

Evaluating the Post-Crisis Corporate Restructuring in Korea

Ha-Joon Chang and Jang-Sup Shin ¹

This paper assesses Korea's corporate reform programme implemented after the financial crisis in 1997. After critically reviewing the economic analyses that informed the corporate reform programme, we look at the key corporate reform measures, especially those related to the *chaebols* in some detail. We look at the reduction in debt-equity ratio, the 'Big Deals,' the 'Workout Programme,' and the measures that are intended to improve corporate governance, such as the changes in fair trading regulation, accounting standards, financial regulation, and the internal governance system. We argue that, while the post-crisis reform programme has introduced some positive elements, it has been implemented at substantial costs and furthermore reduced the long-run dynamism of the economy by negatively affecting the corporate financing system.

Keywords: Corporate governance, Corporate finance,
Financial crisis

JEL Classifications: G2, G3, K2, L4

I. Introduction

Korea's 1997 financial crisis has led to a thorough restructuring of the country's traditional economic system, often known

*Faculty of Economics and Politics University of Cambridge, (E-mail) hjc1001@econ.cam.ac.uk; Assistant Professor, Department of Economics National Singapore University, (E-mail) ecssjs@nus.edu.sg, respectively. A revised version of the paper prepared for the Tenth Seoul Journal of Economics International Symposium on "The Socio-Economic Roles of Firms and Chaebols," Seoul August 29, 2002. This paper draws heavily on Jang-Sup Shin & Ha-Joon Chang, *Restructuring Korea Inc. – Financial Crisis, Corporate Reform, and Institutional Transition* (London, Routledge Curzon: 2003). We thank Se-Jin Chang, our commentator at the Symposium, for his helpful comments on the first draft of the paper.

[*Seoul Journal of Economics* 2002, Vol. 15, No. 2]

(somewhat misleadingly) as 'Korea Inc.'. This system was based on a close collaboration between the state, banks, and the *chaebols*, with the state as the dominant player. The post-crisis restructuring programme attempted to re-mould the system, at least at the formal level, into an essentially Anglo-American one based on a minimal state, arms'-length contractual relationships, and focus on short-term financial profitability.

What is notable about Korea's post-1997 restructuring programme is that, unlike in other IMF-led "market-oriented" reforms, the private corporate sector, especially the *chaebols*, was identified as the main target of reform. The *chaebols* were condemned as overly-diversified groups of inefficient firms surviving on low profit only because they can borrow more than what they deserve thanks to their collusion with the state and banks, and to 'unfair' intra-group transactions.

On the basis of such analysis, a 'broad' and 'deep' corporate reform programme was implemented. It was 'broad,' because the close links between the state, banks, and the *chaebols* that had existed meant that a radical corporate reform requires reforms in many other areas. It was 'deep' in the sense that it virtually dismantled the group structure of the *chaebols*, although it fell short of forcefully disbanding them. The measures included the ban on intra-group transactions, the imposition of a *de facto* numerical cap on debt-equity ratios, strengthening of minority shareholder rights, improvement in accounting transparency, introduction of outside directorship, and so on. It may be reasonable to say that the scale of the corporate reform implemented in Korea since 1997 is the largest in the world since the forceful break-up of Japanese and German firms by the Allied occupation forces after the Second World War.

In this paper, we assess Korea's post-crisis corporate reform programme and argue that, while it has introduced some important positive changes, on balance it is likely to reduce the dynamism of the corporate sector in the future. Then we argue that what the country needs is a "second-stage catching-up system" that reclaims some positive features of the old Korean economic system and combines them with the positive elements of the post-crisis reform.

II. A Critical Look at the Standard Analysis of the Role of the Corporate Sector in the 1997 Crisis

The IMF-sponsored reform programme implemented in Korea following the crisis was based on the perception that the crisis was caused by some deep-rooted structural features of the Korean economy. Often epitomised by terms like 'crony capitalism' and 'moral hazard,' these supposed structural features were regarded as having obstructed rational functioning of the economic system. Those who held this view, including the IMF, inevitably called for a 'fundamental' structural reform of the country.

However, on a closer look, this types of diagnosis is theoretically ill-grounded and lacks empirical supports (Furman and Stiglitz 1998; and Chang 2000). The resulting reform measures, especially the reform of the corporate sector, were consequently misguided. In the below, we examine two of the so-called "structural" causes of the Korean crisis that specifically relate to the corporate sector.

A. Peculiar Nature of the Corporate Sector

One of the most popular explanations of the Korean crisis is that the Korean economy got into the crisis because of the peculiar nature of its corporate sector. The most important in this argument is the high leverage combined with low profitability of the Korean firms, especially the *chaebols*, which is regarded as a sign that these are inefficient entities which are sustained only through persistent borrowing based on cross-loan guarantees among their affiliates and through continuous (and excessive) diversification into areas where they can drive out the existing firms through their superior financial power. It is also said that high leverage was preferred by the 'owning families' of the *chaebols* because they did not want the dilution of control that equity financing will entail.

However, this characterisation of the Korean corporate structure is questionable, and, even if it is correct, it is doubtful whether it can 'explain' the crisis.

First of all, it is not true that corporate leverage was uniquely high in Korea. The average debt-equity ratio of Korean firms, which historically moved in the range between 300% and 350%, is not exceptionally high by international standards. According to a World Bank study covering the period between 1980 and 1991 (Demigruc-

TABLE 1
CAPITAL STRUCTURE OF FIRMS IN SELECTED COUNTRIES (1980-91)

Countries	Debt-ratio	Long-term debt to total equity	Short-term debt to total equity	Depreciation to total assets	Dividend to total assets	Earnings to total assets
Australia	1.248	0.563	0.653	0.033	0.025	0.064
Austria	2.696	1.121	1.495	0.051	0.017	0.075
Belgium	2.023	0.764	1.259	0.039	0.022	0.092
Brazil	0.560	0.139	0.421	—	0.014	0.057
Canada	1.600	0.990	0.539	0.045	0.007	0.064
Finland	4.920	3.094	1.856	0.042	0.014	0.077
France	3.613	1.417	2.108	0.043	0.013	0.094
Germany	2.732	1.479	1.188	0.070	0.057	0.087
Hong Kong	1.322	0.309	0.967	0.017	0.019	0.121
India	2.700	0.763	1.937	0.038	0.014	0.132
Italy	3.068	1.114	1.954	0.041	0.070	0.080
Japan	3.688	0.938	2.726	0.026	0.007	0.067
Jordan	1.181	0.266	0.915	—	0.033	0.073
Korea	3.662	1.057	2.390	0.053	0.008	0.100
Malaysia	0.935	0.284	0.639	0.021	0.026	0.087
Mexico	0.817	0.375	0.442	—	—	0.076
Netherlands	2.156	0.710	1.297	0.043	0.020	0.094
New Zealand	1.527	0.752	0.776	0.030	0.025	0.106
Norway	5.375	3.495	1.880	0.049	0.009	0.092
Pakistan	2.953	0.595	2.358	0.038	0.028	0.115
Singapore	1.232	0.491	0.718	0.022	0.018	0.077
South Africa	1.115	0.597	0.518	0.013	0.062	0.206
Spain	2.746	1.086	1.649	0.040	0.016	0.095
Sweden	5.552	2.879	2.321	0.036	0.011	0.100
Switzerland	1.750	0.878	0.872	0.043	0.016	0.073
Thailand	2.215	0.518	1.769	0.030	0.029	0.129
Turkey	1.996	1.511	1.511	—	0.068	0.239
UK	1.480	1.065	1.065	0.032	0.025	0.025
USA	1.791	1.054	0.679	0.045	0.016	0.016
Zimbabwe	0.801	0.187	0.615	0.031	0.028	0.028

Sources: Chang and Park (2000). Calculated from the International Finance Corporation's Corporate Finance Data by Demigruc-Kunt and Maksimovic (1996, p. 354).

TABLE 2
GROSS SOURCES OF CORPORATE FINANCE IN SELECTED COUNTRIES (1970-89)
(%)

	Germany	Japan	UK	US	Korea*
Internal	62.4	40.0	60.4	62.7	29.0
Bank finance	18.0	34.5	23.3	14.7	18.9
Bonds	0.9	3.9	2.3	12.8	5.7
New equity	2.3	3.9	7.0	-4.9	13.4
Trade credit	1.8	15.6	1.9	8.8	n.a.
Capital transfer	6.6	n.a.	2.3	n.a.	n.a.
Other	8.0	2.1	2.9	5.9	n.a.

Note: * 1972-91

Sources: Chang and Park (1999). All figures other than those for Korea are from Corbett and Jenkinson (1994: 9).

Kunt and Maksimovic 1996), a key table from which is reproduced below (Table 1), the corporate sector debt-equity ratios of Japan (369%), France (361%) and Italy (307%) were similar to Korea's. The figures for Sweden (555%), Norway (538%), and Finland (492%) are even higher, at near or above 500%. The ratio for Japan in the 1970s was also around 500%.

Secondly, it is not clear whether high corporate leverage in itself is a bad thing. There is well-known and still-inconclusive debate in financial economics on the relative merits of equity financing and debt financing, with some people regarding debt financing as offering a more 'high-powered' incentive system (Harris and Raviv 1991; and Brennan 1995).

Third, the belief that the *chaebols* had high leverages because they eschewed equity financing is also not borne out by facts. The contribution of stocks in investment financing in Korea during the period of 1972-91 was at 13.4%, much higher than that in Germany (2.3%), Japan (3.9%), the UK (7.0%), or the USA (-4.9%) (Table 2). Korean corporations had large debts not because they eschewed stock financing, but only because they found even these large sums raised in the stock market insufficient for the aggressive investment strategy that they had pursued with impressive results.

TABLE 3
 STRUCTURE OF PROFIT IN THE MANUFACTURING SECTOR
 IN KOREA, JAPAN, THE USA AND TAIWAN
 (% , average during 1988-97)*

	Korea**	USA	Japan	Taiwan
Operating income to Sales	7.0 (7.1)	6.6	3.3	6.5
Ordinary income to Sales	2.1 (2.7)	4.2***	3.3	4.5
Financial expenses to Sales	5.6 (5.3)	n.a.	n.a.	2.1

Notes: * Taiwan's figures are for 1986-95

** Figures in parentheses are for 1986-95

*** Net profits

Sources: BOK website, BOK (2000), and Chang and Park (2000).

Fourth, whether the Korean firms actually suffered from low profitability, which allegedly led to the debt build-up, is also questionable. According to a study by Claessens *et al.* (1998), where they measure corporate profitability in terms of returns on assets, Korea indeed had the 44th lowest returns on assets among the sample of 46 countries. However, if we use other profitability measures, Korean corporate profitability has not been so exceptionally low. For example, when we use the criterion of 'operating profit,' that is the profit before paying financial expenses like interest payments, foreign exchange losses (gains) and so on, Korea actually had a higher rate of profit than the US, Japan, or Taiwan during 1988-97 (Table 3). Claessens *et al.* (1998, p. 7, Table 3) also confirm this observation. They show that the 'operational margin' (which is similar to the notion of operating profit)¹ of the Korean firms during 1988-96, at 19.6%, was higher than that in the USA

¹The notion of 'operational margin' used by Claessens *et al.* is defined as the difference between sales and the costs of goods sold as a share of sales. This is slightly different from the notion of 'operating profit' that we use, as it does not subtract selling and administrative expenses from the numerator. We think our measure is somewhat superior because the measure used by Claessens *et al.*, by not subtracting the selling and administrative expenses, does not fully reflect the managerial efficiency of the firm.

(14.4%) and Germany (14.6%), although it was lower than that in five of the eight other East Asian countries for which the figures were available (Japan, Indonesia, Taiwan, the Philippines, and Thailand; Hong Kong, Singapore, and Malaysia had lower figures).

Fifth, given this wildly different results that we get from the use of different profitability measures, it is not clear whether low profitability in itself can 'explain' the Korean crisis. For example, as we mentioned earlier, Korea had one of the lowest corporate profitabilities in the world if we use the return-on-assets criterion. However, by the very same profitability criterion, the other East Asian crisis economies had very *high* profitability. Thailand and Indonesia ranked the 1st and the 3rd, and Malaysia ranked the 8th (The 2nd was the Philippines, a semi-crisis country). According to this criterion, the other Asian-crisis economies should not have experienced any crisis.

Sixth, the thesis on excessive diversification of Korean *chaebols* also needs to be re-examined. The *chaebols*, especially the large ones, may have until recently owned 50-60 subsidiaries operating in dozens of different industries, but most of their sales revenues were generated by a few core firms. Between 1988 and 1995, the four largest subsidiaries of the top four *chaebols* generated an average of 79.0 % of their total sales. Especially in the case of Samsung, the four largest firms, two of which were in the same industry (electronics), alone accounted for about 90 % of sales - a striking concentration (rather than diversification) of activities given the number of its subsidiaries (55 as of 1995). The same can be said of the smaller *chaebols*, with the reliance on a small number of subsidiaries tending to increase as their size diminishes. For instance, in 1994, the *chaebols* that ranked between the 6th and the 10th generated 72.6% of their sales from the four largest subsidiaries. In the case of the *chaebols* that ranked between the 11th and the 20th, the three largest subsidiaries generated 72.1% of their sales, and in the case of the *chaebols* that ranked between the 21st and the 30th, as much as 72.3% of the sales were generated by the two largest subsidiaries.

B. The Logic of 'Too Big To Fail'

Many commentators have argued that the *chaebols* took excessive risk because they knew that they were 'too big to fail' (henceforth

TBTF) in the sense that the government cannot afford to sit and watch them go bankrupt for fear of large-scale 'ripple effects' such as large-scale unemployment and bankruptcy of subcontracting firms (*e.g.*, Yoo 1997; and Burton 1998). They cite the government rescue of some large firms in the past as the evidence that the logic of TBTF has been in operation in the country – the most frequently cited example being the nationalization of the bankrupt third-largest car manufacturer Kia in the build-up to the crisis.

At first, the logic of TBTF seems difficult to dismiss, especially given that it is indeed practised by all governments in all countries, including the ones that claim to be most market-oriented. The rescue of the US hedge fund, Long Term Capital Management (LTCM) following the 1999 Russian financial crises, is one prominent recent example, but the history of capitalism is littered with similar examples. In the late 1970s, the country's first right-wing government for over 50 years rescued the bankrupt Swedish shipbuilding industry through nationalization. In the early 1980s the avowedly free-market Reagan administration rescued the carmaker Chrysler from the brink of bankruptcy. To take the most extreme example, the Chilean government under General Augusto Pinochet, which did not hesitate to use violence to quell the opposition its neo-liberal policy, nationalised the entire banking sector in 1982, when the country experienced a severe financial crisis.

The biggest problem with the TBTF story is its conflation of the rescue of a firm and the rescue of its owners or managers who are responsible for making the rescue necessary. To the manager, it is not much of a consolation that his/her firm is saved by the government due to its large size, if the rescue operation involves the termination of his/her contract. So if a manager knows that he/she will lose the job when his/her firm performs badly, there is little incentive for him/her to take excessive risk. The same goes for the owners. If the owners know that the rescue operation requires ceding of their corporate control (as it has been almost always the case in Korea – see below), they cannot afford to be lax in management (in case they are owner-managers) or in supervising the hired managers.

In this sense, the rescue of LTCM, which did *not* involve the removal of the incumbent management (although its control was weakened due to debt-equity swaps), has definitely given a very bad

signal to the rest of the financial industry and will probably encourage excessive risk-taking (or 'moral hazard') in the future. On the other hand, the rescue of Kia, which involved a change in the top management, could not have sent such a signal to the managers of other large enterprises. In other words, whether government bail-out of some large firms encourages excessive risk-taking by the managers of other large firms depends on whether they are accompanied by punishments for bad management.

The evidence in the case of Korea is simply not on the side of the TBTF story. Especially in the 1960s and the 1970s, when the country was going through rapid structural changes, it was not infrequent to see even some of the largest *chaebols* going bankrupt and their carcasses being divided up through state-mediated take-overs. The second largest *chaebol* during the 1960s, Samho, had all but disappeared by the late 1970s after a series of bankruptcies of its core firms. The Gaepoong *chaebol*, which ranked between the 3rd and the 4th during the 1960s, virtually disappeared by the mid-1970 following a series of business failures. The Donglip *chaebol*, which ranked the 9th in the early 1960s, went bankrupt by the end of the decade. The owner of the once-largest car manufacturer in the country, Shinjin, was forced to sell it off to the state-owned Korea Development Bank (which subsequently sold it to Daewoo) in the late 1970s, when it got into trouble. Dongmyung, the *chaebol* built around what was the world's largest producer of plywood around the early 1970s, went bankrupt in 1980.

These are striking statistics. For example, the collapse of the three of the top-10 *chaebols* of the 1960s (namely, Samho, Gaepoong, and Donglip) is equivalent in American terms to the disappearance by the early 1980s of Standard Oil (New Jersey), Ford Motor, and IBM, which ranked the 2nd, the 3rd, and the 9th respectively in the *Fortune* US enterprise ranking in 1964. As a result, until the mid-1980s, there was a very high turnover even in the ranks of the top 10 *chaebols*. Only three of the top 10 *chaebol* in 1966 were among the 1974 top 10 and only five of the 1974 top 10 were in the 1980 top 10 (Chang 1994, p. 123).

After the mid-1980s, and especially in the 1990s, the ranking of the top 10 *chaebols* remained highly, if not completely, stable, but among the lesser *chaebols* there was still a high turnover. Between

1986 and 1996, among the 20 *chaebols* that ranked between the 11th and the 30th, there were on average 14 changes in the rankings and 2.2 new entries into the group every year (Park 1998, Table 9). Between 1990 and 1996 alone, three of the top 30 *chaebols* (Hanyang, Yoowon, and Woosung) went bankrupt, showing that there is no substance to the claims such as: "In Korea, none of the *chaebol* had been allowed to fail for a decade before Hanbo steel collapsed in early 1997" (Radelet and Sachs 1998, p. 42). In 1997, in the build-up to and at the beginning of the crisis, six of the top 30 *chaebols* (Kia, Halla, Jinro, Hanbo, Sammi, and Haitai) went bankrupt, again debunking the TBTF story (Chang *et al.* 1998).

Of course, all these are not to deny that the Korean government not infrequently injected money into ailing large enterprises through the state-owned banks (especially the development bank, Korea Development Bank). However, these financial injections were conditional, with very few exceptions, on the change of ownership and top management, and were always accompanied by tough terms of financial restructuring. In other words, the rescue of large enterprises by the Korean government should be seen as government-mediated take-over or restructuring rather than as bail-out in the strict sense (*a la* LTCM).²

In sum, whether government rescue of large ailing enterprises based on the logic of TBTF will lead to 'moral hazard' (in the form of excessive risk-taking) on the part of the managers of other large firms depends on the terms of the rescue, especially whether and how much the existing managers are made to pay for their mistakes (recall our distinction between the Kia and the LTCM types of government rescue). It is only when the managers of the bailed-out enterprises are not properly punished that the logic of TBTF works. There is no evidence that this logic was in operation in Korea to any meaningful degree.

²When the money involved in the rescue operation (*e.g.*, debt write-offs, tax exemption, and other direct and indirect subsidies) was considered too large, the government went for direct nationalization. The merger and subsequent nationalization of the four companies in the power-generating equipment industry in the early 1980s is the best example (for further details, see Chang (1993, pp. 148-9)).

III. Restructuring the *Chaebols*

The reform of the *chaebols* was the main thrust of the post-1997 corporate reform programme. The major benefit anticipated from the *chaebol* reform was the lowering of financial risks in the corporate sector, which in turn will lower the financial risks for the overall economy. In the longer run, it was also expected that the reform would help improve competitiveness of the Korean firms by improving their governance. However, these benefits are yet to materialise, and even if they do, they should be set against the costs generated by the same set of reform measures.

A. Reduction in Debt-Equity Ratio

The drastic reduction in corporate debt-equity ratio is often claimed to be one of the key achievements in the post-crisis corporate reform. Following the crisis, the five largest *chaebols* were mandated to lower their debt ratios, which stood at 473% on average at the end of 1997, to below 200% by the end of 1999. They “over-achieved” the target by reducing it to 235% in 1998 and to 148.9% in 1999. The ratio for the 30 largest *chaebols* also went below 200% in 2000 (Table 4). The debt-equity ratio of the manufacturing sector as a whole consequently fell from 396% in 1997 to 214% in 1999 and to 210.5% in 2000, the lowest since 1968.

Unfortunately, this drastic fall in debt-equity ratios has *not* really been translated into a lowering of financial risks in the corporate sector. To begin with, the reduction in debt-equity ratio did not lead to a corresponding reduction in interest payments. In 1999, financial expenses to sales in the manufacturing sector fell from 9% in 1998 to 6.9% – an apparently significant reduction. However, the 1999 figure was still higher than the figure in 1997 (6.4%), the year when the financial crisis broke out, as well as the average figure during 1990-7 (5.8%). This was because Korean companies reduced their debt-equity ratios mainly through new stock issue, asset sales, and asset revaluation, rather than through repayment of their debts. The amount of total debt in the manufacturing sector in fact slightly increased from 389.6 trillion won (\$324 billion) in 1998 to 391.2 trillion won in 1999 (BOK 1999a, p. 2000).

TABLE 4
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

Notes: Figures at the end of the year. Financial affiliates are excluded.

Source: FTC website.

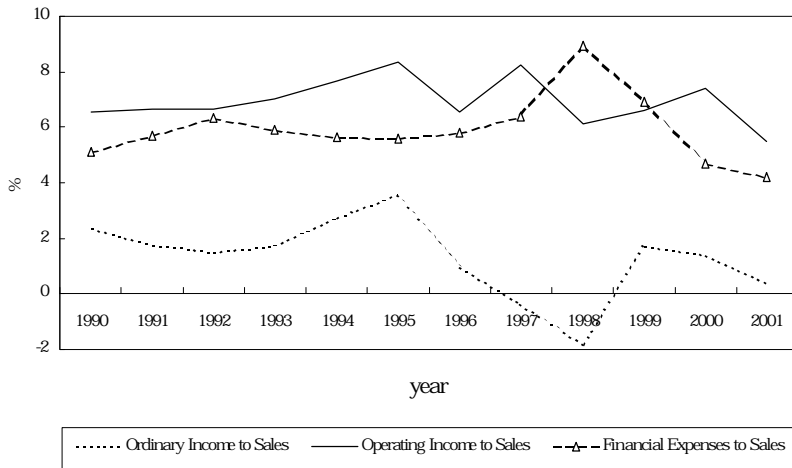
The 'financial engineering' that was involved in this process has brought about, on the whole, few benefits. Of the three key measures that the Korean companies used in order to reduce their debt-equity ratios, asset sales contributed to improving profitability of the manufacturing sector by around 1% point in 1999 (BOK 2000, p. 16).³ However, this gain was nearly cancelled out by the costs incurred in asset revaluation, which was another major method taken by the *chaebols* to reduce their debt-equity ratios.⁴

Exactly because it was achieved in these 'wrong' ways, the reduction in debt-equity ratios did not raise the traditionally low profitability of Korean corporations, which was ultimately why the reform measures were being implemented.

The ratio of ordinary income to sales (ordinary profit rate) for the manufacturing sector recovered to 1.68% in 1999, from negative figures in 1997 and 1998, but it slipped again to 1.29% in 2000 and further to 0.4% in 2001. The average ordinary profit rate for the two years of vigorous economic recovery in 1999 and 2000 was only around half of the historical average before the financial crisis (2.8% during 1973-96). If we include the figure for 2001, the year

³The BOK estimated that the extraordinary income in the manufacturing sector, which it said came mainly from asset sales, amounted to 1.0% of total sales, i.e., 4.6 trillion won (US\$ 4 billion) in 1999.

⁴The Korean government did not allow revaluation of corporate assets from 1981 for fear that the *chaebols* might leverage on it for speculation in real estates. Once the debt level became a critical issue, the *chaebols* persuaded the government to allow revaluation of their assets to get a fair valuation of their financial status since the denominator, the value of their debt, was varying with price movements while the numerator, the value of their equity, was fixed in accounting.



Source: BOK Website.

FIGURE 1

TREND OF PROFITABILITY IN THE MANUFACTURING SECTOR IN KOREA

of sharp economic slowdown, the average is even worse at 1.12%. The corporate sector with 'high debt plus thin profit margin' has been transformed into something possibly even worse – namely, one with '*lower debt plus even thinner profit margin*' (Figure 1).

Moreover, there was no improvement in operating profit or sales, which in our view are better measures of corporate competitiveness than ordinary profit. In fact, their post-crisis figures show deterioration. The ratio of operating income to sales (operating profit rate) for the three years of recovery was 6.5% on average – lower than the 7.2% average for 1990-97.

These profit rate figures are even worse than what they may appear at first sight, when we consider that the denominator (sales) was not growing during this period as fast as it used to. Sales growth rate in the manufacturing sector in 1999 and 2000, the years of sharp macroeconomic turnaround, was 11.6% on average, much lower than the average during 1990-97, which was 14.5%. The average sales growth rate during the three post-crisis years

(1999-2001) was only 8.3% on average (the sales growth rate in 2002 was only 1.7% – the lowest since 1961, except for 1998, when it was 0.7%).

If the benefits of the radical, policy-driven reduction in debt-equity ratio are difficult to find, if not non-existent, its costs were significant.

Above all, companies with high debts were categorically regarded as non-viable ones regardless of their short-term efficiency or long-term prospects. Financial institutions, facing stiffer supervision standards and preoccupied with their own survival, called in or stopped rolling over their loans to those companies with high debt-equity ratios, driving them into bankruptcy (more on this later). This was a major reason why credit crunch in the Korean financial market persisted well into 2000, when the interest rate was at a historically low level.⁵

The debt-equity ratio reduction policy also drove the Korean firms to sell their assets at bargain prices. Although what exactly constitutes a bargain price can be debated, considering the asymmetry of negotiating power between sellers and buyers in times of financial crisis, it seems reasonable to suppose that those assets they sold were mostly sold at heavily discounted prices.

B. The 'Big Deals' and the 'Workout Programme'

In dealing with *ex post* adjustments of industrial capacity and financial problems, the Korean government adopted different approaches between the five largest *chaebols* and the smaller ones. For the five largest *chaebols*, which were regarded as having sufficient financial and managerial resources for restructuring by themselves, the government 'encouraged' the 'Big Deals,' that is, business swaps among the *chaebols* in industries with over-capacity. For the 6th to the 30th largest *chaebols*, who were considered too weak to restructure by themselves, the government devised the 'workout programme,' a bank-sponsored restructuring process. In July 1998, it was announced that eight major business sectors that include 17 companies of the five *chaebols* were going

⁵Thus seen, a large part of build-up of non-performing loans (NPLs) after the crisis was due less to the inherent inefficiencies of the Korean corporate sector than to an abrupt change in financial environment in a way that excessively punished high debt.

to be subject to the big deals. One hundred companies were also put under the workout programme.⁶

Unfortunately, these programmes have not been very successful. Among the eight big deals proposed, none proceeded in the form of business swaps. Most of them ended up as one-sided take-overs or as simple mergers. Even worse, some proposed deals were simply not made. Also, among those deals concluded, many projects do not yet show signs of turnaround.

Likewise, despite a substantial debt restructuring, large portion of the 'workout' companies have not been turned around yet. Creditor banks rescheduled 86 trillion won of debts and newly provided 4.5 trillion won in fresh money to these companies by May 2000. Of the 100 companies selected for the workout programme, however, 29 companies went bankrupt and 35 companies were still under the programme as of June 2001. 36 companies that 'graduated' from the programme are mostly small and medium-sized enterprises (MOFE 2001; and SERI 2001).

One achievement of the Big Deal Programme and the workout programme has been to reduce the number of affiliates in the *chaebol* groups, thus possibly reducing their 'excessive' diversification. The average number of businesses run by the five largest *chaebols* was reduced from 30.0 in 1997 to 23.2 in April 2001. The total number of affiliates of the 30 largest *chaebols* also fell by 22.3%, from 804 in April 1998 to 624 in April 2001 (MOFE 2001).

Was this a good thing? Apart from the fact that the number of affiliates *per se* does not necessarily indicate the degree of diversification (see section II.B above), there is no empirical evidence that diversification of the *chaebols* had been a negative thing. To be sure, there have been some corporate failures due to ill-managed diversifications such as the cases of the Kia Group or the Hanbo Group. However, the diversified business structure provided the *chaebols* with a better ability to spread risk. The point is that there are both pros and cons for business diversification, and there is no such thing as 'optimal' degree of diversification that fits all business groups. And therefore reduction in diversification in itself cannot be judged positive or negative.

⁶The programme soon expanded to smaller conglomerates and medium-sized companies, and later included the 12 Daewoo affiliates after the group became technically bankrupt in August 1999 (MOFE 2001; and SERI 2001).

C. Reforming the Governance of the Chaebols

If the radical reduction of debt-equity ratios, the big deals, and the workout programme were intended to deal with the symptoms of the *chaebol* structure, there were also attempts to change the very structure that was supposed to have caused these symptoms. Towards this aim, far-reaching changes have been made in relation to fair trading regulation, accounting, financial institutions, mergers and acquisitions, and internal corporate governance. Table 5 provides a summary of these measures.

a) Fair Trading Regulation

A major strength of business groups like the *chaebols* lies in their ability to make internal resource transfers *at prices designated by the centralised decision-making authority within the group*. Accepting this logic, before the financial crisis, the Fair Trading Commission (FTC) in Korea focused on restraining the concentration of economic power by the *chaebols* without denying the desirability of business grouping itself. As a result, it was lenient in regulating internal transactions among affiliates of the *chaebols*, although its attitude slowly but continuously hardened since the early 1980s.

However, the post-crisis corporate reform was carried out on the assumption that transactions among *chaebol* affiliates that do not use market prices are 'unfair' tradings. Consequently, in the three years during 1998-2000, the FTC embarked on unprecedented investigations on 'unfair internal transactions' by the *chaebols*, and levied 234.3 billion won (US\$ 195.2 million) of fines on the 30 largest *chaebols*, most of which was on the five largest *chaebols*.⁷

Another pillar of intra-*chaebol* transaction, *i.e.*, debt guarantee among affiliates, was also completely abolished. Debt guarantee was singled out as an important factor that allowed 'unfair' expansion of the *chaebols*. It was also seen as increasing financial vulnerability at the group level, as it can lead to 'chain bankruptcy.' Thus, the abolition of debt guarantee was undertaken not only as a fair trading regulation but also as a measure to strengthen financial market discipline over the *chaebols*. The size of debt guarantee of

⁷During this period, the FTC conducted four investigations on the largest 5 *chaebols* and one investigation on other 6-30 largest *chaebols*, and imposed 216.2 billion won of fines on the former and 18.1 billion won on the latter (FTC website).

TABLE 5
SYSTEM CHANGES IN GOVERNANCE OF THE *CHAEBOLS*

Classification	Main contents
Fair trade regulation	<ol style="list-style-type: none"> 1. Strengthening punishment on 'unfair' internal transactions 2. Revival of regulation on the amount of investing in related firms to 25% of net assets of a business group 3. Abolition of debt guarantee
Accounting standard	<ol style="list-style-type: none"> 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 <i>chaebols</i>
Financial market discipline	<ol style="list-style-type: none"> 1. Regulations in banks loans <ul style="list-style-type: none"> - Debt-equity ratio 200% became a <i>de facto</i> limit in the 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. Liberalisation of the M&A market <ul style="list-style-type: none"> - Permitting hostile takeovers - Abolition of regulations on foreigners' shareholding
Internal governance	<ol style="list-style-type: none"> 1. Outsider director system <ul style="list-style-type: none"> - At least 1/4 of the board of directors should be outside directors 2. Responsibility of major shareholders <ul style="list-style-type: none"> - Registration of the controlling shareholder as the representative director of leading affiliates - Removal of the 'Chairman's Office' 3. Right of minority shareholders <ul style="list-style-type: none"> - 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 <ul style="list-style-type: none"> - Allowing voting rights for shares in funds managed by investment trust companies and bank trust accounts

Sources: MOFE website, and SERI (2001).

TABLE 6

REMOVAL OF DEBT GUARANTEE IN THE 30 LARGEST *CHAEBOLS* (trillion won)

	Apr. 1998	Apr. 1999	Dec. 1999	Mar. 2000
Loans with guarantee	26.9 (39.5%)	9.8 (9.7%)	4.3 (4.3%)	0.0 (0.0%)
Number of firms with debt guarantee	216	127	68	0

Source: FTC website.

the 30 largest *chaebols* stood at 26.9 trillion won as of April 1998, an amount equivalent to 39.5% of their total loans at the time. Under the joint pressure from the FTC and the Financial Supervisory Commission (FSC), this was reduced to 9.8 trillion won by April 1999 and became nil at the end of March 2000 (Table 6).

b) Accounting Standards

As a measure to increase transparency and thereby accountability of the *chaebols*, the Korean government revised the corporate audit law and made it compulsory for the 30 largest *chaebols* to produce 'consolidated financial statements,' that is, accounts for the business group as a whole, and not just for the individual affiliates.

With the introduction of the consolidated financial statement, it has become possible for the outsiders to see the 'true' financial situation of a business group (including the sizes of internal transactions and of interlocked shareholding), which used to be 'insider' knowledge. As a result, it has become impossible for the *chaebols* to inflate the value of their sales and assets through internal transactions and 'circular' or 'roundabout' holding of shares, which was a typical way of overcoming lack of financial resources.

Apart from the introduction of the consolidated financial statement, the Korean government has also made it obligatory for the *chaebol* affiliates and all listed companies to establish an election committee for the appointment of outside auditors in order to ensure the objectivity of the auditing process.

TABLE 7

MAJOR MEASURES TAKEN FOR RESTRUCTURING THE FINANCIAL SECTOR

Classification	Main contents
Strengthening Financial Supervision	<ol style="list-style-type: none"> 1. Established Financial Supervisory Commission in April 1998 2. BIS ratio strictly applied as a deciding indicator of soundness of financial institutions (8% for commercial banks and 4% for small financial institutions) along with introduction of prompt corrective action measures 3. Introducing forward looking criteria (FLC), conforming to 'global standards,' in December 1999
Disposal of Insolvent Financial Institutions and Consolidation	<ol style="list-style-type: none"> 1. Disposal of 572 ailing financial institutions by end-April, 2001 (27.2 % of total financial institutions in existence at the end of 1997). 2. Injecting 137 trillion won of public funds into the sector. 3. Consolidated four commercial banks and one merchant bank into the Woori Financial Holding Company.
Partial Deposit Guarantee System	<ol style="list-style-type: none"> 1. Changed the previous Full Deposit Guarantee System into a Partial Deposit Guarantee System (When a financial institution enters bankruptcy, only up to 50 million won of deposits is guaranteed).
Governance	<ol style="list-style-type: none"> 1. Introduction of outsider director system 2. Introduction of a committee for recommending appointment of bank presidents. 3. Credit is assessed by an independent credit assessment committee

Source: MOFE website.

c) Regulation of the *Chaebols* through Financial Regulation

Since the accumulation of non-performing loans (NPLs) in the financial sector was an immediate cause of the financial crisis, the restructuring of the financial sector itself was a major item in the reform agenda. The financial sector therefore underwent the biggest re-organisation in its history. The details of the financial sector restructuring programme are set out in Table 7.

As a result of this programme, 572 ailing financial institutions (27.2% of total financial institutions in existence at the end of

1997) were closed down and several major commercial banks were nationalised as they were recapitalised with public money (see table 7). Other financial institutions that survived the financial crisis have undergone or are undergoing voluntary or government-induced merger and acquisitions (M&As). In addition, the Financial Supervisory Commission (FSC) was established as a comprehensive financial watchdog, functions of which had been previously divided between the Bank of Korea and the Ministry of Finance and Economy. Financial supervision standards were also significantly strengthened.

What is notable is that many financial reform measures were designed in close coordination with the corporate reform programme, because the NPLs after all came mostly from the corporate sector. For instance, the prohibition of loan guarantee among *chaebol* affiliates was not simply a change in financial supervision criteria but also a change in fair trading regulations over the *chaebols*. New financial supervision criteria, such as the forward-looking criteria (FLC), were introduced at the end of 1999 as a way of restraining possible over-investment by the corporate sector. Under the previous standard, financial institutions were required to set aside provisions only against those loans on which interests are not actually paid.⁸ But the FLC require that financial institutions set aside provisions against the loans even though interests on which are regularly paid, if borrowers' management conditions, financial status, future cash flow and so on are regarded inadequate. In judging a borrower's future business prospect, corporate debt-equity ratio is again seen as one of the key considerations (FSC 2000).

Moreover, other financial reform measures that are not directly related to the corporate reform programme, such as the strict application of the BIS minimum capital adequacy standard (the so-called BIS ratio), also have had significant indirect impact on the corporate sector.

For instance, the Korean government instituted a system to automatically force liquidation or merger of financial institutions

⁸With the introduction of the FLC, the very definition of NPLs itself became more stringent. Now loans are to be automatically classified as NPLs if borrowers do not pay full interests for 3 months. The period was 6 months under the previous regulation standard.

when they do not maintain the BIS ratio. Given this, financial institutions came to reduce, or even altogether stop, corporate lending, even when it was evident that a further provision of loans to the corporate sector at the expense of lowering BIS ratio in the short run will increase their profits and soundness in the long run (more on this in section IV). This, in turn, has substantially increased the need for corporations to maintain a higher level of liquidity, reducing the volume of financial resources available for long-term investment.

It seems to us that one of the most serious problems arising from applying rigid criteria of financial regulation, such as those relating to the BIS ratio or the corporate debt-equity ratio, lies in their pro-cyclical nature. In a recession, an increase in bankruptcy and fall in asset prices shrinks the asset base of the financial institutions, which induces them to withdraw their loans from the corporate sector, in order to meet the BIS standard, which makes the recession even worse. Also, in a recession, firms need to increase their borrowing in order to maintain their cash flows, as their sales decrease and raising money through stock issuance becomes difficult. However, the debt-equity ratio regulation precludes the possibility to ride out a short-term liquidity problem by increasing debts. Indeed, we believe that this pro-cyclical nature of the new financial regulations is behind the prolonged credit crunch during the period of crisis, as we shall elaborate later (section IV).

d) Liberalisation of the Mergers & Acquisitions (M&A)

Another element in the corporate reform programme was to institute a fuller liberalisation of the M&A market, which was supposed to introduce harsher discipline on the corporate sector. The Korean government removed the acquirer's obligatory tender offer of shares up to 51% of total shares outstanding and abolished restrictions on the total amount of shareholdings a company can have in other companies, which used to be powerful obstacles to hostile takeovers. Abolition of the regulations on foreigners' shareholding of domestic companies also meant that the M&A market was now fully open to the foreigners.

Although the M&A market was liberalised, hostile M&As are rare as yet. This is partly because hostile M&As are still frowned upon by the majority of the population, but also because domestic institutional investors, who would be the main players in the M&A

market, are still cautious about their participation. Legally, however, there are no obstacles to hostile M&A, and it may only be a matter of time that the M&A market becomes active (although this is not a foregone conclusion). And knowing this, the 30 largest *chaebols* increased their internal shareholding from 43.2% in 1997 to 50.5% in 1999 (FTC website) in order to safeguard themselves against hostile takeovers, despite the fact that this was a period of severe liquidity constraints and therefore that such move would cost them dearly.

e) Internal Governance Reforms

Internal governance reforms were directed at improving the managerial transparency and accountability of the *chaebol* owners.

First, the 'Chairman's Office,' which had been the nerve centre of co-ordination within the *chaebols*, was abolished. At the same time, legal responsibility of the *chaebol* owners was strengthened, as they were forced to register themselves as representative directors of their leading affiliate firms, which makes them liable for public prosecution and civil lawsuit for managerial misconduct.

Second, the government revised the commercial law to make it obligatory for listed companies to appoint at least one quarter of directors from outside the firm. People who share interests with major shareholders were also banned from being elected as outside directors.

Third, the rights of institutional investors were significantly enhanced. Investment trust companies and bank trust accounts were given voting rights. Although institutional investors are required to get approval from the FTC when they are involved in takeover activities, they have come to acquire almost all the rights of other shareholders.

Fourth, the rights of minority shareholders were strengthened. The minimum proportion of shares that are required in bringing a lawsuit against misconduct of managers was reduced from 1% to 0.01%. The minimum requirements for inspecting the accounting books were also weakened from 3% to 1% of shareholdings (0.5% in case of listed companies with more than 100 billion won worth of equity capital). A cumulative voting system was also introduced in order to make it easier for the minority shareholders to appoint board members representing their collective interest.⁹

IV. Assessing the Governance Reform Programme

There are certainly some positive aspects in the governance reform programme implemented since 1998. For instance, the strengthening of regulations on auditing and accounting is important in providing concerned parties with objective and reliable performance indicators of companies, especially when the number of concerned parties becomes large as companies diversify and broaden their sources of finance. In the same vein, it is desirable to strengthen the rights of minority shareholders to defend their interests from possible neglect from the managers, who tend to cater for the interests of major shareholders. However, other measures in the programme have had negative effects on the national economy.

In the short run, many reform measures created, or at least intensified, a credit crunch because they made it necessary for the corporate sector to maintain a higher level of liquidity and for the financial sector to withdraw liquidity from the corporate sector. This, in turn, increased non-performing loans in the economy and consequently the public burden for adjustment after the crisis.

In the long run, the governance reforms put the *chaebols* under serious constraints in operating as business groups, especially through the ban on internal transactions. To be sure, there can be negative effects of internal transactions, but they also have positive effects. Previously, internal transaction was a major source of the *chaebol's* strength in supporting new large-scale ventures, as evidenced by Samsung's entry into the semiconductor industry or Hyundai's entry into the shipbuilding industry. Coupled with the stringent regulation on corporate debt-equity ratio, the restriction on internal transaction has substantially reduced financing options for the *chaebols*.¹⁰

⁹This system lets shareholders to vote on *all of the directorships*, not on individual directorship separately. In a system where shareholders vote on individual directorship, minority shareholders cannot win any single directorship against majority shareholders. However, in the cumulative system, they can concentrate their votes on one or a few directors and elect their own candidates.

¹⁰Regarding this, a leading businessman in Korea, in an interview with one of the authors in August 2000, said the following: "It has been possible for major *chaebols* to mobilise a large amount of investment funds through

TABLE 8
EXTERNAL FINANCING OF THE CORPORATE SECTOR (billion won)

	1996	1997	1998	1999	2000	2001
Total	118,769	118,022	27,664	51,755	66,531	51,939
Indirect Financing	33,231	43,375	-15,862	2,198	11,391	1,185
From Banks	16,676	15,184	259	15,525	23,348	3,381
From NBFIs	16,555	28,191	-16,550	-13,267	-11,997	-2,377
Direct Financing	56,097	44,087	49,496	24,792	18,996	36,838
CPs	20,737	4,421	-11,678	-16,116	-1,133	4,210
Stocks	12,981	8,974	13,515	41,137	20,806	16,504
CBs	21,213	27,460	45,907	-2,827	-2,108	11,761
Foreign borrowing	12,383	6,563	-9,809	11,537	15,765	2,283
Others	17,059	23,997	3,839	13,228	20,380	11,633

Notes: CP is corporate paper. CB is corporate bond. Others include corporate loans, government loans and so on.

Source: Flow of Funds, BOK Website.

As Table 8 shows, a remarkable trend in corporate financing after the crisis was an abrupt depletion of external funds available for the corporate sector. The total amount of external financing of the corporate sector dropped from 117 trillion won in 1997 to less than a quarter, *i.e.*, 27.6 trillion won in 1998. Even during the period of vigorous economic recovery in 1999 and 2000, the external funds available for the corporate sector was only around half of that available in 1997 and the situation became worse in 2001.

The major culprit here was the fall in the borrowing from financial institutions, *i.e.*, indirect financing. In 1998 when the country was in the depth of the crisis, financial institutions *withdrew* 15.8 trillion won of loans from the corporate sector in their attempts to raise their BIS ratios and to reduce their risk exposure – in other words, it was actually siphoning money out of

internal mechanism without letting foreign competitors or foreign financial institutions know about their plans. The size and the speed of mobilisation of those resources were what foreign competitors feared most. But now, even the major *chaebols* (the 5 largest ones) have to go to the international financial market if they need an investment over 1 trillion won (US\$ 870 million)."

the corporate sector! Although indirect financing slowly began to recover from 1999, its level fell far short of the pre-crisis level, even if we accept that there may have been a certain amount of 'excessive' lending before the crisis. The amount of external financing available in 1999, at 2.2 trillion won, was only about 5% of the 1997 level (43.4 trillion won). In 2000, it was, at 11.4 trillion won, still only 26% of the 1997 level. As the economy began to slow down sharply along with the recession in the world economy, indirect financing shrank dramatically again in 2001. In 2001, indirect financing shrank back to just under 1.2 trillion won, or down to 2.5% of the 1997 level.

The corporate sector has tried to survive this severe credit crunch by increasing issuance of stocks and corporate bonds. However, they were far from sufficient to compensate for the total collapse in indirect financing. Even with more than a doubling of equity financing (from 10,978 million won in 1996-7 to 22,991 million won in 1998-2001), total direct financing fell to less than 2/3 of the pre-crisis level (from 50,092 million on in 1996-7 to 32,531 million won in 1998-2001). Given the total collapse of indirect financing that we talked about above, the total amount of external (direct and indirect) financing available for the Korean corporate sector during the post-crisis period (1998-2001) was only 31% of the pre-crisis level (49,472 million won, as opposed to 118,409 million won for 1996-7).

Moreover, these options to issue corporate bonds or new stocks were available only to the largest companies who had established their credibility in the securities market. For example, when excluding asset-backed securities, the share of big firms in the corporate bond market reached 99% in 1998 and 95% in 1999 – the corresponding figure was 72% in 1991 and 87% in 1994 (Crotty and Lee 2001). All these mean that the smaller firms had virtually no access to external financing.

As a result of the collapse in external corporate financing, there was a collapse in investment in the years following the 1997 financial crisis. Gross investment ratio in the national accounts fell from the average of 37.1% during 1990-97 fell to a mere 25.8% during 1998-2001 (27.3% even if we exclude 1998 as an exceptional year) (the figures are from the BOK website).

Overall, it is certainly true that the *chaebols* had some negative features – some inherent in their structure, others more

incidental. However, by altogether banning internal transactions and other features that allowed them to operate as business groups, the reform programme has destroyed the positive aspects of the group structure as well – a classic case of ‘throwing the baby away with the bath water.’ It is vital that these and other positive aspects of the old system are revived in a way that minimises the negative features of the old system and preserves the positive aspects of the recent reforms. In the next section, we explore how this may be done.

V. The Need for a ‘Second-Stage Catching-up System’ for the Korean Economy

In our view, what was needed for Korea after the crisis was not to try a transition to an idealised Anglo-American system but to build what we call a ‘second-stage catching-up system,’ which the country had failed to do before the crisis.

Our position starts from the recognition that Korea’s catching-up still has a long way to go. The country may have spectacularly succeeded in the first-stage of catching-up but still is only a middle-income country with per capita income of \$9,628 in 2000, around one fourth that of that of the U.S.. According to Lee’s (1999) estimate of ‘relative backwardness,’ Korea in 1995, when country’s per capita income reached \$10,000, was approximately where Japan in the middle of the 1960s, when the Japanese catching-up system was at its most spectacular in its success.

The reformers believe, at least implicitly, that Korea’s transformation into a high-income country would be more or less automatically achieved only if the ‘global standards’ institutions in finance and corporate governance they have recently introduced can be made to stick. However, as we pointed out above, the reform measures were principally geared to reducing financial risk of the system, even to the extent of over-killing the economy in the short run. Nowhere in the reform programme was the question of long-term growth and catching-up considered. Indeed, we would argue that many of the ‘global standard’ financial and corporate institutions that the reform programme has introduced are likely to damage the future growth prospect for the Korean economy.

An important case in point is the BIS capital adequacy ratio. The

BIS rule requires that the capital base of financial institutions should correspond to the weighted risk of their assets. The problem is that this is an 'unfair' rule from developing-country point of view, as they have relatively scarce financial resources but are required to maintain the same capital base per lending. Moreover, the pressure on developing country financial institutions to adopt the BIS standard more or less overnight forced them to expand their capital base very rapidly, thus creating a severe credit crunch, as seen in the case of Korea.¹¹

This is not all. If the logic behind the BIS ratio is fully applied, the latecomers are put in an even more disadvantageous position. Financial risk for assets in developing countries is normally higher than that for assets in developed countries, which means that financial institutions in developing countries should maintain a larger capital base for the same amount of loan exposure, compared to their counterparts in developed countries. In fact, the 'New Basel Accord' announced by the Basel Committee in January 2001 requests that financial institutions should apply different weights to corporate lending according to the ratings given to the borrowing company by international credit rating agencies. So, for instance, if a company has a credit rating between AAA to AA⁺, a 20% risk weighting is applied whereas a 150% risk weighting is applied to a company with a credit rating of BB⁻ and below, into which most Korean companies were classified in 2001 (SERI 2001).¹² From the viewpoint of the companies or financial institutions in developing countries, this is a major blow to their ability to attract or provide investment financing.

¹¹This kind of credit crunch happened even in Japan in 1997 and 1998. One reason why the Asian financial crisis was exacerbated was that, according to the Basel accord, Japanese commercial banks had to meet the 8% of BIS ratio by March 1998, when the quality of their assets substantially deteriorated due to the spread of the South East Asian financial crisis and the prolonged recession in the local economy. As a consequence, they had to withdraw existing loans to raise their BIS ratios (MOFE 1998).

¹²Even according to the old BIS rule, there are some differences between the OECD member countries and the non-member countries in the application of the BIS rule. For instance, loans to commercial banks receive the risk weight of 20% (compared to 100% risk weight that corporate lending has) in the OECD member countries, while they receive a higher weight in non-member countries. But the risk weighting was same within OECD countries, or within non-OECD countries, according to the old rule.

The same argument applies to other 'global standard' institutions. For instance, if equity-financing is considered the global standard for corporate financing, this will have particularly adverse effects on countries that have been heavily relying on debt-financing. In the Korean case, this idealised preference for equity-financing created far too negative a perception about its relatively high corporate debt-equity ratio and brought about the policy aimed at its radical reduction, which resulted in a severe credit crunch and the 'fire-sales' of corporate assets. For another example, if the 'global standard' condition for 'fair' competition is that each company operates as a stand-alone unit, those companies who have been growing through business grouping, such as the *cheabols*, are suddenly put into a disadvantageous position.

As an economy that is still catching up, Korea needed, and still needs, to devise a new economic system that is suited to a second-stage catching-up. In our view, this new system should be built on the strengths of the traditional system, and not based on a complete abandonment of it. We sketch below how this new system may look like.

The most important lesson from the experience of the post-crisis reform in redefining the role of the Korean state, in our view, is that the state should act as the 'mediator' between the homogenising forces of globalisation and the unique characteristics of the local economy. The economic reforms in Korea were designed and implemented on the belief that the country should adopt 'global standard' institutions. The unique characteristics of the local economy were regarded as outdated, or even pathological, and thus were destroyed or allowed to languish. As we have repeatedly pointed out, however, the 'global standard' institutions have not only imposed unnecessary costs but many of them are currently functioning more as obstacles to, rather than spurs for, further development of the economy.

Of course, in the present international environment, it will be difficult for Korea to completely resist the introduction of certain 'global standards.' However, it does not mean that it should follow them blindly, regardless of their consequences for the national economy.

A case in point is, once again, the adoption of the BIS capital adequacy ratio. Given that the BIS rule is now a 'global' norm, there was little that the Korean government could do in changing

the rule itself. However, it could still have applied it more flexibly, in a way that promotes national interest. For instance, rather than applying the rule to all commercial banks, it could have made it obligatory only for those that have high international exposure, whilst applying less stringent standards to those that have limited exposure to international financial markets.

A similar kind of creative response is required in relation to industrial policy. Outwardly, the Korean government has almost totally given up on industrial policy. However, there still exist important *de facto* industrial policy measures, especially the regulations on corporate lending. The problem with this approach is that, if industrial policy is implicitly conducted through the financial supervision system, it is likely to be geared towards the needs of the financial sector, rather than those of the whole economy. Therefore, if it is felt necessary to control the financial risks from investment competition between major firms, it should be dealt with by explicit industrial policy measures tied to a long-term development strategy, rather than through indirect intervention through financial regulation, which is too blunt an instrument for the job.

In a similar vein, the state should find a way to regain control over cross-border capital flows. While open capital markets can allow developing countries to have access to larger and cheaper funds, this has to be set against the costs of open capital markets. First of all, a large part of foreign funds comes from entities for whom the maximisation of short-term financial returns is paramount (*e.g.*, pension funds), and therefore they tend to demand corporate practices that are not conducive to high investment and rapid growths (*e.g.*, demands for high dividends rather than retention of profit). Second, the access to foreign funds is subject to very quick reversals, as Korea has learnt from bitter experience in the 1997 crisis. Third, if the possibility of such reversal is to be minimised, a large foreign exchange reserve has to be kept as it is the case with Korea now, which means that the country has to forgo the financial returns that could come if this sum was kept in less-liquid, higher-yielding assets. Fourth, should a currency crisis happen (as even a huge reserve is not an absolute guarantee against a currency crisis for a country whose currency is not one of the major settlement currencies), open capital accounts make it necessary to keep interest rates high, thus driving otherwise

healthy enterprises into bankruptcy (as it happened in Korea in the first six months of the IMF programme).

Of course, the degree of external financial liberalisation is basically a result of international negotiation, and therefore there is certainly a limit to deciding on the degree of financial openness purely on the basis of domestic considerations. However, the state should at least maintain some policy tools to guard the economy against disruptive forces of cross-border capital flows, given the costs that they can impose.

Similar kinds of policy pragmatism and flexibility in the implementation process are required in relation to the reform of the *chaebols*. As a middle-income country, Korea still needs to utilise this positive aspect of business grouping, such as its ability to take greater risk. The possible abuse of internal transactions can be checked by increasing transparency of corporate management and strengthening the right of minority shareholders, rather than by an outright ban on internal transaction. A reformed industrial policy, more explicit and direct than the *de facto* industrial policy of recent years but more transparent and indirect than the traditional one, can also contribute to checking excessive risk-taking in the corporate sector.

VI. Some Final Thoughts

The corporate reform programme implemented by the IMF and the Korean government following the 1997 financial crisis set out to dismantle what remained of the traditional economic system of the country after the liberalisation exercise in the 1990s and replace it with an Anglo-American-style system. In our view, however, what the country needed was a re-invention of the traditional model, and not a total break with it.

The new system is mainly geared towards ensuring the stability and the profitability of the financial sector. It is, therefore, not a big surprise that corporate financing has dried up, significantly reducing the investment capability of the corporate sector, as shown in the dramatic fall in national investment figures. However, the new system has even failed to reduce financial risk of the corporate sector, has imposed significant "transition costs" on the economy (in the form of "unnecessary bankruptcy," etc.), and is

likely to reduce the dynamism of the country's corporate sector in the long run.

The biggest challenge for the country will be whether it can figure out a way to forge a second-stage catching-up system, which revitalises investment dynamism while managing financial risk properly in the economy. We have tried to outline some elements of this new strategy in this paper.

(Received 29 August 2002; Revised 15 January 2003)

References

- Bank of Korea (BOK). *Financial Statement Analysis*. Seoul: Bank of Korea, 1999, 2000 (in Korean).
- _____. Website, <http://www.bok.or.kr>.
- Brennan, M. "Corporate Finance Over the Past 25 Years." *Financial Management* 24, 1995.
- Burton, J. "Boxed into a Corner." *Financial Times* 23 November 1998.
- Chang, H-J. "The Political Economy of Industrial Policy in Korea." *Cambridge Journal of Economics* 17 (No. 2 1993): 131-57.
- _____. *The Political Economy of Industrial Policy*. London and Basingstoke: Macmillan, 1994.
- _____. "The Hazard of Moral Hazard – Untangling the Asian Crisis." *World Development* 28 (No. 4 2000): 775-88.
- Chang, H-J., and Park, H-J. "An Alternative Perspective on Government Policy towards Big Businesses in Korea: Industrial Policy, Financial Regulation, and Political Democracy." In Jwa, S-H. and Lee I. (eds.), *Korean Chaebol in Transition: Road Ahead and Agenda*. Seoul: Korea Economic Research Institute, 2000.
- Chang, H-J., Park, H-J., and Yoo, C. G. "Interpreting the Korean Crisis: Financial Liberalisation, Industrial Policy, and Corporate Governance." *Cambridge Journal of Economics* 22 (No. 6 1998): 735-46.
- Claessens, S., Djankov, S., and Lang, L. Corporate Growth, Financing, and Risks in the Decade before East Asia's Financial Crisis, Policy Research Working Paper, No. 2017, Washington, D.C.: World Bank, 1998.
- Crotty, J., and Lee, K-K. Economic Performance in Post-Crisis

- Korea: A Critical Perspective on Neoliberal Restructuring, Mimeograph, Department of Economics, University of Massachusetts, Amherst, 2001.
- Demigruc-Kunt, A., and Maksimovic, V. "Stock Market Development and Firm Financing Choices." *The World Bank Economic Review* 10 (No. 2 1996): 341-69.
- Fair Trading Commission (FTC) Website. <http://www.ftc.go.kr>.
- Financial Supervisory Commission (FSC). *The Direction of the Development of Financial Activities after the Introduction of the Forward Looking Criteria*. 2000 (in Korean).
- Furman, J., and Stiglitz, J. "Economic Crises: Evidence and Insights from East Asia." *Brookings Papers on Economic Activity* (No. 2 1998): 1-135.
- Harris, M., and Raviv, A. "The Theory of Capital Structure." *The Journal of Finance* 46 (No. 1 1991): 297-355.
- Lee, J-M. "East Asian NIEs' Model of Development: Miracle, Crisis, and Beyond." *Pacific Review* 12 (No. 2 1999): 141-62.
- Ministry of Finance and Economy (MOFE). *Causes of, Responses to and Consequences of the 1997 Economic Crisis*. Unpublished Internal Report, 1998 (in Korean).
- _____. *An Assessment of Corporate Restructuring until June 2001 and Future Plans*. Unpublished Internal Report, 2001 (in Korean).
- _____. Website, <http://www.mofe.go.kr>.
- Park, H-J. *Strategy, Competition, and Organisational Structure of the Cheabul*, Mimeograph. School of Oriental and African Studies, University of London, 1998.
- Radelet, S., and Sachs, J. "The East Asian Financial Crisis: Diagnosis, Remedies and Prospects." *Brookings Paper on Economic Activity* (No. 1 1998): 1-90.
- Samsung Economic Research Institute (SERI). *Three Years after the IMF Bailout*. 2001.
- Yoo, S. M. *Evolution of Government-Business Interface in Korea: Progress to Date and Reform Agenda Ahead*, Working Paper, No. 9711, Seoul: Korea Development Institute, 1997.