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# Corporate Restructuring in Post-Crisis Korea

March 2010



MINISTRY OF STRATEGY  
AND FINANCE

**KDI** Korea Development Institute

# Corporate Restructuring in Post-Crisis Korea

## Corporate Restructuring in Post-Crisis Korea

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March 2010

\*This case study is largely based on Lim-Hahm (2004) and Lim (2007)



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## Background

1. Evolution of the Pre-Crisis System
2. Deterioration of Balance Sheets and Failed Reform Efforts
3. The Nature of the Crisis and Reform Environment

# Background

The economic crisis of 1997 provided Korea with a rare opportunity to overhaul a government-business risk partnership that had become increasingly dysfunctional under liberalization and democratization. Well before the opening of capital markets in the 1990s, liberalization and democratization led to significant changes in Korea's developmental state model. While expectations for government protection against large bankruptcies remained strong, institutional reforms and credible market signals (e.g., large-scale corporate failures) designed to replace weakening government control with market-based discipline were not introduced in the pre-crisis period. The weakening of investment discipline since the late 1980s served as the underlying cause of the 1997 economic crisis (Lim-Hahm 2004).

The crisis had the effect of weakening the political clout of vested interests, which otherwise might have blocked reform. A newly elected reformist president took advantage of the crisis atmosphere to push major bills through the National Assembly, even though his coalition did not have a majority. Endorsed by international investors as well as non-governmental organizations campaigning for shareholder value, his reform initiative, in turn, strengthened market forces and made it increasingly difficult for the government to "suspend" bankruptcies and backtrack on reform.

In the wake of the crisis, Korea faced two major challenges. First, "legacy costs" or problems resulting from mistaken or unlawful decisions of the past had to be addressed. Foremost among these problems were massive nonperforming loans (NPLs) that had resulted from unprofitable investment. Public funds had to be injected to clean up NPLs and rehabilitate the financial sector. Also, any unlawful acts or practices that had contributed to corporate failures had to be investigated. Second, to avoid a repeat of this kind of disaster, institutional

reforms had to be implemented. The pre-crisis distortions in financial resource allocation and corporate governance had to be fixed. Reducing moral hazard, improving corporate governance, and promoting competition constituted the central pillars of Korea's corporate restructuring program in the post-crisis period.

## 1. Evolution of the Pre-Crisis System

Eager to promote economic development, the Korean government in the 1960s adopted drastic measures to share the investment risks of the private sector, channeling policy loans through state-owned banks and providing explicit repayment guarantees to foreign financial institutions on loans extended to Korean firms. The resulting government-business risk partnership, for which the export performance of private-sector firms was used as a selection criterion, defined the core of what later came to be known as “the Korean model of economic development.” (Lim 2000, 2003)

Since the military government re-nationalized commercial banks in the early 1960s, the government has effectively controlled the banking sector in Korea. During the Park Chung Hee years (1961-1979), in particular, the government directed the banks to support economic activities it felt were essential to rapid growth. The use of “policy loans,” or loans with preferential interest rates and availability that are supported by the central bank's automatic rediscounts, was extensive in this period. In 1965, when the government raised the interest rate on general bank loans to 26.0 percent to protect depositors against inflation, the interest rate on loans for exports was set at 6.5 percent. The interest rate gap hovered around 10 percentage points well into the 1970s. The mid-1970s marked the heyday of policy loans as the government orchestrated an investment drive to promote heavy and chemical industries (HCI). Policy loans constituted nearly half of the total credit provided by domestic financial institutions in this period [Cho and Kim (1997: 42-52)].

However, the excesses of the government-orchestrated heavy and chemical industry (HCI) drive of the 1970s led to a reappraisal of the state-controlled financial system. Technocrats who initiated policy reform in the early 1980s believed that extensive government control in the financial sector had to be relaxed if the government was to escape from the vicious cycle of intervention.

In the aftermath of the HCI drive, the government scrapped the industrial targeting approach and drastically reduced the preferential terms of policy loans. The interest rate gap between general bank loans and export loans, for instance, was completely eliminated in 1982. Starting

in the early 1980s, the government also sold its shares in commercial banks and allowed several new entrants into the banking sector. Despite nominal privatization and relaxation of entry regulations to some degree, however, government control of the banking sector persisted for the most part. In particular, the government had a final say in the appointment of CEOs for all the banks.

Korea's family-based business groups, or the *chaebol*, had to depend on the government for the lion's share of their investment capital until restrictions on the licensing of non-bank financial institutions began to be relaxed in the early 1980s. The *chaebol* took advantage of this liberalization measure to control a large portion of the non-bank financial sector, which grew rapidly over the subsequent decade to overtake the banking sector in asset size. The *chaebol* control of non-bank financial institutions (NBFIs), combined with the legacy of implicit government guarantees, redefined government-business relations and weakened investment discipline.

Thus, attempts at financial liberalization— in particular, the relaxation of entry restrictions into the non-bank financial sector— implied a structural weakening of the traditional risk partnership. The *chaebol* expanded their influence in the financial sector through the control of non-bank financial institutions (NBFIs) such as merchant banks, security companies, investment trusts, and insurance companies.

Corporate financing behavior evolved in response to the structural shift, and NBFI financing and direct debt financing through the issuing of corporate bonds and commercial papers emerged as important financing vehicles by the early 1990s. Indeed, NBFI and direct debt financing accounted for a major share in corporate financing during the investment spree of the 1990s, which lasted up to the onset of the 1997 financial crisis. The overall change in the financing pattern implied that the *chaebol* were gaining an increasing degree of independence in their major investment decisions (Hahm 2003).

This shift in balance of power in the government-business risk partnership was, however, fraught with serious moral hazard risks, because expectations for government protection against large bankruptcies remained intact while various entry restrictions and investment controls were lifted. In other words, although the *chaebol* were no longer tightly reined in by the government, they— and almost everyone else— continued to believe that the government would come to their rescue should they fall into financial difficulties.

This explosive combination of de-control without de-protection had serious implications for the financial system. Banks continued to extend loans to the *chaebol* without much regard for default risks. Moreover, by “guaranteeing” a much higher rate of return than the banks, the *chaebol*-controlled NBFIs were able to attract a great deal of financial resources. The *chaebol*

in turn used NBFIs financing to carry out their investment projects. The financing scheme implied that the *chaebol* were able to capture the benefits of one-sided financial liberalization policy (Lee et al 2000, Hahm 2003). Globalization accentuated this trend by making it easier for the *chaebol* to gain access to foreign capital without having to go through rigorous credit evaluations. Most of foreign capital inflows, in fact, took the form of inter-bank lending. Foreign creditors, for the most part, were content to make loans to Korean banks, which in turn made “care-free” loans to Korean firms.<sup>1</sup>

The dearth of autonomous financial institutions that could say no to the government and the *chaebol* proved to be the Achilles heel of the Korean economy. On the surface, Korea might appear to have had a bank-based financial system until the mid-1980s and a market-based system since then, with the rise of NBFIs controlled by the *chaebol*. However, Korea's bank-based system differed from the Japanese main bank system or the German system in that the banks were for the most part the agents of the government with little independent authority to monitor and discipline corporate management; Korea's market-based system was also very different from the Anglo-Saxon system in that shareholders and institutional investors exerted little influence on corporate management. What Korea basically had was a government-business risk partnership whose balance of power increasingly shifted to the *chaebol* with the gradual removal of government controls and the emergence of financial entities directly linked to the *chaebol*— without the establishment of market institutions to monitor and discipline corporate management (Lim 2001).

Although the progressive removal of entry barriers increased competition in most industries in the 1990s, the investment behavior of large business groups changed little. Because of expectations for implicit government protection from large bankruptcies, increased competition failed to make them become aware of the increased potential risks of the high-leverage strategy. The government phased out industrial policy and no longer capped the level of investment and restricted the number of firms in a given industrial sector; however, Korea's large business groups apparently felt that the government's implicit guarantee against their bankruptcy remained in force. The 1997 crisis may be regarded as a result of this explosive combination. In fact, what Korea had in 1997 was not the commonly understood example of East Asian capitalism, but rather a hybrid combining the problematic features of a developmental state and a market economy.

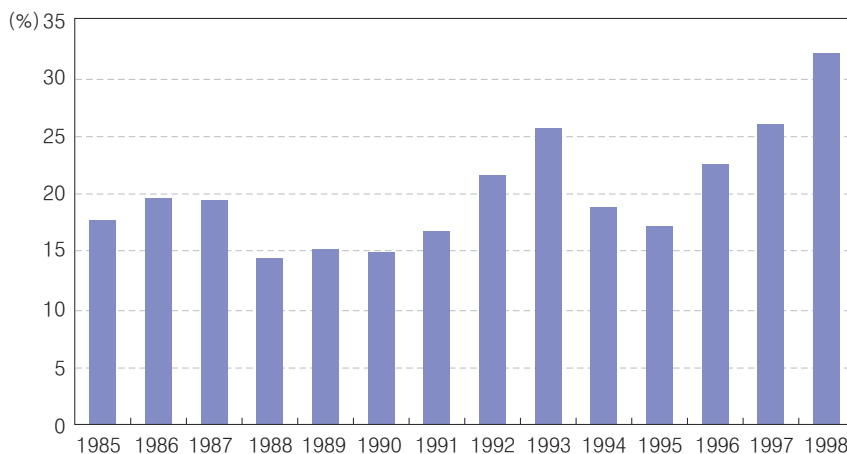
1\_ For example, Korea First Bank, with a capital of 2 trillion won, provided 2 trillion won of credit to Hanbo. Although the working staff had given a D-rating to Hanbo, the chief executive of the bank overruled and decided to provide credit. Hanbo was the first of the major *chaebol* to fall in 1997.

## 2. Deterioration of Balance Sheets and Failed Reform Efforts

Reflecting distortions in resource allocation under the legacy of government-business risk partnership and without effective market mechanism to control investment risks, balance sheets of financial institutions deteriorated substantially before the onset of the 1997 crisis. Figure 1 shows the percentage of loans extended to the firms whose interest coverage ratio was less than one from 1985 to 1998 (Hahm and Mishkin 2000).<sup>2</sup> The asset quality of financial institutions kept deteriorating in the years leading to the crisis, as financial institutions propped up “zombie companies.” In particular, firms such as Halla, Jinro, and Sammi, which would all go bankrupt in 1997, had debt-equity ratios of over 2,000 percent as early as 1995— more than five times the acceptable level of leverage in most countries.

**Figure 1 |** The Ratio of Latent NPLs out of Total Corporate Sector Loans

(Unit)



Source: Hahm and Mishkin (2000)

Why was this problem not corrected? It was in part due to complacency and lack of awareness. In pre-crisis Korea, asset classification criteria and loan-loss provisioning requirements for commercial banks were quite lenient. As a result, it was difficult to assess the

<sup>2</sup> The interest coverage ratio is the ratio of a firm’s EBITDA relative to interest payment, where EBITDA denotes the earnings before interest payment and tax plus depreciation and amortization. If the interest coverage ratio is less than one, it means that the borrowing firm cannot meet its interest payment with its operating cash flow.

true magnitude of bank balance sheet problems. In fact, according to official data, nonperforming loans were estimated to be well below 10 percent of total credit. Moreover, the Korean economy in the mid-1990s was putting up stellar macroeconomic figures, thanks in part to aggressive corporate investment. Impressed by Korea's overall economic performance, few bothered to check if there were any hidden problems in the financial and corporate sector. Those few who compared the *chaebol* to "runaway locomotives" and pointed to potentially massive problems created by their reckless investment were dismissed as Cassandras.<sup>3</sup>

The failure to address the latent nonperforming loans problem also had something to do with the political economy, for addressing this problem would have raised sensitive questions about corruption, incompetence, and negligence on the part of public officials and business executives.<sup>4</sup> Faced with the prospect of injecting a massive amount of public money to clean up nonperforming loans, taxpayers naturally would have asked who was to blame. Moreover, 1997 happened to be the final year of the Kim Young Sam government, and the lame-duck government would have found it very difficult to win popular support for massive corporate and financial sector restructuring even if it had been clearly aware of the magnitude of the nonperforming loans problem.

This political environment, combined with a blind faith in the "fundamentals" of the Korean economy and the virtues of market liberalization, skewed policy discussions in a particular direction. More often than not, the distinction between old-fashioned industrial policy and prudential regulation was ignored, and deregulation or termination of "government intervention" was equated with reform in the financial sector. As a result, financial sector liberalization in Korea in the pre-crisis period proceeded without an adequate build-up in the capacity to design and enforce prudential regulation and supervision. Although the government did review regulation and supervision issues prior to Korea's accession to the OECD in 1996, the focus was on controlling the flow of foreign capital rather than safeguarding the soundness of domestic financial institutions. The government opted for a gradual opening of the capital market to international investors, but neglected to take substantive measures to improve prudential regulation in the financial sector.

3\_ For a prescient pre-crisis analysis of potential risks associated with moral hazard, see "The House that Park Built: A Survey of South Korea," *Economist*, June 3, 1995, as well as analyst reports in Marvin (1998).

4\_ For example, the number of merchant banks had increased from six to thirty within a course of a few years before the crisis, and there were allegations of corruption in the issuing of new licenses. Had the government tried to restructure distressed merchant banks and use taxpayers' money to clean up nonperforming loans, public officials would have been faced with tough questions about irregularities in the issuing of the licenses and subsequent failures in regulatory oversight. Unwilling to attract public scrutiny during their tenure, they delayed the day of reckoning. Most of the newly licensed merchant banks failed in the wake of the crisis.

It was not until the fateful year of 1997 that the government made serious efforts to overhaul the outmoded financial system. The Presidential Commission for Financial Reform (PCFR), launched in January of that year, conducted a comprehensive study and submitted a number of policy recommendations that were to become essential components of the post-crisis reform program, including prescriptions to strengthen prudential regulation. However, these recommendations came too late.<sup>5</sup> A series of major bankruptcies, starting with Hanbo in January, had begun to rock the financial system. Faced with a political scandal in the wake of the Hanbo bankruptcy, which led to the arrest of President Kim Young Sam's son, the lame-duck government operating in a democratic environment could not avoid public scrutiny and indefinitely provide new credit to financially vulnerable companies. Nor could it attack the nonperforming loans problem head-on with the presidential election just around the corner. Instead, the government let financially vulnerable companies fail but pressured their creditors to agree to "suspend" formal bankruptcy proceedings. Government indecision precipitated a crisis of confidence. Foreign creditors became increasingly concerned with the security of their loans to Korean banks, which had provided credit to Korean firms, and they began to pull the plug on Korea. This formed the background of the 1997 crisis.

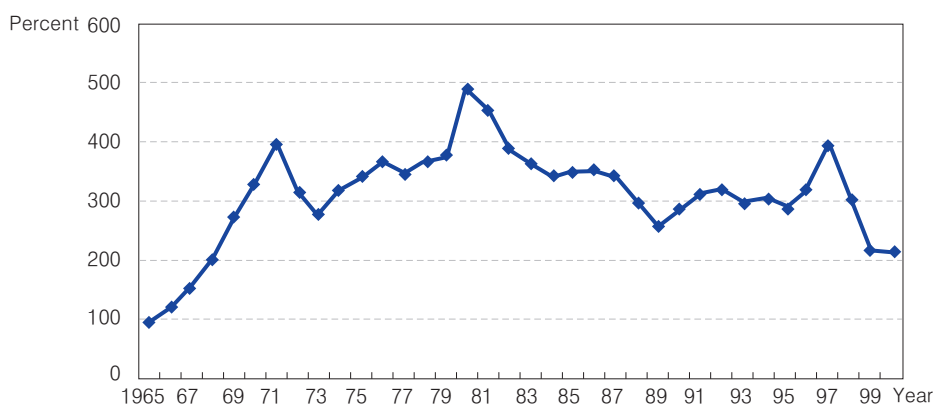
### 3. The Nature of the Crisis and Reform Environment

The 1997 crisis was not the only major financial crisis that Korea experienced in its modern economic history. As Figure 2 shows, the financial vulnerability of the Korean economy, as indicated by the average debt-equity ratio for the Korean manufacturing sector, was at least as high in the early 1970s and early 1980s as in the years leading to the 1997 crisis. However, the nature of the previous financial crises was quite different from the 1997 crisis, and this difference had a significant impact on the subsequent course of reform.

The crisis in the early 1970s primarily had to do with Korean firms' dependence on short-term curb loans from the informal domestic financial sector. Speaking for "hard-working entrepreneurs" suffering from crushing debt, business leaders at the time went so far as to urge the Park Chung Hee government to reduce taxes, expand money supply, and have state-owned banks take over the "usurious" curb loans. In the end, the authoritarian Park government issued an emergency decree in 1972 and bailed out the debt-plagued corporate sector by placing a three-year moratorium on the repayment of curb loans and converting short-term high-interest

<sup>5</sup> Besides, a jurisdictional fight between the Bank of Korea (BOK) and the Ministry of Finance and Economy (MOFE) over financial supervision delayed the legislative implementation of these recommendations.

**Figure 2 | Average Debt-Equity Ratio for the Korean Manufacturing Sector**



Source: Lim (2001)

loans into long-term loans on concessional terms. The government in effect sacrificed the property rights of underground curb lenders to relieve the debt burden of entrepreneurs it had come to trust as agents to carry out its ambitious economic development plans (Lim 2000: 31-36). Subsequently, there was very little financial sector reform other than efforts to bring in informal financial companies into the formal sector.

The financial crisis in the early 1980s was a product of the ambitious government-led HCI drive of the 1970s. As such, the crisis had primarily to do with policy-oriented loans provided by state-owned banks, and the government could afford to take a gradual approach. In fact, after calling off the HCI drive in 1979, the government took a number of industrial rationalization measures—spiced with “special loans” from the Bank of Korea to commercial banks—and waited for the economy to grow out of the problem. The government could manage this domestic financial crisis without triggering a political problem.<sup>6</sup>

The 1997 crisis was different in that it involved a significant amount of short-term loans provided by foreign creditors in the private sector. With the liberalization of capital markets in the 1990s, the amount of capital inflow into Korea had greatly increased in the years leading to the crisis. As Table 1 shows, inward foreign investment in the pre-crisis period was primarily in the form of portfolio investment and bank lending rather than direct investment, which tends to be less sensitive to short-term factors. In fact, portfolio investment and bank lending accounted for more than 90 percent of total foreign investment, and their combined subtotal almost

<sup>6</sup> Korea’s massive external debt in the early 1980s was also a problem, but Cold War security concerns apparently led the U.S. to provide relief. Korea was “too important to fail.”

quadrupled between the 1990-93 period and the 1994-96 period.

**Table 1 | Composition of Foreign Investment Inflows to Korea**

(Unit: \$ Billion)

	1986-1989 <sup>1)</sup>	1990-1993 <sup>1)</sup>	1994-1996 <sup>1)</sup>	1997	1998	1999	2000
Total Inward Foreign Investment <sup>2)</sup>	-3.54 [-2.2]	9.33 [3.1]	35.92 [7.6]	17.93 [3.8]	-3.73 [-1.2]	7.55 [1.9]	19.23 [4.2]
Direct Investment	0.80	0.82	1.64	2.84	5.41	9.33	8.73
Portfolio Investment	-0.31	4.52	14.40	12.29	-0.29	6.99	11.96
- Equity	-	2.42	4.60	2.53	3.86	12.07	12.97
- Bonds	-0.31	2.10	9.81	9.76	-4.15	-5.08	-1.00
Other Investment <sup>3)</sup>	-4.04	3.99	19.88	2.80	-8.86	-8.78	-1.47

Note: 1) Yearly averages.

2) Percentage ratio of inward foreign investment relative to nominal GDP in brackets.

3) Mostly bank lending.

Source: Bank of Korea

Particularly problematic was the relative size of short-term foreign debt. In 1997, the amount of foreign debt coming due in a year was more than twice Korea's foreign currency reserves. The ratio between short-term foreign debt and foreign currency reserves rapidly deteriorated in the second half of the year. In fact, Table 1 shows that foreign bank lending (accounting for the lion's share of "Other Investment" in Table 1) declined sharply from the average of US\$19.9 billion in 1994-96 to US\$2.8 billion in 1997, as foreign creditors refused to roll over existing loans. Spooked by a series of major bankruptcies in Korea since the beginning of 1997 as well as the outbreak of the currency crisis in Southeast Asia, foreign creditors began to express doubts about the asset quality of Korean commercial banks that had provided substantial loans to failed companies. The foreign exchange liquidity problem in Korea was mainly caused by the creditors' run on Korean banks rather than by the speculation of short-term portfolio investors (Shin 2000).

The Korean government tried to buy time in dealing with corporate failures and used its considerable influence to persuade domestic creditors to abide by an aptly titled "bankruptcy suspension agreement" on an *ad hoc* basis. The government, however, did not have effective policy tools to prevent foreign creditors' bank run, because it could not credibly guarantee the repayment of foreign loans—short of taking over debt obligations from financial institutions. Because of the latent nonperforming loans problem, Korea would have had a financial problem of massive proportions even if it had been less exposed to foreign debt, but foreign creditors in effect forced the government to come to grips with the crisis by pulling out of Korea. The

government had little choice but to go to the IMF for immediate relief, adopt internationally acceptable accounting standards, and promptly recognize the latent problem of nonperforming loans.<sup>7</sup> Although the weakening of investment discipline under one-sided liberalization was the underlying cause of the 1997 crisis, financial globalization thus played an important role in the outbreak of the crisis.

In addition to the international nature of the crisis, its severity also had a significant effect on the manner in which the crisis was resolved. Because of massive nonperforming loans, which amounted to 28 percent of Korea's GDP, it was unrealistic to expect affected financial institutions to grow out of their problems. Moreover, if financial institutions had been left to struggle to fight for their own survival, they would have called in loans to meet BIS-mandated capital adequacy ratios, and the ensuing credit crunch would have aggravated the crisis. The government could not muddle through if it was to avoid a social upheaval. If it was serious about dealing with the crisis, it had to turn to taxpayers and use public funds to clean up nonperforming loans.

The severity of the crisis and the subsequent burden it imposed on taxpayers had the effect of weakening the power and authority of those who might have opposed restructuring for fear of losing their control. This had significant implications for the politics of reform. It is often argued that because reform typically involves an asymmetric payoff matrix, reform provokes a highly lopsided political contest between fewer but better organized "losers" and more numerous but silent "winners." The economic crisis, however, had the effect of discrediting vested interests and emboldening entrepreneurial reformers. Long-delayed reforms had a better chance for implementation in the post-crisis period. Yet it would be too simplistic to suggest that the crisis took care of reform. The window of opportunity for reform was not large. Recovering from their initial shock, vested interests in crisis-stricken countries typically put up a strong fight to protect their position.

In short, although the crisis forced the government to come to grips with the problem of nonperforming loans and affected the politics of reform, its role in promoting reform should not be overemphasized. After all, not every country buffeted by an economic crisis used it as an opportunity to implement long-awaited reform. In particular, as long as international creditors got their money back, they could care less about the content of the reform program. The crisis forced the government to recognize the underlying problem, but the manner in which the problem was addressed depended to a great extent on political mediation.

7\_ On November 21, 1997, Korea formally requested emergency assistance from the IMF. The IMF loan of US\$19.5 billion consisted of US\$13.5 billion in supplementary reserve facility (SRF) and US\$6 billion in standby loan (SBL). The SRF was completely repaid by September 1999, and the redemption of the SBL also ended in August 2001.



## The Politics of Reform in the Transition Period

1. Changes in Political Leadership and Policy Paradigm
2. Crisis Management and Coalition-Building

## The Politics of Reform in the Transition Period

In looking at the politics of post-crisis reform in Korea, it may be useful to start out by debunking specious explanations. For instance, while the concentration of political and bureaucratic power in Korea might be an important factor to consider, especially in comparison with Japan, it has not always been a force conducive to reform. In fact, as previously mentioned, top bureaucrats exercised their considerable power to introduce a “bankruptcy suspension agreement” on an *ad hoc* basis in 1997, effectively delaying the resolution of corporate failures. It would be also wrong to infer that Korean politicians and bureaucrats had little concern about the stability of financial markets and the possibility of a political backlash against public funds— factors often cited in “explaining” Japan’s failure to move decisively and effectively to dispose of nonperforming loans. As we shall see, Korean policymakers were all too aware of political risks involved in economic restructuring.

The actual dynamics of post-crisis reform in Korea was more complex, and involved some factors that might not be easily replicable in other countries. The severe economic crisis forced the government to tackle the nonperforming loans problem head-on and politically strengthened the position of entrepreneurial reformers, at least in the early post-crisis period. This immediate political impact of the crisis might be quite similar across crisis-stricken countries, but in Korea the outbreak of the crisis also coincided with a change of government, allowing the government to manage the crisis with a relatively clean slate. The change in political leadership brought about a change in policy paradigm as well. For over a quarter-century, Kim Dae Jung (or Kim Dae-jung), the newly elected president, had advocated that Korea make a transition from a developmental dictatorship to a democratic market economy, and he was more than willing to take full charge of the post-crisis reform program as a means of realizing his vision. As a result, the political commitment to reform in Korea was much stronger than in most other crisis-stricken countries.

Moreover, instead of blaming the crisis on “foreign speculators,” Kim made serious efforts to attract foreign capital, not only as a source of hard currency and managerial know-how but perhaps also as a possible counterweight to the *chaebol*. The increased presence of demanding foreign investors, combined with institutional reforms designed to strengthen market discipline, helped to make Korea’s post-crisis reform program credible and irreversible. While the government appealed to the patriotism of the Korean people, as evidenced by a public campaign to collect gold in the immediate wake of the crisis, it tried to ensure that this wave of patriotism did not turn into a nationalist backlash against foreign capital. Only a few other crisis-stricken countries seem to have used this combination of patriotism and openness to cope with their problems.

## 1. Changes in Political Leadership and Policy Paradigm

On December 18, 1997, barely two weeks after Korea had signed a financial rescue agreement with the IMF, Kim Dae Jung was elected President. His victory marked the first peaceful change of government in Korea since the inception of the republic in 1948. It was also a tremendous personal triumph for the 73-year-old former dissident, who had endured imprisonment, house arrests, and assassination attempts during his fight for democracy.

Kim attracted strong passions from both his supporters and critics. He was a source of inspiration for many of his supporters at home and abroad. For instance, impressed by what he had to endure during his long struggle, an American journalist wrote that Kim Dae Jung was “a leader in a class with Nelson Mandela, someone who has experienced everything that is wrong in his society but still believes in pardon and redemption and can capture the world’s imagination with his all but unbelievable personal saga.”<sup>8</sup> Yet his critics remained deeply suspicious of him. They regarded him as a dangerous demagogue with a soft spot for communism. In the eyes of many voters, he was an anti-establishment candidate representing Korea’s underdeveloped southwestern region, handicapped by his age and connections to old-fashioned money politics.<sup>9</sup>

There was also a question of experience and expertise. Although Kim claimed that he was a “well-prepared” candidate, his lack of experience in governing and his thin pool of advisors raised concern. As Korea was faced with an economic crisis, it did not seem like a good idea to entrust the presidency to a man widely thought to have only a rudimentary grasp of economics.

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8\_ Mary McGrory, “Can Kim Fix It?”, *Washington Post*, December 28, 1997.

9\_ “Kim Dae Jung’s Triumph...”, *Washington Post*, December 21, 1997.

In fact, investors and analysts tended to dismiss Kim Dae Jung as “an economic bumbler” who, however solid his credentials as a pro-democracy dissident, knew little about financial markets. Some feared that he would actively resist reform because of his political ties to labor unions. Those concerns were reinforced when he declared his intention to “renegotiate” the terms of the IMF agreement in the final days of the election campaign, raising questions about Korea’s commitment to reform.<sup>10</sup>

They had their reasons to be concerned, but their expectations proved to be wrong. What Kim offered to the electorate was nothing less than “a democratic alternative for Korea.” When he first ran for President in 1971, he advocated what he called “a mass-participatory economy” as an alternative to Korea’s developmental dictatorship, which he argued was creating serious political and social distortions under the pretext of generating rapid economic growth. He wanted to restore market mechanism and dismantle collusive ties between the government and the *chaebol* so that all groups, including entrepreneurs, workers, farmers, and consumers, could benefit from the opportunities that a free market economy had to offer. He also wanted to “liberate” business executives from having to curry favor with the government and let them focus on running their companies (Kim 1985).

He regarded democracy as a universal value, and strongly argued that it would be imperative to guarantee democratic freedom in the age of knowledge-based economy. When Singapore’s Lee Kuan Yew went on the offensive against western individualism and defended authoritarian rule in Asia, Kim Dae Jung contended that the anti-democratic bias of “Asian values” was a myth. Citing Mencius, he noted that the idea of popular sovereignty was an ancient concept in Asia. He argued that in order for Asian nations to foster innovation and make a transition to economic growth based on productivity improvement, Asia would have no practical alternative to democracy (Kim 1994).

These ideas formed the intellectual background of his presidency. As soon as he was elected President, Kim declared that he would make “the parallel development of democracy and a market economy” his governing philosophy. In a newspaper interview, he said: “Democracy is key to maintaining sound economic development. If we had had a democratic system in the past, then there would be no corrupt connection between businessmen and political power, no government-controlled economy, and also no wrongdoing of businessmen. A major cause of our economic failure today comes from lack of democracy in this country.”<sup>11</sup> He also made it clear that he would not use the economic crisis as an excuse to resort to authoritarian tactics.

10\_ Clay Chandler, “S. Korea’s Kim Proves Mettle in Financial Crisis: President-Elect Gains Support for Savvy Economic Strategy,” *Washington Post*, December 29, 1997.

11\_ Bernard Krisher, “Kim Dae Jung: Linking Liberal Democracy to Economic Growth in South Korea,” *Los Angeles Times*, January 11, 1998.

Instead, he indicated he would try to legitimize structural reform through a democratic process, such as tripartite consultation bringing in labor, management, and government representatives.

To the president-elect, the unprecedented economic crisis was not only a tremendous challenge but also a monumental opportunity to turn his long-held vision into reality. Although he was closer to social democrats or ordo-liberals than to neo-liberals in his thinking, his vision for a democratic market economy was not in serious conflict with the demands of the IMF program. On issues connected with corporate and financial sector reform, the new government actually wanted to do more than what the IMF required. Moreover, although the IMF typically demands cutbacks in welfare, Korea had only a minimal program of welfare at the time of the crisis and actually had to strengthen its social safety net.<sup>12</sup> Even the IMF agreed that an increase in the welfare program was necessary to maintain social stability.

## 2. Crisis Management and Coalition-Building

Politically, Kim Dae Jung had to persuade two relatively sympathetic, but widely divergent audiences, while protecting his position from a possible counterattack by those with vested interests in the old system, including the *chaebol*. On the one hand, to keep Korea from insolvency, he had to convince international creditors that he understood the importance of the IMF program and was fully committed to painful reform. On the other, he had to persuade the general public who were concerned about job losses and were highly suspicious of “foreign intrusion.” His solution was to pre-empt the demands of international creditors and go beyond what the IMF required in terms of structural reform. To the general public, including his longtime supporters, he offered a strengthened social safety net instead of blanket protection from unemployment,<sup>13</sup> and made a strong case for the benefits of foreign

12\_ In Indonesia, which had fallen prey to a currency crisis a few months before Korea in 1997, the IMF’s demand to cut public subsidies in the midst of the crisis was widely criticized.

13\_ Strong job security in exchange for weak workers’ rights had been an integral part of the implicit social contract under the authoritarian regime in Korea. After Korea was democratized in 1987, this arrangement came under attack from both labor and management. Workers demanded wage increases as well as full-fledged rights to organize and take collective action. Business executives complained that lifetime employment practices impeded corporate restructuring and flexible adjustment to changes in the global market. A grand bargain between labor and management would have involved enhanced workers’ rights and social security in exchange for increased labor market flexibility. In the pre-crisis period, however, repeated attempts by the government to broker such an agreement between the two sides resulted in protracted gridlocks.

direct investment.<sup>14</sup> Just like Charles DeGaulle on Algeria's independence and Richard Nixon on the normalization of U.S. diplomatic relations with China, Kim Dae Jung took advantage of his track record as a champion of workers and persuaded his supporters that economic conditions had changed. To the *chaebol* and other vested interests wary of his reform policy, he emphasized that the old system based on collusive business-government relations had run its course. At the same time, however, he made it clear that he would support the honest efforts of business executives. He skillfully took advantage of the crisis atmosphere to deliver his messages.

His first test with his "international constituents" came on December 22, 1997, when he met with David Lipton, U.S. Treasury undersecretary for international finance, who wanted to gauge the president-elect's commitment to reform. Kim told Lipton that, while he was sympathetic to workers' plight, job losses were inevitable because of the harsh terms of the IMF-led rescue package, and he promised he would work closely with labor unions to gain their cooperation. Kim's comments helped to reassure international creditors that Korea was serious about reform and if they agreed to roll over their loans to Korea they would eventually be repaid.<sup>15</sup> He thus passed his "job interview" in flying colors and won the support of his international constituents (Kim et al. 2003: 17-26).

Kim then used the crisis atmosphere to persuade his domestic constituents. In a meeting with national lawmakers on December 23, the president-elect said, "We don't know whether we'll default tomorrow or the day after tomorrow. The cash vault is empty.... I can't believe how the government has been so negligent." By the Election Day on December 18, Korea's foreign currency reserves had dwindled to US\$3.9 billion, and, without an immediate infusion of hard currency, were projected to reach *minus* US\$6 to 9 billion by the end of the year. It was, however, one thing for the president-elect to be aware of the near-default situation and quite another for him to go public with the alarming news. Combined with the downgrading of Korea's credit rating to "junk bond" status announced on the same day, Kim's comments threw

14\_ From the outset, foreign investors occupied an important position in Kim Dae Jung's reform coalition. In his first TV town hall meeting, Kim forcefully argued that Toyota USA was a much more American company than IBM Japan. To the stunned audience who had been accustomed to the "patriotic" protectionist practices of "Korea, Inc.," he said Korea should make every effort to attract foreign investment. Foreign executives were stunned as well. Although they knew the president-elect had few allegiances to the *chaebol*, foreign executives feared he lacked a sophisticated understanding of Korea's economic problems and that his support for labor would be a major obstacle to structural reform. In an unprecedented face-to-face meeting with foreign executives, however, he promised that discrimination against foreign companies would be terminated, as would the collusive ties between the government and the *chaebol*. While some might have suspected this new openness was simply born out of expediency, it proved to be a much more profound change. See Sandra Sugawara, "In S. Korea, Business Anything but Usual: A Surprisingly Aggressive Kim Stuns Foreign, Korean Investors Alike," *Washington Post*, February 24, 1998.

15\_ Paul Blustein and Clay Chandler, "Behind the S. Korean Bailout: Speed, Stealth, Consensus," *Washington Post*, December 28, 1997.

financial markets into a tailspin. Yet, in retrospect, his move might have been a calculated gamble to deliver a wake-up call to the Korean people and persuade them their sacrifice would be needed.

In his subsequent meeting with labor leaders, he basically repeated what he had told Lipton and said job losses were inevitable. He promised he would expand unemployment insurance and guarantee workers' rights in return for increased labor market flexibility.<sup>16</sup> Some labor union members felt betrayed by his turnaround on the need for layoffs, but under the crisis atmosphere, they could not openly protest and risk becoming a "scapegoat" for damaging Korea's credibility in the eyes of international investors. The president-elect then turned his attention to the *chaebol*. In January 1998, he used a highly publicized meeting with business leaders to lay out basic principles of corporate restructuring that emphasized accountability, transparency, and financial soundness.<sup>17</sup> Through TV town hall meetings, he also urged citizens to work together to overcome the economic crisis. The nation quickly rallied around the president-elect "with a survival instinct and patriotic fervor reminiscent of World War II America."<sup>18</sup> Perhaps the best example of this patriotic fervor came in the form of a public campaign to collect gold in the immediate wake of the crisis. In a few months, more than 2 billion dollars in gold were collected to help pay the nation's foreign debt.<sup>19</sup> Unlike some crisis countries marred by capital flights and "dollarization," Korea drew strength from the nation's collective will to overcome the crisis.

The crisis atmosphere also helped Kim Dae Jung to overcome his limitations as a minority president, especially in the early post-crisis period. The new government was based on a coalition between the reformist National Congress for New Politics (NCNP) and the conservative United Liberal Democrats (ULD).<sup>20</sup> The NCNP-ULD coalition remained a

16\_ Unemployment insurance was introduced in Korea in 1995. When the economic crisis broke, its coverage was limited to companies with more than 30 regular employees. In 1998, the minimum number of regular employees required to qualify for unemployment insurance was lowered to ten in January and five in March. In October, the coverage was extended to all companies and temporary/part-time workers. The compensation rate was also raised from 50 percent to 70 percent of previous wages, and the minimum benefit period was doubled to 60 days. In 1998, a total of 441,000 unemployed workers received some insurance benefits. In the wake of the crisis, the unemployment rate reached 8 percent at its peak, more than three times the pre-crisis level. To push ahead with structural reform, it was essential that the government maintain social stability

17\_ Donald Kirk, "Corporate Chiefs' Pledge Raises Spirits in Seoul," *International Herald Tribune*, January 14, 1998. These principles were subsequently incorporated into capital structure improvement plans (CSIPs) that companies signed with their main creditor banks under the guidance of the Financial Supervisory Commission (FSC). Corporate sector restructuring was thus linked to financial sector restructuring.

18\_ Evelyn Iritani, "S. Koreans' Crisis Mentality: Patriotism," *Los Angeles Times*, January 14, 1998.

19\_ John Burton, "South Korea: Kim stands tall before bowed nation," *Financial Times*, February 25, 1998.

20\_ Kim had been defeated in 1987 and 1992 when the opposition parties could not unite, but in 1997, to

minority in the parliament. In the 299-member National Assembly, NCNP and ULD had 78 and 42 seats, respectively, while the opposition Grand National Party (GNP) had 161 seats. However, GNP, the former ruling party, was widely blamed for having mismanaged the economy, and was too much discredited to put up active resistance, at least in the early days of the new government.<sup>21</sup> For that matter, no party, including ULD, could defend old business-government relations with a straight face in the post-crisis environment. Although the NCNP-ULD coalition did not have a parliamentary majority, it took advantage of the crisis atmosphere to enact major reform bills with a little help from the IMF.<sup>22</sup>

Once the new government set its sight on reforming Korea's economic system, the concentration of political power in Korea came in handy. President Kim proactively defined his reform agenda and directed professional bureaucrat to implement specific measures. Korea's meritocratic bureaucracy, relatively insulated from particularistic interests and trained to be loyal to the president, played a critical role in implementing reform (Kim 2002). The professional bureaucrats supplemented President Kim's thin pool of advisors, although they did not always agree on the pace and scope of reform.

Unlike in the authoritarian period, non-governmental organizations (NGOs) also became important players in the politics of reform. In particular, People's Solidarity for Participatory Democracy (PSPD) led a campaign to introduce reforms designed to improve corporate governance and monitored progress in corporate and financial sector restructuring. Lacking a parliamentary majority, the government frequently drew strength from civil society, which in turn urged the government to push ahead with reform.

reassure conservative voters and improve his "electability," he struck a deal with Kim Jong Pil and Park Tae Joon, two of the stalwarts of the Park Chung Hee regime. The less institutionalized party system in Korea, which revolved around personalities rather than ideological beliefs, helped to facilitate such a strange coalition. When a maverick politician who had defected from the ruling party split the establishment vote, Kim slipped through with a narrow margin of victory. His victory was thus a triumph of electoral calculus and luck, as well as a reflection of voter dissatisfaction with the old collusive system that had brought about the economic crisis.

21\_ In the early post-crisis period, GNP could not openly defend old business-government relations nor advocate one-sided deregulation. It had to go along with reform measures designed to improve accountability and transparency. When it did criticize the new government, it resorted to "free market" rhetoric and argued that the government should stop meddling in economic affairs under the pretext of implementing reform. On other occasions, GNP also criticized the government for selling off valuable companies to foreigners.

22\_ However, any hopes of an extended political honeymoon for Kim Dae Jung were quickly dashed. Hours after the inauguration on February 25, 1998, conservative opponents in the National Assembly moved to block approval of his choice for prime minister.

## Corporate Restructuring and Institutional Reform

1. The Resolution of Legacy Costs
2. Institutional Reform

# Corporate Restructuring and Institutional Reform

In the wake of the crisis, Korea faced two major challenges. First, “legacy costs” or problems resulting from mistaken or unlawful decisions of the past had to be addressed. Foremost among these problems were massive nonperforming loans (NPLs) that had resulted from unprofitable investment. Public funds had to be injected to clean up NPLs and rehabilitate the financial sector. Also, any unlawful acts or practices that had contributed to corporate failures had to be investigated. Second, to avoid a repeat of this kind of disaster, institutional reforms had to be implemented. The pre-crisis distortions in financial resource allocation and corporate governance had to be fixed. Reducing moral hazard, improving corporate governance, and promoting competition constituted the central pillars of Korea’s corporate restructuring program in the post-crisis period.

## 1. The Resolution of Legacy Costs

### 1-1. Cleaning Up Nonperforming Loans

Although the legal infrastructure for financial and corporate sector restructuring was laid out, actual progress was rather slow in the immediate post-crisis period. Financial institutions were neither willing nor able to take tough measures on nonperforming loans, for that would lead to a further deterioration of their balance sheets. Indeed, until their balance sheets improved sufficiently and their capital adequacy ratios substantially exceeded the BIS-mandated level (8 percent for banks, for instance), the creditor banks had little incentive to make a full

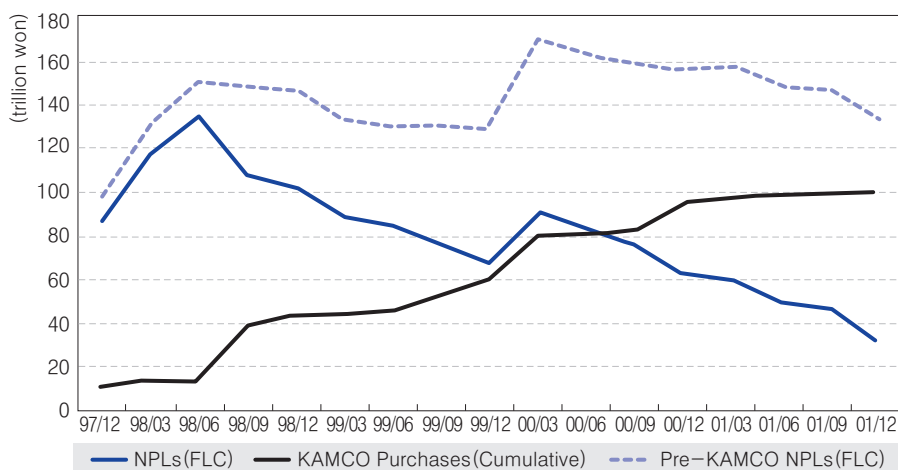
provisioning for bad loans and realize large losses that might threaten their own survival. The corporate debtors, for their part, personally had little left to lose once the loss of corporate control became a virtual certainty, although the firm itself might be worth saving through court-led corporate reorganization. The individual incentives of the creditors and the debtors prevented them from taking actions to arrest the continuing destruction of firm value.

The government had to step in with public funds and urge financial institutions to take proactive measures against insolvent firms. Although the injection of public funds was likely to generate political controversy, the government decided to bite the bullet and stabilize the financial system. As nonperforming loans reflected the investment mistakes of the past, there was little point in delaying the resolution of this problem. Moreover, the magnitude of the problem was such that it was basically impossible for banks themselves to clean up NPLs. Although the injection of public funds would threaten the job security of bank managers, they did not have the political clout to derail the restructuring process.

Once the government decided to inject public funds to rehabilitate the financial sector, the question became what exactly constituted “nonperforming loans.” Prior to the crisis, only loans in arrears of 6 months or more had been classified as NPLs. In estimating the “true” magnitude of NPLs at the end of March 1998, however, the government followed internationally acceptable standards and included loans in arrears of 3 months or more. The government arrived at the figure of 118.0 trillion won, or approximately 28 percent of Korea’s GDP in 1997— twice as large as the estimated NPL total of 59.6 trillion won based on the old asset classification standards. The government initially estimated that the public cost required to complete financial sector restructuring would be around 64 trillion won.

In June 1998, five banks with negative BIS capital adequacy ratios, with the proportion of NPLs ranging from 21 percent to 49 percent of total credit, were closed and their healthy assets were transferred to financially strong banks through purchase and assumption (P & A). Seven other banks were required to submit restructuring plans by the end of July 1998. Eventually, five out of these banks were merged in the recapitalization process. Although bank employees concerned with job security did stage demonstrations, bank executives and shareholders did not have the political clout to block financial sector restructuring triggered by prudential regulation, which involved the injection of public funds in return for equity write-downs and managerial changes.

**Figure 3 | Non-Performing Loans before and after KAMCO Purchases**



Source: MOFE and FSC (2000: 280-286), *White Paper on Public Funds*; MOFE and PFOC (2001: 215), *White Paper on the Oversight of Public Funds*; Korea Asset Management Corporation; Public Fund Oversight Committee

In December 1999, under the terms it agreed with the IMF, the government further strengthened prudential regulation by introducing a forward-looking approach in asset classification, taking into account the future performance of borrowers in addition to their track record in debt service. The forward-looking criteria (FLC) pushed creditors to make a more realistic assessment of loan risks based on borrowers’ managerial competence, financial conditions, and future cash flow. Creditors classified loans as “substandard” when borrowers’ ability to meet debt service obligations was deemed considerably weakened. In March 2000, the asset classification standards were further strengthened with the introduction of the enhanced FLC, which classify loans as “nonperforming” when future risks are significant—even if interest payments have been made without a problem up to that point. Based on the enhanced criteria, NPLs would have increased from 66.7 trillion won to 88.0 trillion won at end-1999.

The introduction of the forward-looking criteria, combined with the collapse of Daewoo in 1999, Korea’s second largest business group at the time, raised renewed concerns about the capital adequacy of financial institutions. Once again, given the magnitude of the problem, the injection of public funds appeared to be the only realistic option. However, facing a National Assembly election in April 2000, the government could not afford to risk a political backlash by pronouncing the need to raise additional public funds. The government waited until financial markets became turbulent enough to ask for an additional public fund of 50 trillion won. It persuaded the public that there was little alternative but to launch a second round of financial sector restructuring in September 2000.

The imposition of stricter standards and additional corporate failures in the post-crisis period made NPLs something of a moving target. Between 1997 and the end of 2001, KAMCO purchased 101.2 trillion won of NPLs (face value) for the actual cost of 38.7 trillion won. Figure 3 shows NPLs before and after KAMCO purchases. In the figure, the size of NPLs before and after 2000 is re-estimated based on FLC and enhanced FLC, respectively. The spike in the trend line at the beginning of 2000 is due to this change in asset classification standards and the increase in NPLs after the collapse of Daewoo. NPLs before KAMCO made the purchases had been declining since 2000, and thanks to improved profitability, financial institutions on their own have been able to dispose of NPLs aggressively since 2001.

In Korea, there were also political economy factors specific to the financial sector that facilitated reform. In particular, the absence of controlling shareholders at commercial banks helped to make large-scale financial sector restructuring a politically viable process in Korea, at least in comparison with other crisis-stricken countries. In Thailand, for instance, large bankers were too powerful politically for the government to include in a financial sector restructuring program in which public money was injected in return for equity write-downs, downsizing, and management change.<sup>23</sup> Consequently, the Thai government let large banks restructure “voluntarily” by setting up private asset management companies (Kim 2002: 206). In Korea, by contrast, the government was able to push through a comprehensive financial sector restructuring program with relatively little trouble because the appointment of top bank executives was in effect controlled by the government. When there were controlling shareholders at distressed financial institutions, however, restructuring became an uphill battle for the government as these shareholders put up active resistance to avoid the loss of managerial control.<sup>24</sup> Although many of the smaller *chaebol*-controlled non-bank financial institutions (e.g., merchant banks and securities companies) were “restructured” through bankruptcies at the end of 1997 and beginning of 1998, it was much more difficult for the government to restructure larger NBFIs with strong controlling shareholders. For instance, the controlling shareholder of Daehan Life Insurance staged a tough legal battle against the government before the court finally ruled in favor of the government.<sup>25</sup>

As for the role of foreign capital, only a limited number of foreign creditors and investors took part in sharing the “legacy costs” of previous investment mistakes, even though they had played a critical role in forcing the Korean government to recognize these costs at the time of

23\_ As of December 1997, 11 out of 15 Thai banks were controlled by Chinese emigrants or related firms in Thailand.

24\_ In the corporate sector, too, the powerful *chaebol* strongly resisted reform. In fact, the top five business groups were initially placed outside the scope of corporate workouts that might threaten the governance rights of incumbents. The government let them “voluntarily” restructure themselves until the problems at Daewoo and Hyundai became too large to ignore (Haggard, Lim, and Kim 2003).

25\_ For details, see Kim et al. (2003: 149-168).

the crisis. Portfolio investors with stakes in Korean companies might have suffered investment losses when these companies subsequently went bankrupt; foreign creditor banks with loans to financially distressed firms such as Daewoo Motors and Hyundai Electronics (later renamed Hynix) had to take “a haircut” in subsequent debt restructuring negotiations; however, on the whole, the burden of paying for the legacy costs of previous investment mistakes fell largely on Korean taxpayers. International organizations such as the IMF and foreign investment analysts pushed the Korean government to be as transparent as possible about the magnitude of nonperforming loans by demanding strict asset classification criteria.

Despite various potential risks remaining in the financial sector, the overall outcome of the financial sector restructuring seems to be positive. As a result of the first and second round of financial restructuring, a total of 787 insolvent financial institutions (or 37.5 percent) had been either closed or merged as of June 2003. Table 2 summarizes the changes in the number of financial institutions by group.

**Table 2 | Financial Restructuring in Korea**

(As of June 2003, Unit: Number of Institution)

	Total No. (end-1997) (A)	Type of Resolution					New Entry	Total No. (end-June 2003)
		License Revoked	Merger	Others <sup>1)</sup>	Subtotal (B)	Ratio (%) (B/A)		
Banks	33	5	10	-	15	45.5	1	19
Merchant Bank Corporations	30	22	6	-	28	93.3	1	3
Securities Companies	36	5	3	2	10	27.8	18	44
Insurance Companies	50	8	6	2	16	32.0	13	47
Investment Trust Companies	31	6	1	-	7	23.3	9	32
Mutual Savings and Finance Companies	231	100	27	1	128	55.4	12	115
Credit Unions	1,666	2	106	463	571	34.3	9	1,104
Leasing Companies	25	9	1	1	12	48.0	4	17
Total	2,101	157	161	469	787	37.5	67	1,381

Note: 1) Includes dissolution and asset transfers to bridge institutions.

Source: Public Fund Management Committee, Ministry of Finance and Economy, *White Paper on Public Funds*.

In this process, the government injected 160.4 trillion won, which is equivalent to approximately 30 percent of Korea's GDP in 2002. Two-thirds of the public funds were raised through bonds issued by KAMCO and Korea Deposit Insurance Corporation (KDIC). More than 46 trillion won was used to settle deposit insurance obligations and to provide liquidity to distressed financial institutions (deposit payoffs and capital contribution). This money is presumed to be unrecoverable. Funds used for recapitalization and the purchase of NPLs and other assets make up the rest, with better prospects for recovery. As of June 2002, it was estimated that a total of 69 trillion won would in effect be irrecoverable. Table 3 shows the uses of public funds.

**Table 3 | Sources and Uses of Public Funds, November 1997-June 2003**

(Unit: Trillion Won)

	KDIC and Others				KAMCO	Total
	Recapitalization	Capital Contribution	Deposit Payoffs	Purchase of Assets	Purchase of NPLs	
Banks	34.0	13.7	0	14.0	24.6	86.2
NBFIs	26.3	3.3	29.8	0.3	14.5	74.2
Merchant Banking Corporations	2.7	0.2	17.2	0.0	1.6	21.7
Insurance Companies	15.9	2.9	0.0	0.3	1.8	21.0
Securities and ITCs	7.7	0.0	0.01	0.0	8.5	16.2
Mutual Savings Banks	0.0	0.2	7.9	0.0	0.2	8.2
Credit Cooperatives	0.0	0.0	4.7	0.0	0.0	4.7
Others	0.0	0.0	0.0	0.0	2.4	2.4
Total	60.3	17.0	29.8	14.3	39.1	160.4

Source: Public Fund Management Committee, Ministry of Finance and Economy, *White Paper on Public Funds*.

**Table 4 | Nonperforming Loans Held by Banks and NBFIs, 1999-2001**

(Unit: Trillion Won)

		End-1999	End-2000	End-2001
NBFIs	NPLs	21.1	20.6	13.2
	(% of Total Credit)	(24.1)	(22.6)	(13.7)
	Total Credit	87.5	91.1	96.4
Banks	NPLs	61.0	42.1	18.8
	(% of Total Credit)	(12.9)	(8.0)	(3.4)
	Total Credit	474.3	526.3	551.1

Notes: 1) Loans classified as "substandard" or below are defined as NPLs.

2) NBFIs (non-bank financial institutions) include merchant banks, mutual savings banks, credit unions, and financial companies specializing in providing credit (e.g., credit card companies).

Source: Financial Supervisory Service.

As a result of the restructuring program, both the capital adequacy and profitability of financial institutions have improved substantially. The BIS capital adequacy ratio has exceeded 10 percent since 1999, and the share of nonperforming loans has fallen sharply as shown in Table 4. With continuous NPL resolution efforts and improved bank management environment, pre-provision profit began to exceed provisions from 2001, and commercial banks finally began recording profits.

## 1-2. Holding Culpable Individuals Accountable

While the Korean government swiftly moved to clean up nonperforming loans, it was inexplicably slow in making coordinated efforts to investigate malfeasance on the part of managers (and their monitors such as accountants and auditors) whose firms or financial institutions had become insolvent. This delayed response was not due to lack of awareness. In 1998, a number of experts urged the government to follow the example of the United States in its resolution of the Savings & Loans (S & L) crisis and appoint a special team of public prosecutors and investigate any unlawful acts or practices that had led to the failures.<sup>26</sup> Although some might find the targeted nature of investigations distasteful, they argued that the government should make every effort to win taxpayers' support for the injection of public funds. In their view, such investigations not only constituted an integral part of the resolution of "legacy costs," but also would have a deterrence effect on corporate managers and their monitors. Bringing culpable parties to justice would make them consider the *personal* costs of malfeasance and enhance the credibility of institutional reforms, particularly in the area of corporate governance.

From the outset, the government should have imposed a heavy penalty on those whose misconduct had contributed to the demise of their firms and financial institutions, and should have made every effort to reduce the amount of public funds necessary to clean up nonperforming loans. In particular, the government should have closed loopholes that made it possible for the owner-managers of some firms to renege on their previous loan guarantees and hide their assets. Clearly, there is moral hazard if corporate managers draw the inference that they can minimize personal losses from firm failures by concealing their wealth and shifting the burden on to the public.

The government paid a high price for its delayed response. According to a Board of Audit

26\_ The U.S. federal government allotted a budget of \$50 million to conduct extensive investigations and uncover any unlawful acts or practices that had led to the S & L crisis. The Justice Department sent 367 FBI agents to the Resolution Trust Corporation (RTC) to support its investigations. The U.S. government indicted 2,333 persons from 1989 to 1995 in connection with S & L failures. 2,168 persons were found guilty and ordered to pay damages in excess of \$600 million.

and Inspection report released in 2001, corporate managers of insolvent firms had concealed at least 7.1 trillion won of their assets. Strictly speaking, it is not true that these managers somehow found ways to siphon off public funds for their private gain. Public funds were injected into banks and other financial institutions, not directly into the firms. The net effect, however, is basically the same, because corporate managers in Korea typically make personal guarantees on loans extended to their firms. According to the report, a number of corporate managers bypassed these obligations by hiding their wealth or transferring their assets to their relatives or overseas.

Belatedly, the government began to close loopholes and make coordinated efforts to address this problem. In 2001, following an amendment of the Depositor Protection Act, KDIC started investigating managers of failed firms for malfeasance and discovered that Daewoo executives had illegally transferred their assets around the time the firm had initiated its workout program. Public prosecutors also launched major investigations in 2001 and arrested more than 100 executives [MOFE & PFOC (2001: 178-187)].

## 2. Institutional Reform

In addition to resolving “legacy costs,” the government had to terminate implicit guarantees against bankruptcy, improve corporate governance, and strengthen competitive pressure so that firms and financial institutions would make their investment decisions under the discipline of market forces. The efficiency model of the *chaebol*, as described in Section 3, would have prescribed only the last component of this reform program, but weak competitive pressure constituted only a part of the *chaebol* problem. As principal-agent and political economy approaches pointed out, distortions in corporate governance and financial resource allocation mechanism had to be addressed.

In addition, unemployment insurance and other social security programs had to be expanded to make economic restructuring politically viable. Strong job security in exchange for weak workers’ rights had been an integral part of the implicit social contract under the authoritarian regime in Korea. After Korea was democratized in 1987, this arrangement came under attack from both labor and management. Workers demanded wage increases as well as full-fledged rights to organize and take collective action. Business executives complained that lifetime employment practices impeded corporate restructuring and flexible adjustment to changes in the global market. A grand bargain between labor and management would have involved enhanced workers’ rights and social security in exchange for increased labor market flexibility. In the pre-crisis period, however, repeated attempts by the government to broker such an agreement

between the two sides resulted in protracted gridlocks [Park (2000)].

In fact, only in the wake of the 1997 crisis did the two sides agree to increase labor market flexibility and enhance workers' rights. The government struck a grand bargain with labor and management by making it easier for firms to lay off workers in exchange for strengthening the social safety net. Economic restructuring demanded labor market flexibility, which in turn rested on social security.<sup>27</sup>

## 2-1. Reducing Moral Hazard

The war on moral hazard constituted the most significant part of the reform program. It entailed formal institutional reforms as well as corporate failures and investor losses that enhanced the credibility of these reforms.

The most significant institutional reform in this area was the introduction of partial deposit insurance. Prior to the crisis, depositors and investors outside the informal curb market had assumed their assets were fully protected by the government. To expand their businesses, financial institutions had been all too willing to play on these expectations, "guaranteeing" high rates of return on their financial products. After shutting down insolvent financial institutions in 1997 and 1998, the Korean government introduced partial deposit insurance to reduce moral hazard. The coverage of deposit insurance was reduced in July 1998 to exclude such risky assets as bonds.<sup>28</sup> Starting January 2001, the deposit insurance limit was set at 50 million won (approximately \$ 41,700) per person per financial institution.

Massive corporate failures served as credible signals that the government's implicit guarantee regime had indeed changed. Through both court-led corporate reorganizations and out-of-court workouts, the management of many leading *chaebol* was displaced and controlling shareholders saw their holdings either written down or altogether wiped out. In fact, of the 30

27\_ Unemployment insurance was introduced in Korea in 1995. When the economic crisis broke, its coverage was limited to companies with more than 30 regular employees. In 1998, the minimum number of regular employees required to qualify for unemployment insurance was lowered to ten in January and five in March. In October, the coverage was extended to all companies and temporary/part-time workers. The compensation rate was also raised from 50 percent to 70 percent of previous wages, and the minimum benefit period was doubled to 60 days. In 1998, a total of 441,000 unemployed workers received some insurance benefits.

28\_ In fact, 92.6 percent of corporate bonds issued in the last quarter of 1997 were "guaranteed" by financial institutions. The exclusion of newly issued corporate bonds from deposit insurance after July 1998 led to a dramatic reduction in guaranteed bond issues. Only 2.8 percent of corporate bonds issued in the last quarter of 1998 were with guarantees. Investors would later test whether no guarantees really meant no guarantees during the Daewoo crisis in 1999.

largest business groups in 1996, 14 had gone bankrupt or entered workout programs by the end of 1999. Moreover, as in the Samsung Motor and Hyundai Construction cases, it was not uncommon to see subsidiaries of surviving *chaebol* get disaffiliated from the rest of the group due to financial distress.

The resolution of the Daewoo crisis marked the culmination of the government's efforts to reduce moral hazard. Investors, small and large alike, apparently believed that implicit government guarantees against bankruptcy continued to operate for the top five *chaebol*, even after smaller business groups had crumbled in 1997 and 1998. In fact, the government initially declared that the top five *chaebol* were formally shielded from out-of-court workouts, adding substance to investors' expectations. Implicit government guarantees and *chaebol* control of non-bank financial institutions created serious distortions in financial markets. Daewoo, in particular, had issued 17 trillion won of new corporate bonds and commercial papers by September 1998. Many investors snapped up Daewoo bonds, betting the government would come to its rescue. This episode showed that when market expectations themselves created serious distortions, "market-led" corporate restructuring could produce a perverse result. On October 28, 1998, frightened by Daewoo's snowballing debts, the government imposed a cap on exposure to corporate bonds issued by any single *chaebol* at 10 percent for banks and 15 percent for investment trust companies (ITCs).

The massive failure of Daewoo in August 1999 finally shattered "too-big-to-fail" expectations. The government did use taxpayers' money to bail out small individual investors rather generously, allowing them to redeem up to 95 percent of the face value of Daewoo corporate bonds. Nevertheless, imposing even a 5-percent loss rate represented a dramatic departure from the past regime. Convinced that corporate bonds no longer had the implicit backing of the government, investors converted corporate bonds and fled from ITCs to banks. This flight to quality forced the government to step in and bail out ITCs, which had suffered huge losses from Daewoo bonds.

The Daewoo crisis created an interesting transitional problem of missing markets. As investors became aware of default risks, many firms began to have trouble rolling over their corporate bonds. In effect, Korea's bond market became deluged with "junk bonds" without an operational junk bond market in place to handle them. In 1999 and twice in 2000, the government felt compelled to orchestrate market stabilization measures that included partial government guarantees. In effect, the government's full implicit guarantees had been replaced by explicit partial guarantees.

The introduction of the forward-looking criteria (FLC) at the end of 1999 was designed to address the problem of forbearance that received increased attention in the wake of the Daewoo fiasco, by encouraging financial institutions to take decisive actions on distressed firms. In July

2000, the government also expanded mark-to-market principles to cover all investment funds. Further progress in Korea's transition to a more market-oriented economy crucially depends on how quickly Korea can replace stopgap measures with market solutions and induce the orderly exit of nonviable firms.

Although the resolution of the Daewoo crisis marked a watershed in Korea's war on moral hazard, it was still not the end of the story. When large firms with potentially serious repercussions for the economy were on the verge of failure, the government tended to put off the day of reckoning in the hope that the companies themselves might take care of their problems through self-rescue programs. This wait-and-see policy, however, could not work for long in the changed institutional environment of post-crisis Korea. The government's reform program had greatly strengthened market forces, and "bankruptcy suspension" could not be sustained.

The resolution of problems at Hyundai Construction was a case in point. The company had suffered more than \$800 million of uncollected payments (accounts receivable) in Iraq in the 1980s and carried a vulnerable financial structure for more than a decade. Investors apparently expected other subsidiaries in the Hyundai Group to come to rescue in a typical *chaebol* fashion should the company have trouble meeting its debt obligations. Although each subsidiary of a business group is a separate legal entity with its own ownership structure, in-group inter-subsidiary resource transfers were common practices in pre-crisis Korea. The feudalistic infighting for corporate control among the Hyundai founder's sons in early 2000, however, discredited the preconception that profitable subsidiaries would come to the rescue of their "brother companies" in distress. In fact, the founder's sons began to go separate ways, each taking a sub-group of subsidiaries. Moreover, increased awareness of shareholders' rights in the post-crisis period led minority shareholders at profitable companies to protest against resource transfers to distressed ones. As a result, by the middle of 2000, the vulnerable financial structure of Hyundai Construction had finally become a cause for concern. Yet, the government and government-controlled banks were slow to take tough measures, hoping the company would somehow take care of its problem through asset sales and other self-rescue programs.

However, the business-as-usual scenario could not be sustained. Hyundai Construction ran out of viable assets to sell. Investors demanded a higher and higher risk premium on its corporate bonds. Fearing litigation, which had become a realistic threat in post-crisis Korea, the creditors objected to providing fresh loans for the company unless its vulnerable financial structure was fixed and its prospects materially improved. International financial institutions and credit-rating agencies held Hyundai Construction as a litmus test for Korea's reform prospects. In the end, after nearly a year of wavering, the creditors implemented a serious restructuring plan, which included a massive debt-equity swap and issuance of convertible

bonds. The previous owner-manager's equity was wiped out, minority shareholders' equity was written down in the ratio of 6 to 1, and a new management team was brought in by the creditors.

## 2-2. Improving Corporate Governance

The government from very early on focused its corporate restructuring efforts on improving the governance of the *chaebol*. In January 1998, then-President-elect Kim Dae-jung announced five principles of corporate restructuring, which included: (1) enhancing the transparency of corporate management; (2) eliminating in-group inter-subsidiary loan guarantees; (3) improving capital structure; (4) focusing on core competence; and (5) enhancing the accountability of controlling shareholders and managers. Principles (1) and (5) were designed to address the problem of “arbitrary imperial rule” by the *chaebol* bosses, most of whom at the time were not even legally registered as chief executives but exercised complete control over their firms. The intent of principles (2), (3), and (4) appeared to be to break up the “convoy-style” management of the *chaebol*, which was largely based on undue resource transfers among legally separate subsidiaries in violation of shareholders' interests.

Starting in 1998, a number of measures were introduced to improve financial disclosure and accounting standards, including requirement for consolidated financial statements covering all companies under the effective control of the same business group regardless of the level of shareholdings. To strengthen minority shareholder rights, the government lowered shareholding requirements for bringing derivative actions, requesting termination of directors and auditors, and convening a special shareholders' meeting [Kim (2000)]. The government also eliminated the system of “shadow voting,” in which institutional investors had to cast their votes in proportion to other votes cast instead of exercising their independent voting rights. To enhance the independence of corporate boards, listed companies are now required to include at least one outside director in the board membership.<sup>29</sup> Cumulative voting has also been introduced, although companies are allowed to preclude it in the articles of association. The National Assembly is also considering a securities class action bill.

In addition to shoring up a legal infrastructure designed to protect the property rights of shareholders, the Monopoly Regulation and Fair Trade Act (MRFTA) increasingly became a tool for achieving these objectives. Amendments of the Act sought to regulate inter-subsidiary transactions that controlling families had frequently used to advance their interests at the expense of other shareholders. The principal means of preventing “tunneling” and facilitating

29\_ Effective April 1998, one quarter (at least one) of all directors of a listed company had to be outside directors. Effective January 2000, one half (at least three) of all directors of a listed company with total assets of 2 trillion won or more had to be recruited from the outside.

corporate restructuring was to impose controls on various in-group inter-subsiary transactions, particularly loan guarantees and share and bond purchases at above-market prices.<sup>30</sup> Undue resource transfers or unreasonable assistance among *chaebol* subsidiaries became a priority of the Korean Fair Trade Commission's enforcement efforts.

These institutional reforms, combined with increased scrutiny by investors in the post-crisis period, have led to substantive improvement in the corporate governance of Korean firms. Gone are the days when directors on corporate boards left their official stamps with the company so that decisions made by controlling shareholders could be formally approved without much ado. Although there remain some loopholes in regulations on the transaction of shares, attempts to expropriate minority shareholders are no longer likely to go unnoticed. The threat of litigation and damage to reputation is also forcing accountants, auditors, and creditors to become more cautious in their dealing with their corporate customers. In a landmark case at the end of 2001, a district court in Suwon ruled in favor of shareholder activists and ordered the chairman and nine past and present executives of Samsung Electronics to pay compensation of nearly 100 billion won for misuse of company funds and undue resource transfers to other subsidiaries.

Yet much remains to be done. According to a Korea Stock Exchange (2001) survey on the corporate governance of publicly listed firms, institutional reforms seem to have had only a limited effect on board independence. As of 2001, there were a total of 4,218 directors at 638 listed companies, with 34.8 percent having been recruited from outside the company. 24.7 percent of the directors were directly related to controlling shareholders, and the remaining 40.5 percent were professional managers. Although outside directors accounted for a considerable proportion, they were not free from the influence of controlling shareholders. In fact, 76 percent of the companies responded that controlling shareholders' recommendation was the most important factor in the appointment of outside directors. Only 3.7 percent of the companies reported cases in which outside directors raised objections at board meetings. Although 52 percent of the listed firms had a contact point in the company for outside directors, only 9 percent made it mandatory to provide them with pertinent business information. Only 10 percent of the listed firms had a mechanism in place for outside directors to seek the advice of independent experts at the expense of the firm.

More institutional reforms are needed to make it easier for parties at interest to monitor and discipline corporate management. In this regard, shareholder derivative actions have serious incentive problems. In derivative action, shareholders file a suit against directors of a firm on behalf of the firm. Even if they win, shareholders are not directly rewarded because directors

30\_ No controls are imposed on inter-divisional transactions since divisions, unlike subsidiaries, are not separate legal entities. Divisions are owned by the same group of shareholders.

pay damages to the firm. According to the Korea Stock Exchange (2001), only 5.4 percent of the listed firms experienced shareholder lawsuits over the past three years. Moreover, the *chaebol* control of a large portion of the non-bank financial sector weakens the possibility of financial institutions imposing discipline on corporate management. Even the banks and NBFIs not directly controlled by the *chaebol* may need their business and thus may take less than a principled stance against them. These problems suggest that it will take much more than a few rule changes to develop credible market discipline by parties at interest. Private remedies should be made more effective by reflecting the incentives of shareholders and enhancing the autonomy of institutional investors.

## 2-3. Promoting Competition

In addition to addressing the problems of moral hazard and corporate governance, the Korean government paid serious attention to the competitive context of the *chaebol*. To strengthen market forces, it removed various entry and exit barriers that harmed economic efficiency.

The most important and extensive policy reforms occurred in the rules governing foreign investment. In the early stages of development, Korea had opted to tap into foreign capital in the form of loans rather than foreign direct investment. As a result, the *chaebol* grew up under a foreign direct investment regime that was one of the most restrictive in Asia. Korea gradually liberalized foreign investment in the late 1980s, but the economic crisis brought a new urgency to this task.

In the wake of the crisis, the government completely eliminated the ceiling on foreign equity ownership in the stock market. By lifting the requirement that foreigners obtain board approval for ownership of more than one-third of the outstanding shares of a firm, the government provided a powerful impetus to cross-border mergers and acquisitions. The real estate market was opened to foreigners and foreign exchange transactions were liberalized further. A new Foreign Investment Promotion Act enacted in November 1998 streamlined investment procedures, strengthened incentives, and created innovative new mechanisms for regional governments to play a role in attracting foreign investment.

Thanks to these measures and improved prospects for the Korean economy, the share of foreign investors in the market capitalization of companies listed on the Korea Stock Exchange more than doubled from 1997 to 2001, from 14.6 to 36.9 percent. In addition to the infusion of funds and managerial expertise, increased foreign direct investment also had political economy consequences. For example, the foreign management of Korea First Bank, taken over by Newbridge Capital in 1999, not only changed the bank's operations but it flatly refused to

support government efforts to orchestrate the continued extension of credit lines to firms deemed unworthy of further support. GM's takeover of Daewoo Motors in 2002 is perhaps the most symbolic of the changes in Korea's FDI regime in the post-crisis period. Prior to the crisis, selling a major company in such a "strategic" industry as automobiles to a foreign buyer would have been almost unthinkable. Putting a distressed firm to international bidding is clearly a post-crisis development.

In addition to encouraging new entry by domestic and foreign firms alike, the government also made efforts to remove exit barriers that had impeded corporate restructuring. Moral hazard constituted a major component of this problem, but bankruptcy laws were also culpable. Bankruptcy reforms in the post-crisis period expedited the bankruptcy procedure and introduced a major change in principle: To qualify for court-led bankruptcy procedures required an assessment of whether the value of the firm as a going-concern did in fact exceed its liquidation value. The courts were required to rule in favor of liquidation when the returns from doing so exceeded the firm's value as a going-concern. This principle was actually tested when Dong-Ah Construction was liquidated in 2001.

## Corporate Performance in Post-Crisis Korea

1. An Overview of Major Trends in Performance
2. Changes in Investment Behavior
3. The Extent of Bifurcation in Performance

# Corporate Performance in Post-Crisis Korea

How much has the performance of Korean firms improved in the post-crisis period? While it may be too early to draw definitive conclusions, it may be useful to look for discernible changes in their profitability and financial stability and to assess the extent of potential risks. We first looked at performance indicators for the manufacturing sector to get an overview of corporate performance before and after the crisis.<sup>31</sup> We also used a larger sample of externally audited non-financial firms to assess the extent of financial distress and bifurcation in the performance of the corporate sector.

## 1. An Overview of Major Trends in Performance

Table 5 shows the trends of major indicators for financial stability, profitability, and growth before and after the crisis. The financial stability of the Korean manufacturing sector has

31\_ On an annual basis, the Bank of Korea (BOK) analyzes the financial statements submitted by a sample of approximately 3,000 firms out of approximately 37,000 non-financial taxpaying corporations with an annual sales of at least 2 billion won. The sample includes all publicly listed firms, all firms with an annual sales of at least 70 billion won, and all top five firms based on sales in each industry as well as representative smaller firms from each industry. For the year 2001, for instance, the BOK sample included 3,323 firms. Of these, 1,345 firms were selected based on the first three criteria, and they accounted for 72.3 percent of the total sales of the population (37,024 firms). The remaining 1,876 firms were sampled based on sales volume and industrial classification. 2,175 were in manufacturing, 180 were in construction, 335 were in wholesale and retail trade, 153 were in transportation and communications, and 480 were in the other sectors.

improved a great deal since the crisis years of 1997-98. Also, cash flow has improved as Korean firms exercise a much higher degree of prudence in investment decisions compared with the pre-crisis period.

With regard to financial stability, the average debt-equity ratio has seen a remarkable decline in the post-crisis period, but the significance of this improvement is less than it may appear. As Figure 2 shows, the average debt-equity ratio for the manufacturing sector has been something of a leading indicator of an impending financial crisis in Korea; it had climbed to 400 percent prior to each of the major crises [Lim (2000)]. A decline in the debt-equity ratio in the post-crisis period has been nothing short of dramatic. In fact, the debt-equity ratio of 182.2 percent in 2001 is comparable to 159.4 percent for the United States in 2001 and 159.7 percent for Japan in 2000.

**Table 5 | Performance Indicators for the Korean Manufacturing Sector, 1990-2001** (Unit: Percent)

	1990-96 Ave.	1997	1998	1999	2000	2001	US (2001)	Japan (2000)
Financial Stability Indicators								
Debt-Equity Ratio	301.7	396.3	303.0	214.7	210.6	182.2	159.4	159.7
Borrowings-Assets Ratio	45.7	54.2	50.8	42.8	41.2	39.8	27.4	29.7
Current Ratio	94.8	91.8	89.8	92.0	83.2	97.9	122.1	132.3
Profitability Indicators								
Op. Income-Sales Ratio	7.1	8.3	6.1	6.6	7.4	5.5	4.3	3.8
Ord. Income-Sales Ratio	2.1	-0.3	-1.8	1.7	1.3	0.4	2.0	3.9
ROIC	9.0	7.6	10.3	6.4	8.7	7.3		
WACC	10.1	9.2	14.0	7.9	8.6	6.9		
Financial Exp.-Sales Ratio	5.7	6.4	9.0	6.9	4.7	4.2	2.3	0.7
Labor Cost-Sales Ratio	13.5	11.4	9.8	9.8	9.7	10.0		
Interest Coverage Ratio	123.5	129.1	68.3	96.1	157.2	132.6	187.0	542.9
Growth Indicators								
Sales Growth Rate	15.1	11.0	0.7	8.0	15.2	1.7		
Tang. Asset Growth Rate	16.3	13.7	17.2	-0.0	2.4	-1.5		
Capacity Utilization Rate	79.7	79.2	68.0	76.4	78.5	73.2		

Source: Bank of Korea, *Financial Statements Analysis*, various years.

Note: The pre-crisis averages for ROIC (return on invested capital), WACC (weighted average cost of capital), are for the 1992:1H-1996:1H period. The post-crisis figures for the two financial variables are also first-half figures.

As Table 5 shows, during the 1992-1996 period, the weighted average cost of capital (WACC) for the Korean manufacturing sector exceeded its return on invested capital (ROIC). In other words, EVA in this period was negative. In the wake of massive corporate failures, however, firms apparently came to reassess the opportunity cost of capital relative to return on investment. This change in risk assessment has helped to improve the total EVA for the manufacturing sector. In fact, it has turned positive since 2000. The performance of firms listed on the Korea Stock Exchange also shows a similar trend. Approximately 70 percent of publicly listed firms had a negative EVA during the 1992-1996 period. After reaching the peak of 80 percent in 1997, however, the proportion of listed firms with a negative EVA began to decline and reached 54 percent in 2001. Although the Korean corporate sector still has a long way to go, it is moving in the right direction.

As for growth indicators, the post-crisis period has seen a dramatic reduction in the growth rate of tangible assets. As Table 5 shows, on average, tangible assets grew at an annual rate of 16.3 percent during the 1990-96 period as Korean firms carried out massive investments. Since the crisis years of 1997-1998, however, tangible assets have hardly increased.<sup>32</sup> Although this slowdown in investment in the post-crisis period has caused some concern among policymakers preoccupied with Korea's growth prospects, it should be interpreted as a natural consequence of reduced moral hazard.

## 2. Changes in Investment Behavior

There are indeed some signs that Korean firms have begun to exercise more prudence in investment and to rely more on internal financing especially in the wake of Daewoo's collapse in 1999. Table 6 shows that total corporate investment in 2000 was below the 1996 level even though Korea's nominal GDP increased from 418 trillion won to 522 trillion won during the 1996-2000 period.

<sup>32</sup> The 17.2 percent increase in tangible assets for the manufacturing sector in 1998 was mainly driven by asset revaluation. Gross fixed capital formation for the Korean economy as a whole declined by 21.1 percent in 1998.

**Table 6 | Corporate Investment Trends in Korea, 1996-2000**

(Unit: Trillion Won, current prices)

	1996	1997	1998	1999	2000
Total Investment (A)	107.4	104.0	53.3	79.0	95.9
Gross Fixed Capital Formation	95.0	98.2	75.5	80.9	90.7
Increase in Inventories	3.3	-2.1	-20.6	-3.2	1.9
Net Purchase of Land	7.0	5.1	-3.7	-2.1	0.8
Net Purchase of Intangible Assets	2.2	2.9	2.1	3.3	2.4
Internal Funds (B)	38.5	44.0	28.1	51.7	58.9
Net Savings	4.6	6.1	-11.5	5.5	15.2
Depreciation Charges	32.9	36.6	38.7	46.0	42.7
Internal Funds Ratio (B/A, percent)	35.8	42.3	52.7	65.4	61.4

Source: Bank of Korea

However, what is even more striking than this trend in the level of investment is the change in the *composition* of investment financing in the post-crisis period. In 1996, Korean firms relied on external financing for more than 60 percent of their investment needs. Loans from domestic banks and corporate bond issues made up the bulk of this external financing. However, as implicit government guarantees no longer became a certainty, especially in the wake of the Daewoo crisis, firms began to rely much more heavily on internal financing. In 2000, retained earnings and depreciation charges accounted for more than 60 percent of investment funds, reversing the relative importance of internal and external funds.

Financial institutions, for their part, have also been exercising more caution in extending credit to large firms. As commercial banks increasingly focused on consumer and housing loans, the share of the corporate sector in won-denominated bank loans (*stock*, not flow) declined from 75.0 percent at the end of 1996 to 48.7 percent at the end of 2001.<sup>33</sup>

33\_ The expansion of consumer credit had a couple of positive macroeconomic effects as well. It helped Korea to compensate for the weakening external demand in 2001 and maintain a relatively respectable GDP growth rate based on strong domestic demand. It has also helped to boost the profitability of banks and enabled them to aggressively write off nonperforming loans. Korean banks provisioned for more than 8 trillion won and still made a post-provisioning profit of more than 5 trillion won in 2001. Consumers in effect helped banks to clean up the mess that had been created from their imprudent corporate loan decisions of the past, without having to rely on yet another batch of public funds.

### 3. The Extent of Bifurcation in Performance

To assess the extent to which bifurcation might be a problem in Korea, we looked at how the performance of different cohorts changed over time. We used the financial statements of externally audited firms collected by the National Information and Credit Evaluation, Inc. (NICE), a credit-rating agency. The number of firms included in the data set varies from year to year because NICE does not collect financial information on all externally audited firms but rather focuses on firms whose credit it evaluates. To control for composition effects, we selected 3,616 non-financial firms whose financial data are available for every year during the 1996-2001 period. As a result, our sample consists of relatively well-established firms. Firms included in our sample account for more than 70 percent of the total assets of all the firms in the NICE data set. In 1996, for instance, there were a total of 6,351 externally audited firms in the NICE data set with their total assets amounting to 638 trillion won. The collective assets of 3,616 firms in our sample amounted to 520 trillion won that year. In 2001, our sample firms had collective assets of 713 trillion won while 8,294 firms in the NICE data set had total assets of 969 trillion won. We grouped our sample firms into four quartiles based on their interest coverage ratios and looked at how each quartile performed before and after the crisis.

Since a firm's interest coverage ratio (ICR) compares its operational profit with its debt service obligations on a flow basis, it may be used as a "summary statistic" for the viability of the firm.<sup>34</sup> Operational profit may be measured by operating income, EBIT (Earnings Before Interest payment and Taxes), or EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). Debt service obligations are typically measured by interest expenses. In this exercise, we defined ICR as the ratio between operating income and interest expenses.

34\_ If we define ICR as the ratio between operating income and interest expenses, we can decompose it into four components as follows, where IBDs denotes interest-bearing debts:

$$\begin{aligned} (\text{operating income} / \text{interest expenses}) &= (\text{operating income} / \text{sales}) \times (\text{sales} / \text{assets}) \\ &\quad \times (\text{assets} / \text{IBDs}) \times (\text{IBDs} / \text{interest expenses}) \end{aligned}$$

The first component, operating income-sales ratio, shows the operational profitability of the firm. The second component, asset turnover ratio, measures the effectiveness with which the firm utilizes its assets. The third component, the reciprocal of the (interest-bearing) debt dependency ratio, measures the financial stability of the firm. The fourth component is simply the reciprocal of the average interest rate on the firm's interest-bearing debts and is characterized by "a vintage effect" reflecting the maturity structure of the debts.

**Table 7 | Trends in Major Financial Variables for the Sample, 1996-2001**

(Unit: Trillion Won)

	1996	1997	1998	1999	2000	2001
Assets	520.32	630.07	696.31	765.35	749.43	712.53
Shareholders' Equity	130.47	112.34	167.86	250.88	236.29	241.79
Debts	389.82	517.48	528.44	514.46	513.13	470.79
Sales	488.45	569.72	605.31	645.36	729.36	710.69
Operating Income	25.34	37.34	30.23	26.62	45.45	36.17
Interest Expenses	23.30	27.54	43.66	37.82	33.21	28.98
Operating Income / Sales (%)	5.19	6.55	4.99	4.13	6.23	5.09
Sales / Assets	0.94	0.90	0.87	0.84	0.97	1.00
Interest Coverage Ratio (%)	108.74	135.55	69.23	70.39	136.86	124.79

Source: National Information and Credit Evaluation, Inc. (NICE).

Note: The sample consists of 3,616 externally audited non-financial firms for which financial statements are available every year from 1996 to 2001.

Table 7 shows trends in major financial variables and ratios for the sample firms from 1996 to 2001. Representative of Korea's corporate sector as a whole, firms in our sample more than doubled the equity of their shareholders and significantly reduced their total debt between the crisis year of 1997 and 2001.<sup>35</sup> Though affected by macroeconomic fluctuations, sales and operating income increased at approximately the same rate as assets.<sup>36</sup> In other words, at least on average, the operational profitability and asset turnover ratio of these firms hardly improved in the post-crisis period.

For Table 8, we grouped the sample firms into four quartiles *each year* based on their interest coverage ratios for that year. Accordingly, the 1<sup>st</sup> Quartile in 2001 consists of different firms from those that make up the 1<sup>st</sup> Quartile in 1996.

35\_ The total debts for 1997 were inflated by the collapse of the Korean won. The won-dollar exchange rate soared from 845 won to the dollar at end-1996 to 1,695 won to the dollar at end-1997. The exchange rate came down to 1,204 won to the dollar at end-1998. It has fluctuated around this level since, falling to 1,138 at end-1999 and then rising to 1,265 at end-2000.

36\_ Korea's GDP grew at an annual rate of 6.8 percent in 1996 and 5.0 percent in 1997. It contracted by 6.7 percent in 1998 but expanded by 10.9 percent in 1999 and 9.3 percent in 2000. GDP growth dropped to 3.0 percent in 2001.

**Table 8 | Distribution of Interest Coverage Ratios (Current-Year Quartiles)**

	1996	1997	1998	1999	2000	2001
Overall	108.74	135.55	69.23	70.39	136.86	124.79
1 <sup>st</sup> Quartile	405.55	424.99	320.84	709.55	1351.86	1470.83
2 <sup>nd</sup> Quartile	155.25	148.57	135.08	234.30	248.67	295.20
3 <sup>rd</sup> Quartile	89.94	89.11	58.77	102.43	120.27	110.29
4 <sup>th</sup> Quartile	-17.93	-32.89	-70.13	-66.14	-33.36	-40.88

The 1<sup>st</sup> Quartile as a whole in 2001 was better than its counterpart in 1996 in every respect: Its operational profitability was higher, asset turnover ratio was higher, debt dependency ratio was lower, and the average interest rate on its interest-bearing debt (IBDs) was lower. As a result, its total operating income was nearly 15 times its interest expenses in 2001. Measured by asset size, firms that comprise the 1<sup>st</sup> Quartile are on average smaller than those in the other quartiles. As for the 2<sup>nd</sup> Quartile, while operational profitability in 2001 was lower than in 1996 and the average interest rate on IBDs was about the same, the asset turnover and debt dependency ratios improved. The 3<sup>rd</sup> Quartile in 2001 showed a slightly higher operational profitability and interest cost but a lower asset turnover ratio than in 1996. A significant reduction in the debt dependency ratio was the primary reason for the improved ability to cover interests. Except for a higher asset turnover ratio, the 4<sup>th</sup> Quartile in 2001 was in worse shape than its counterpart in 1996. In particular, unlike the other quartiles, it had a higher debt dependency ratio in 2001 than in 1996.

Table 9 is the transition matrix for the period between 1996 and 2001 based on interest coverage ratios. It shows that 48 percent of the firms in the 1<sup>st</sup> Quartile in 1996 were also in the 1<sup>st</sup> Quartile in 2001 while 17 percent dropped to the 4<sup>th</sup> Quartile.

**Table 9 | Transition Matrix Based on Interest Coverage Ratios, 1996-2001 (%)**

	1996				
	1 <sup>st</sup> Quartile	2 <sup>nd</sup> Quartile	3 <sup>rd</sup> Quartile	4 <sup>th</sup> Quartile	
2001	1 <sup>st</sup> Quartile	48	23	13	17
	2 <sup>nd</sup> Quartile	22	31	27	20
	3 <sup>rd</sup> Quartile	13	27	35	25
	4 <sup>th</sup> Quartile	17	19	25	38

For Table 10, we grouped the sample firms into four quartiles based on their interest coverage ratios *in 1996* and looked at how each cohort performed over the years. Accordingly, the 1<sup>st</sup> Quartile in 2001 is identical in composition to the 1<sup>st</sup> Quartile in 1996.

**Table 10 | Distribution of Interest Coverage Ratios (Fixed 1996 Quartiles)**

	1996	1997	1998	1999	2000	2001
Overall	108.74	135.55	69.23	70.39	136.86	124.79
1 <sup>st</sup> Quartile	405.55	358.65	231.91	366.85	471.12	434.24
2 <sup>nd</sup> Quartile	155.25	215.95	101.19	124.38	201.90	128.20
3 <sup>rd</sup> Quartile	89.94	98.72	34.36	-1.72	64.08	80.76
4 <sup>th</sup> Quartile	-17.93	31.88	33.60	50.91	65.95	75.46

A comparison of Tables 8 and 10 suggests a great deal of inter-quartile mobility in terms of interest coverage ratios. Firms belonging to the 1<sup>st</sup> Quartile in 1996 did not necessarily perform better than other firms over the 1996-2001 period. In fact, firms in the 4<sup>th</sup> Quartile in 1996 collectively performed better than the 3<sup>rd</sup> Quartile over the same period. Apparently, financially distressed firms in 1996, it seems, were not necessarily just put on a life-support system while their performance continued to deteriorate. In fact, firms belonging to the 4<sup>th</sup> Quartile in 1996 improved their operational profitability, asset turnover ratio, and debt dependency ratio even as the average interest rate on their IBDs went up during the 1996-2001 period.

The main findings of this section may be summarized as follows:

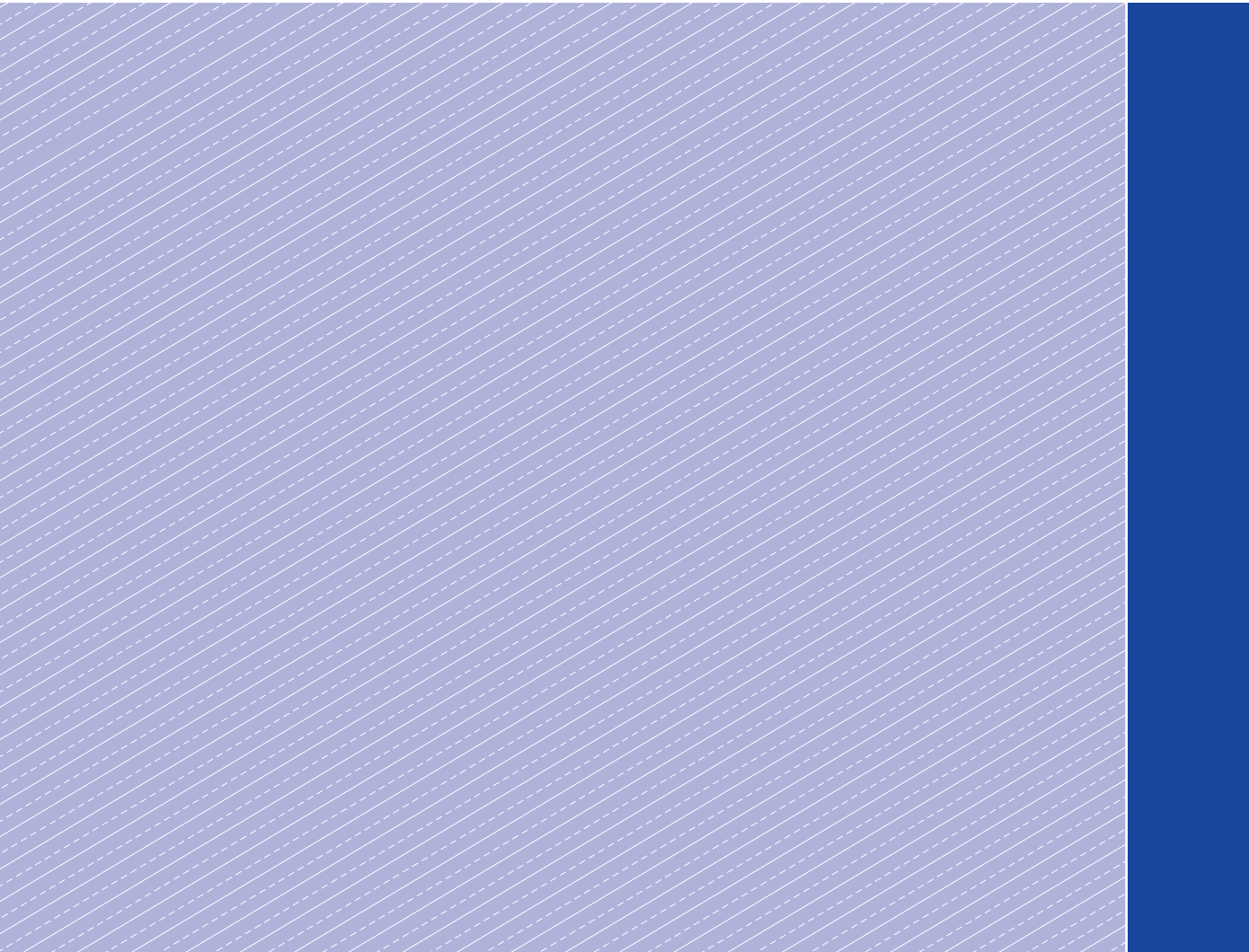
- The financial stability and the profitability of Korean firms on average have improved a great deal since the crisis years of 1997-98.
- While Korean firms seem to have some way to go before their profitability relative to their debt burden reaches a sufficiently high level, they clearly have become much more prudent in their investment behavior in the post-crisis period.
- These overall trends, however, mask significant differences in performance among Korean firms in the post-crisis period. The performance of the top quartile, in particular, has improved by a great deal in the post-crisis period. By contrast, the bottom quartile is continuing to show signs of trouble. This result is driven by a great deal of inter-quartile mobility rather than a lock-in.
- Overall, the extent of financial distress does not seem to pose a serious systemic risk.



Corporate Restructuring in Post-Crisis Korea

# Chapter 05

## Conclusion



## Conclusion

In post-crisis Korea, the role of the government in the economy is being changed in a fundamental yet potentially problematic way. As the crisis of 1997 is widely blamed on the old government-business risk partnership, the government no longer has the mandate to “lead” the economy. At the same time, with the *de facto* nationalization of many banks and other financial institutions in the wake of the crisis, the government ironically has more resources under its control than before.

As for the *chaebol*, their “convoy-style” business structure is being seriously eroded in the post-crisis period, as shareholders are becoming increasingly impatient with resource transfers that are perceived to reduce firm value. Increasing asymmetries in the ownership structure of affiliates belonging to the same business group suggest that this trend away from cross-subsidization will become even stronger in the future.

Yet the specter of *chaebol*'s increasing dominance of the financial sector through the takeover of nationalized financial institutions raises the possibility of retrogression. The balance of power among major players in the Korean economy is such that government intransigence is the most likely scenario for bank privatization in the short run, but a takeover by *chaebol* cannot be ruled out.

Although Korea's financial markets have changed a great deal in the post-crisis period, the dearth of autonomous financial institutions continues to make market-led corporate restructuring a difficult proposition in Korea. Even if Korea manages to import state-of-the-art bankruptcy laws and institutions from abroad, the governance problem created by government or *chaebol* control would distort incentives for financial institutions. Bank privatization and separation of banking and commerce (including NBFIs) should be an integral part of economic reform if financial resource allocation is to improve.

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