diminish its role in the economy. As it has been proved that with government loosening restrictions of international trade and investment, business groups are subject to intense international competition, which threatens them and thus they become less viable, the government should have prepared programs to tackle the challenges which opening-up and globalizing the Korean economy would bring. Chaebols should have been more flexible, so corporate governance reform should have been started sooner, but the main goal should have been professionalization and rationalization of managerial techniques, rather that blind implementation of Western practices.

For the future, it is necessary that chaebols become more open and flexible as the international business environment is changing at ever growing speed. They should learn how to cooperate with foreign companies and realize benefits from increasing portion of FDI coming to Korea. At the same time, they should try to keep certain level of cooperation among their companies, as in many cases it is the only way to stay competitive face to face with large MNC. However, the danger of chaebols structure which still prevail despite all the reforms is rigidity, so chaebols should find ways how to be more responsive toward management techniques changes and how to support the initiative of employees at lower level of company hierarchy. Also, chaebols should pay more attention to their business structure. Although certain level of diversity helps them to tackle entrepreneurial risks, they should focus more on the core activities, as this helps to increase their operational responsiveness. Joint-ventures or other forms of international cooperation will ease technology transfer and presence in domestic market through international partner will help to realize the production in the area. As convergence is a reality in present world, chaebols should try to find ways how to gradually incorporate new company culture, ways of thinking and attitudes in their functioning, without violently and abruptly changing present techniques. Simply put, chaebols should try to keep their strengths, but overall they must become much more flexible and responsive if they are to succeed vis-à-vis globalized world economy.

VI. Conclusion

As stated in the goals mentioned in introduction, the paper discussed main features of chaebols as well as the role which they newly assumed in South Korea after 1997 IMF crisis. Their characteristics, strengths and weaknesses were analyzed in view of two different perspectives – Anglo-American and traditional Korean one. While according to Western perspective, chaebols and their flaws caused the 1997 IMF crisis and are regarded as pathological by nature, in Korean view, chaebols still retain their strengths which should be enhanced so that chaebols can continue to perform successfully in Korean business environment. As post-crisis reform was conducted under free-market doctrine, large portion of the measures which were taken were not efficient, since they focused on the alleged causes of the crisis instead of the real ones. Thus, the reform results were not as positive as they could have been and the reform put chaebols in a position, where they faced even more difficulties threatening their very existence. In this situation, economic recovery of Korea happened not thanks to but despite the reform. I believe that if the direction of the reform which was set after 1997 continues, it is going to have detrimental effects on Korean economy. Instead, the potential of chaebols should be exploited, while their functioning mechanism should be modified to make them more flexible and competitive in globalized economy under tightened supervision and enhanced transparency. As this organization form is still economically justified, it is not desirable that they be completely destroyed. Korea and Korean chaebols must find new ways how to face emerging challenges and realize benefits, which well functioning chaebols can bring without any doubt.

I hope that the paper has been helpful in explaining the role of chaebols in post-crisis liberalizing Korea and that it proves beneficial for people who want to know more about Korea and its business environment. It would only be a pity if chaebols were destroyed on the account of misunderstanding about their corporate governance mechanism implied by clash of two different ideologies. I hope that this will not happen and that despite their weaknesses chaebols will be given a change to exploit their strengths once again and thus contribute to Korea's future sustainable economic growth based on healthy combination of modern managerial as well as corporate governance system and Korean traditional cultural institutes which represent the real heart and wealth of Korea.

Appendix 1: Tables

Table 1: Proportion of Shares Controlled by Owners, 1983 – 1997 (%, 30 Biggest Chaebols)

	83	87	89	90	91	92	93	94	95	96	97
Owner (A)	-	-	-	-	-	-	4.1	4.2	4.9	4.8	3.7
Related (B)	-	-	-	-	-	-	6.2	5.5	5.6	5.5	4.8
A + B	17.2	15.8	14.7	13.7	13.9	12.6	10.3	9.7	10.5	10.3	8.5
Related Firms (C)	40.0	40.4	32.5	31.7	33.0	33.5	33.1	33.1	32.4	33.3	33.7

Reference: Lee, Kwon-In; Jwa Sung-Hee: *Korean Chaebol in Transition: Road Ahead and Agenda*, Korea, Korea Economic Research Institute, 2000, 451 p., ISBN 8980311826, p.425

Table 2: Proportion of Shares Controlled by Owners, 1983 – 1997 (%, 4 Biggest Chaebols)

	83	87	89	90	91	92	93	94	95	96	97
Hyundai	81.4	79.9	-	60.2	67.8	65.7	57.8	61.3	60.4	61.4	56.2
Samsung	59.5	56.5	-	51.4	53.2	58.3	52.9	48.9	49.3	49.0	46.7
Daewoo	70.6	56.2	-	49.1	50.4	48.8	46.9	42.4	41.4	41.7	38.3
LG	30.2	41.5	-	35.2	38.3	39.7	38.8	37.7	39.7	39.9	40.1

Reference: Lee, Kwon-In; Jwa Sung-Hee: *Korean Chaebol in Transition: Road Ahead and Agenda*, Korea, Korea Economic Research Institute, 2000, 451 p., ISBN 8980311826, p.425

Table 3: Number of Business Fields and Affiliates, 30 Biggest Chaebols, 1987-1997

Year	87	88	89	90	91	92	93	94	95	96	97
Mean Number of Business Fields	-	-	-	-	-	17.9	18.3	19.1	18.5	18.8	-
Total Number of Firms Belonging to the 30 Biggest Chaebols	501	516	531	573	593	608	604	616	623	669	821
Mean Number of Firms per Chaebol	16.7	17.2	17.7	19.1	19.8	20.3	20.1	20.5	20.8	22.3	27.4

Reference: Lee, Kwon-In; Jwa Sung-Hee: *Korean Chaebol in Transition: Road Ahead and Agenda*, Korea, Korea Economic Research Institute, 2000, 451 p., ISBN 8980311826, p.423

Table 4: Top 30 Chaebols Debt-Equity Ratio

(Unit: %)

1995		1996		1997		1998	
Chaebols	Debt/ Equity Ratio	*Chaebols*	Debt/ Equity Ratio	*Chaebols*	Debt/ Equity Ratio	*Chaebols*	Debt/ Equity Ratio
1. Hyundai	376.4	1. Hyundai	436.7	1. Hyundai	578.7	1. Hyundai	316.0
2. Samsung	205.8	2. Samsung	267.2	2. Samsung	370.9	2. Samsung	355.0
3. LG	312.8	3. LG	346.5	3. Daewoo	472.0	3. Daewoo	252.1
4. Daewoo	336.5	4. Daewoo	337.5	4. LG	505.8	4. LG	315.6
5. Sunkyung	343.3	5. Sunkyung	383.6	5. SK	468.0	5. Hanjin	458.3
6. Ssangyong	297.7	6. Ssangyong	409.4	6. Hanjin	907.8	6. SK	249.8
7. Hanjin	621.7	7. Hanjin	556.6	7. Ssangyong	399.7	7. Ssangyong	1,402.8
8. Kia	416.7	8. Kia	516.9	8. Hanwha	1,214.7	8. Kohap	impaired capital
9. Hanwha	620.4	9. Hanwha	751.4	9. Kumho	944.1	9. Hanwha	327.1
10. Lotte	175.5	10. Lotte	192.1	10. DongAh	359.9	10. Kumho	558.0
11. Kumho	464.4	11. Kumho	477.6	11. Lotte	216.5	11. DongAh	625.4
12. Doosan	622.1	12. Halla	2,065.7	12. Halla	impaired capital	12. Hyosung	281.2
13. Daelim	385.1	13. DongAh	354.7	13. Daelim	513.6	13. Daelim	335.8
14. Hanbo	674.9	14. Doosan	688.2	14. Doosan	590.3	14. Anam	8,550.7
15. DongAh Construction	321.5	15. Daelim	423.2	15. Hansol	399.9	15.Dongkuk Steel	198.8
16. Halla	2,855.3	16. Hansol	292.0	16. Hyosung	465.1	16. Doosan	331.7
17. Hyosung	315.1	17. Hyosung	370.0	17. Kohab	472.1	17. Shinho	impaired capital
18. Dongkuk Steel	190.2	18. Dongkuk Steel	218.5	18. Kolon	433.5	18. Hansol	458.7
19. Jinro	2,441.2	19. Jinro	3,764.6	19.Dongkuk Steel	323.8	19. Kabul	impaired capital
20. Kolon	328.1	20. Kolon	317.8	20. Dongbu	338.4	20. Dongbu	267.5
21. Tongyang	278.8	21. Kohab	590.5	21. Anam	1,498.5	21. Kolon	334.6
22. Hansol	313.3	22. Dongbu	261.8	22. Jinro	impaired capital	22. Jindo	impaired capital
23. Dongbu	328.3	23. Tongyang	307.8	23. Tongyang	404.3	23. Tongkook Co.	impaired capital
24. Kohab	572.0	24. Haitai	658.5	24. Haitai	1,501.3	24. Haitai	impaired capital
25. Haitai	506.1	25. New Core	1,225.6	25. Shinho	676.8	25. Woobang	impaired capital
26. Sammi	3,244.6	26. Anam	478.5	26. Daesang	647.9	26. Tongyang	306.0
27. Hanil	936.2	27. Hanil	576.8	27. New Core	1,784.1	27. Saehan	276.7
28. Kukdong Construction	471.2	28. Keopyong	347.6	28. Keopyong	438.1	28. Byucsan	655.4
29. New Core	924.0	29. Miwon	416.9	29. Kangwon Industrial	375.0	29. Shinwon	impaired capital
30. Byucksan	486.0	30. Shinho	490.9	30. Saehan	419.3	30. Kangwon Industrial	441.6
Total	347.5		386.5		519.0		369.1

Source: Fair Trade Commission.

Table 5: The Share of Chaebols in the Korean Economy (%, 1997)

	5 largest chaebols	30 largest chaebols
Value-added	8.48	13.05
Assets	29.22	46.25
Debts	29.79	47.94
Sales	32.29	45.86
Ordinary profit	-2.22 (46.11)	46.73 (46.09)
Employment	2.70	4.15

Reference: Shin, Jang-Sup: Restructuring Korea, Inc., New York, Routledge Curzon, 2003, 155 p., ISBN 0-415-27865-1, p. 32

Table 6: Major Components of the IMF Programme in Korea

Category	Sub-category	Contents
Retrenchment	Monetary policy	- increase call rates over 30% - reduce the M3 growth rate to 9% in Q1 of 1998 - allow 'cautious' reduction in call rates (the 4th MOU agreed on 7 Feb. 1998)
	Budgetary policy	- maintain a small budget surplus (the 1st MOU) - allow budget deficit up to 0.8% of GDP (the 4th MOU)
Market opening	Product market	- remove trade-related subsidies - import liberalization of remaining items - phase out the Import Diversification Programme
	Capital market	- abolish daily exchange rate band and limit intervention in the FX market - remove restrictions on foreign ownership of equities and real estates - full liberalization of the bond market - remove remaining restrictions on foreign borrowings by corporations and financial institutions
Four system reforms	Financial sector	- strengthening financial supervision - disposal of insolvent financial institutions and consolidation - partial deposit guarantee system - governance
	Corporate sector	- "Big deals – Table 10" - fair trade regulation - accounting standard - financial market discipline - internal governance
	Labor market	- introduce a legislation to make redundancy layoff easier - legalize 'dispatch labor' - introduce social safety net
	Public sector	- privatization of public enterprises - reduce government regulations drastically

Reference: Shin, Jang-Sup: Restructuring Korea, Inc., New York, Routledge Curzon, 2003, 155 p., ISBN 0-415-27865-1, p. 55

Table 7: System Changes in the Governance of Chaebols

Classification	Main contents
Fair trade regulation	1. Strengthening punishment on 'unfair' internal transactions 2. Revival of regulation on the amount of investing in related firms to 25% of net asset of a business group 3. Abolition of debt guarantee
Accounting standard	1. Introduction of consolidated financial statements 2. Obligation of establishing election committee for the assignment of outsider auditors for listed companies and affiliates of the chaebols
Financial market discipline	1. Regulation in bank loans: Debt-equity ratio 200% became a de facto limit in provision of loans Prohibition of new loans with guarantee by affiliated firms Establishing a system for constant assessment of corporate credit risk, including introduction of forward looking criteria (FLC) 2. Liberalization of M&A market: Permitting hostile takeovers Abolition of regulations on foreigners' shareholding
Internal governance	1. Outsider director system: One quarter of the board of directors should be outside directors 2. Responsibility of major shareholders: Registration of the controlling shareholder as the representative director of leading affiliates The removal of the 'Chairman's Office' 3. Right of minority shareholders: Loosening conditions for derivative suits, inspecting accounting books, and request for the dismissal of directors and auditors by shareholders Introduction of a cumulative voting system when appointing directors 4. Right of institutional investors: Allowing voting rights for shares in funds managed by investment trust companies and bank trust accounts

Reference: Shin, Jang-Sup: Restructuring Korea, Inc., New York, Routledge Curzon, 2003, 155 p., ISBN 0-415-27865-1, p. 95

Table 8: Share of Banks Owned by Top 30 *Chaebols* (As of the end of 1996, Unit: %)

Conglomerates	Ownership share
1. Hyundai	Korea First bank(2.20), Hanil bank(2.00), Seoul bank(1.99), Kangwon bank(11.89)
2. Samsung	Chohung bank(2.81), Commercial bank(7.03), Korea First bank(3.96), Hanil bank(4.76), Seoul bank(3.77), Korea exchange bank(1.05), Shinhan bank(3.36), KorAm bank(18.56), Hana bank(3.42), Peace bank(1.28), Daegu bank(5.65), Pusan bank(1.02), Kyonggi bank(1.57), Jeonbook bank(1.20), Kangwon bank(1.22), Kyung nam bank(2.38)
3. LG	Korea First bank(3.03), Hanil bank(2.47), Boram bank(7.58), Cheju bank(1.80)
4. Daewoo	KorAm bank(18.56)
5. SK	Kyonggi bank(3.42)
6. Ssangyong	Chohung bank(1.98), Korea exchang bank(1.04), Hana bank(1.52), Kookmin bank(1.96)
7. Hanjin	Kyonggi bank(5.63)
8. Kia	Korea First bank(1.04)
9. Hanwha	Chungchong bank(16.49)
10. Lotte	Pusan bank(23.93)
11. Kumho	Kwangju bank(7.87)
12. Doosan	Boram bank(11.34)
13. Daelim	Hanil bank(3.57)
14. Hanbo	
15. DongAh	Seoul bank(1.50), Cheju bank(2.31)
16. Halla	
17. Hyosung	Hana bank(5.16), Kyungnam bank(11.57)
18. Dongkuk Steel	Seoul bank(1.27), Pusan bank(3.85), Kyungnam bank(3.92)
19. Jinro	Hana bank(3.51)
20. Kolon	Boram bank(5.80)
21. Tongyang	Donghwa bank(1.03)
22. Hansol	
23. Dongbu	Cheju bank(1.06), Chungbuk bank(1.74)
24. Kohab	
25. Haitai	
26. Sammi	
27. Hanil	
28. Kukdong-Construction	
29. New Core	
30. Byucksan	

Reference: The Bank Supervisory Board

Table 9 Number of NBFIs Owned by Top 70 *Chaebols*[1)] (Unit: number of firms, the end of 1997)

	Top 5 *Chaebols*	Top 6-30 *Chaebols*	Top 31-70 *Chaebols*	Total
Merchant Bank (29)[2)]	3	7	4	14
Securities (26)	6	5	1	12
Investment Trust (24)	4	6	0	10
Life Insurance (31)	2	4	8	14
Fire & Marine Insurance(13)	2	3	0	5
Installment Credit (26)	2	7	3	12
Mutual Saving & Finance (219)	1	5	12	18
Venture Capital (56)	3	4	6	13
Credit Card (7)	3	1	0	4
Finance & Factoring (46)	3	4	5	12
Total (487)[3)]	29	46	39	114

Note:
1) The rank of *chaebols* is based on total borrowings.
2) The figure in the parentheses represents the total number of financial institutions at each financial sector.
3) Leasing companies are excluded as they are owned by banks.
Reference: National Information and Credit Evaluation Inc.

Table 10: Big Deals Among Chaebols

Industry	Government's plan	Implemented as of December 1999	Results as of December 2000
Semiconductors	LG Semiconductor and Hyundai Electronics merge into one company	Acquisition of LG Semiconductor by Hyundai Electronics was completed in July 1999	Due to the lost synergies and the plunge of price of DRAMs, Hyundai Electronics is technically bankrupt. The government asked banks to buy bonds issued by Hyundai Electronics.
Petrochemicals, aerospace	Affiliates of Hyundai, Daewoo, Samsung merge into one company	Aerospace businesses were combined into one in October 1999	The merged company kept making losses. The government provided 530 billion won aids in 2000. Petrochemical deal did no go through.
Railroad vehicle	Hyundai, Daewoo, Hanjin merge their operations	Hyundai, Daewoo, Hanjin merged their operations in October 1999	Labor unions of three companied oppose the postmerger integration process. Overcapacity problem did not ease. The government is seeking a buyer.
Power generation machinery	Samsung and Hyundai sell their business to Korea Heavy Industries	Korea Heavy Industries acquired Samsung and Hyundai's business	Doosan, the 12th largest chaebol, acquired Korea Heavy Industries.
Ship engines	Samsung sells its business to Korea Heavy Industries	Merged as planned	Making a profit. Doosan acquired Korea Heavy Industries.
Petroleum refinery	Hyundai acquires Hanwha Refinery	Hyundai acquired Hanwha Refinery in June 1999	Postacquisition integration has yet to take place.
Automobile Electronics	Daewoo acquires Samsung Motors. Samsung acquires Daewoo Electronics	Deal did not go through. Deal did not go through	

Reference: Chang, Sea-Jin: Financial Crisis and Transformation of Korean Business Groups: The Rise and Fall of Chaebol Business Groups, New York, Cambridge University Press, 2003, 364 p., ISBN 0521814359, p.207

Table 11: Overall Concentration in Manufacturing, 1970 – 1997

	Shipments		Employment	
	50 largest	100 largest	50 largest	100 largest
1970	17.8	28.7	15.4	22.8
1977	35.0	44.9	16.9	23.9
1982	36.9	46.2	16.4	22.2
1987	30.0	38.1	13.3	19.1
1992	31.9	39.2	13.8	18.3
1997	32.6	39.6	13.7	17.5
1998	40.2	47.8	17.4	21.0

Reference: Shin, Kwang-Shik: *Competition Policy and Corporate Restructuring in Korea,* Korea, Korea Development Institute, 42 p., 2001, p. 33

Table 12: Market Concentration of 5-digit Industries in Mining and Manufacturing

		81	86	91	95	96	97	98
CR_3	Simple average	62.3	58.3	52.5	47.8	46.3	46.9	50.6
	Weighted average	58.3	54.4	51.3	49.4	48.2	47.7	54.3
HHI	Simple average	258	238	193	171	162	165	192
	Weighted average	196	190	170	158	147	143	185

Reference: Shin, Kwang-Shik: *Competition Policy and Corporate Restructuring in Korea*, Korea, Korea Development Institute, 42 p., 2001, p. 33

Table 13: Changes of the 30 Largest Chaebols' Size and Structure 1987 – 1999

Year	1987	1993	1994	1995	1996	1997	1998	1999
Ratio of investments to net assets	43.9	28.0	26.8	26.3	24.8	27.5	29.8	32.1
Total assets (trillion won)	-	178.4	199.5	233.4	286.9	348.4	435.3	472.8
In-group ownership share	47.2	43.4	42.7	43.3	44.1	43.0	44.5	50.5
- family	14.7	10.3	9.7	10.5	10.3	8.5	7.9	5.4
- affiliates	32.5	33.1	33.1	32.8	33.8	34.5	36.6	45.2
Average no. of subsidiaries	16.4	20.1	20.5	20.8	22.3	27.2	26.8	22.9
Average no. of industries	-	18.3	19.1	18.5	18.8	19.8	20.0	19.6
No. of subsidiaries	509	604	616	623	669	819	804	686
Equity ratio	-	22.2	21.9	22.3	20,6	-	16.2	-
Debt/Equity	-	402.6	349.7	355.7	347.5	386.5	518.9	379.8
Total debt (trillion won)	-	137.0	148.5	174.9	216.1	269.9	357.4	367.0

Reference: Korea Fair Trade Commission

Table 14: Legal Action Against KFTC Decisions, 1981-1999

Year	81	85	87	88	89	90	91	92	93	94	95	96	97	98	99	Total
Total	1	1	1	3	2	1	4	3	4	6	9	7	22	31	64	159

Reference: Shin, Kwang-Shik: *Competition Policy and Corporate Restructuring in Korea*, Korea, Korea Development Institute, 42 p., 2001, p. 29

Table 15: Trend of Debt-equity Ratios of the 30 Largest Chaebols (%)

	1995	1996	1997	1998	1999	2000
5 largest	297.6	344.2	472.9	235.1	148.7	162.0
6-30 largest	435.1	460.8	616.8	497.1	498.5	186.0
total	347.5	386.5	512.8	379.8	218.7	171.2

Reference: Shin, Jang-Sup: Restructuring Korea, Inc., New York, Routledge Curzon, 2003, 155 p., ISBN 0-415-27865-1, p. 85

Table 16: Removal of Debt Guarantee in the 30 Largest Chaebols (trillion won)

	Apr. 1998	Apr. 1999	Dec. 1999	Mar. 2000
Loans with guarantee (trillion won, %)	26.9 (39.5%)	9.8 (9.7%)	4.3 (4.3%)	0 (0%)
Number of firms with debt guarantee	216	127	68	0

Reference: Shin, Jang-Sup: Restructuring Korea, Inc., New York, Routledge Curzon, 2003, 155 p., ISBN 0-415-27865-1, p. 96

Table 17: Basic Economic Indicators

Year	Growth rate	Private consumption (at 2000 constant prices, % change)	Unemployment rate	Labour Productivity (% change)	Current Account (mil USD)	Balance of Goods (Mil USD)	Capital and Fin. Account (Mil USD)	Ex (% of change)	Im (% of change)
1995	9.2	9.9			-8,665.1	-4,364.6	16,785.6	30.3	32.0
1996	7.0	6.7			-23,120.2	-15,077.1	23,326.8	3.7	11.3
1997	4.7	3.3			-8,287.4	-3,255.7	1,314.4	5.0	-3.8
1998	-6.9	-13.4			40,371.2	41,665.0	-3,196.7	-2.8	-35.5
1999	9.5	11.5			24,521.9	28,463.0	2,040.3	8.6	28.4
2000	8.5	8.4	4.4	4.1	12,250.8	16,953.6	12,110.0	19.9	34.0
2001	3.8	4.9	4.0	2.5	8,032.6	13,488.0	-3,390.8	-12.7	-12.1
2002	7.0	7.9	3.3	5.1	5,393.9	14,777.4	6,251.5	8.0	7.8
2003	3.1	-1.2	3.6	3.7	11,949.5	21,952.0	13,909.4	19.3	17.6
2004	4.7	-0.3	3.7	2.7	28,173.5	37,568.8	7,598.8	31.0	25.5
2005	4.2	3.6	3.7	3.8	14,980.9	32,683.1	4,756.5	12.0	16.4

Reference: OECD website

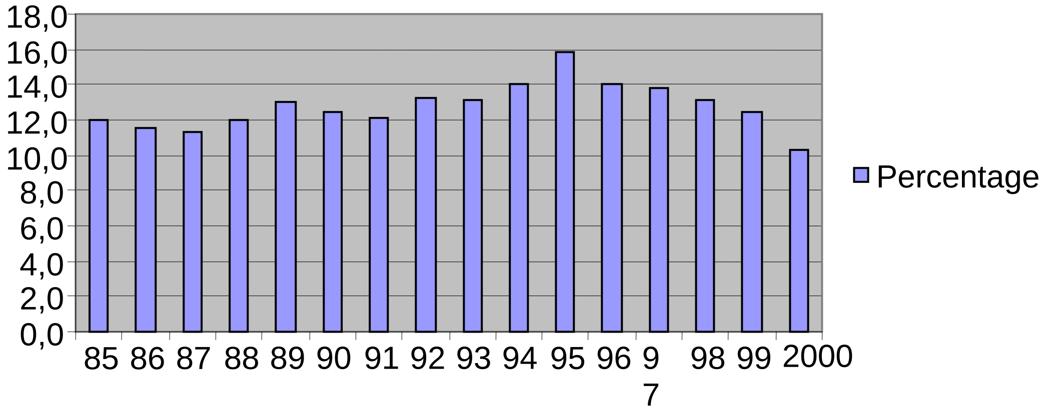
Table 18: Different Aspects of "Western" and "Korean" View of Chaebols' Reform

Item	"Western view"	"Korean view"
Source of growth:	• FDI, PME	• Modified chaebols and PME
Crisis cause:	• Chaebols – allowed for by the fact that government stopped performing its basic functions	• Developmental state decline • Mismanagement of financial liberalization • Failure of chaebols to meet the challenges of globalization
Hidden assumption	• Chaebols no more economically justified, their growth sources have been used up • Chaebols harmful and pathological by nature • Free market and free competition the best system for economy efficiency • Little government intervention desired	• Chaebols performed efficiently under given conditions • Chaebols' behavior was rational and justified • As an organization form, chaebols reflect unique market and cultural conditions and as such cannot be easily dismantled or eliminated from the economy without negative effects • In a modified way chaebols can continue to function profitably in Korean economy
Free market	• Regarded as basic ideal, necessary for successful functioning in the economy	• Can work in the long run, so far culturally difficult to be released, initiative difficulty
Free competition	• Desired as one of the basic principles of functioning market mechanism	• Needed to induce more efficiency in the system
Minority shareholders' rights	• Need to be promoted	• Need to be promoted
Management accountability	• Must be enhanced	• Must be enhanced
Capital adequacy ratio	• Successful, desired effect achieved	• Failure, ratio reduced artificially through accounting management
Leverage in chaebols' operations	• Bearing too much risk, must be decreased	• Does not necessarily have to be harmful, in Asian modes high leverage is traditional, also due to smaller proportion of equity financing
Staff-level offices	• Must be abolished, contribute to lack of transparency and go again free competition principle	• Are much needed for chaebols to operate efficiently and realize synergies through resource sharing
Family ownership and management	• Should be weakened, management must be professionalized and become accountable for their mistakes	• Should be weakened, management must be professionalized and become accountable for their mistakes
Major restructuring	• Absolutely necessary	• Not needed, moderate adjustments respecting traditional model are sufficient

Reference: Writer's own table.

Appendix 2: Charts

Chart 1: Shares of Korean GNP Held by 30 Biggest Chaebols, 1984 - 2000



Reference: Chang, Sea-Jin: *Financial Crisis and Transformation of Korean Business Groups: The Rise and Fall of Chaebol Business Groups*, New York, Cambridge University Press, 2003, 364 p., ISBN 0521814359, p. 11

Appendix 3: Quotations

Quotation 1:

"..the crisis of 1997 was due to this mismatch between changing the external environments and internal capabilities of both chaebols and the government. This mismatch was caused by inertia of both institutions. More fundamentally, these inertias were exacerbated by the lack of functioning governance systems during the economic transition."

Reference: Chang, Sea-Jin: Financial Crisis and Transformation of Korean Business Groups: The Rise and Fall of Chaebol Business Groups, New York, Cambridge University Press, 2003, 364 p., ISBN 0521814359, p.37

Quotation 2:

"In 1994-96, Korean conglomerates undertook an aggressive investment financed by large increases in borrowing from domestic banks, which, in turn, sharply increased short-term external borrowings. During 1997, an unprecedented number of highly leveraged conglomerates went into bankruptcy as the buildup in capacity proved unviable owing to the depreciation of the yen, a sharply adverse movement in Korea's terms of trade, and the slowing of domestic demand in 1996. The bankruptcies resulted in a severe deterioration in the balance sheets of Korean financial institutions."

Reference: IMF, Press Information Notice, 98/39, "IMF Concludes Article IV Consultation with Korea"

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