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Conclusions

A Tale of Two Countries?

In the months prior to this book being completed in late 2002, the US press reported several of the biggest bankruptcies in US history. It indeed seemed almost as though there were a contest among certain large US firms to lay claim to being the biggest failure of all time. Thus, the energy services firm Enron briefly held the record, but its collapse was soon surpassed by the insolvency of the giant telecommunications services provider WorldCom. Each of these two fallen American firms made the bankruptcy of Daewoo in Korea two years earlier seem rather small in comparison. Moreover, the bankruptcy of these American giants largely caught the American public off guard. Whereas problems at Daewoo had festered for years, and the only surprise about its bankruptcy was how long it took for the firm to be declared formally insolvent, the failures of Enron and WorldCom were not at all anticipated.

As in Korea, in the United States the bankruptcies were characterized by substantial material wealth being acquired by certain company insiders, even as thousands of others lost wealth, their livelihood, or both. For example, Kim Woo-chung, the founder of Daewoo, is widely believed to be a very wealthy person. No one knows for sure, because his whereabouts are unknown and he remains subject to an arrest warrant should he return to Korea. But presumably, Kim is leading a life of considerable luxury in some nation that he has chosen for his exile. In the United States, former CEOs of bankrupt companies, along with other top executives, are out of jobs, but many of them are now exceedingly wealthy. Also, like Kim, executives of at least some failed US firms have been indicted on criminal charges, and the US press has speculated that further indictments involving executives of other firms might follow.

Problems other than executive misconduct have plagued those American firms that in 2002 have had to file for bankruptcy protection, and these problems often bore uncanny resemblance to those of the chaebol in the aftermath of the 1997 Korean financial crisis. Thus, for example, off-balance-sheet financing played a key role in the Enron debacle, just as similar financing figured heavily in the demise of Daewoo: in both cases, it was used to hide the true extent of the indebtedness of the respective organizations. Likewise, in both Korea and in the United States, "creative accounting" techniques were widely employed to distort earnings of business organizations as reported in income statements, so that revenues, earnings, or both were inflated and costs understated. Such creative accounting to distort the bottom line of income statements has been widely reported in the press as one factor in the suddenness of the downfall of WorldCom, as well as featuring in some lesser scandals in the United States (e.g., overstatement of profits by a number of firms, including Xerox and AOL-Time Warner); it also seems to have figured in the case of Hynix in Korea.

Similarly, in both countries, lax corporate governance helped to create the difficulties in their corporate sectors. Boards of directors of large companies seemed not to have played the role that, in principle at least, they should have—to evaluate dispassionately whether the management was steering the firms in a direction that served well the interests of their shareholders. Rather, in both countries, these boards often appeared to be the captives either of management in the case of the United States or, in the case of Korea, of the families of the founders of the firms (who, although no longer majority shareholders, nonetheless effectively retained control). Moreover, cronyism between senior officials in government and business leaders seems to have had deleterious effects. For instance, there seems to be little doubt that Enron, for a time at least, had friends in high places in Washington even during a period when the firm's excesses were getting out of hand; and the role of cronyism in Korea is described throughout this book.

But in the corporate insolvencies in Korea and the United States, we can see positive as well as negative similarities. In this regard, it is important to recognize that in both countries, during the very times when corporate malfeasance has been revealed to have taken place, the overall economic performance of the economy was often quite good. Strong economic growth occurred in both Korea and the United States during much of the 1990s (1998 in Korea is an obvious exception, but as noted in the previous chapter, the recession of that year was very short-lived). Furthermore, the fruits of this growth reached deep into the population.

Doubtless one reason for this growth was that investors were willing to take risks by investing in new activities, often based on new technologies.

Thus, while investment in information technology in the United States did lead to the "dot.com bubble" of the late 1990s (and to the related "telecommunications bubble"), it was also accompanied by unquestioned benefits for the US economy, which are almost surely very long-term in nature (see Baily 2002). And in Korea from the 1970s onward, while large-scale investment in new activities unquestionably created a large amount of wreckage, it also created one of the longest periods of sustained economic growth ever recorded by a single nation.

Thus, one challenge facing both Korea and the United States now is to implement reform that will curb the abuses yet not discourage risk taking where the potential returns are high but where there is significant downside potential for loss. Indeed, one hallmark of a dynamic economy is that business failures will inevitably occur, and some of these are likely to be spectacular. The development of new technologies that propel dynamic economic growth, after all, does entail significant risks as well as potentially high returns, and significant risk implies that some investments will not pan out. The objective of reform is, or at least should be, not to prevent business failure per se but to prevent malfeasance on the part of owners and managers that can lead to unnecessary failure.

It is also important to understand that the drawing of parallels between Korea and the United States in 2002 should be taken only so far. There are a number of significant differences between the bankruptcies and near bankruptcies that have occurred in recent years in the two countries. For example, in the United States, bankruptcies of large firms have historically been resolved rapidly. Some of the consequences have been harsh—workers at these firms have lost their jobs and investors in the firms have lost their shirts. But rapid resolution minimizes the drag on the economy caused by business failure, so that the costs associated with the failure are realized rapidly and do not last for years after the failure occurs. Certainly one reason why rapid resolution is possible is that the United States has in place a reasonably effective "social safety net"; for example, a worker that loses employment as the result of a bankrupt business shutting down is able to collect unemployment compensation and other benefits during a prolonged period without work. The current rash of failures in the United States is demonstrating that these safety nets could serve to be strengthened: for example, by pension management reform, so that no worker loses all or even most of his or her accumulated pension benefits because an employer fails; or by reform of the health care insurance system so that a worker who is forced into unemployment as a result of an employer's bankruptcy does not need to worry that personal health problems can lead to personal bankruptcy. Nevertheless, a safety net does exist. In Korea, by contrast, until the crisis of 1997 there was little or no safety net. One consequence has been that when a major firm failed or even tottered, a constituency was created to urge bailouts and subsidies for it. Moreover, the bankruptcy is resolved slowly if at all, making the "drag" from an insolvency greater than necessary. In this matter, Korea has improved in the years since the crisis, but most experts think that it still has a considerable way to go (Ahn 2001; Cho W. 2001; Chopra et al. 2002; Joh 2001; Kim Joon-ki and Lee 2001; OECD, *OECD Economic Surveys: Korea 2001*; Mako 2002a, 2002b).

The Need for Reform in Korea Has Not Ended

The parallels between the failure of large corporations in the United States and Korea underscore that new reform initiatives are needed in the first and that the process of achieving reform in the second has not yet been brought to a full and successful conclusion. The main difference between the two countries in this regard is that Korea has been implementing a whole series of reforms since the 1997 crisis, whereas reforms in the United States have yet to be fully formulated, let alone implemented. This is to be expected, given the relatively recent occurrence of the US corporate insolvencies. But even so, there is much to be learned by the United States (and by other nations) from the reform that has gone forward in Korea, despite the many differences between the two nations.

Indeed, perhaps the main lesson to be drawn from Korea is that quite aggressive reform there did not, as many might have feared, suppress recovery and economic growth. To the contrary, Korean economic growth following the recession of 1998 has been quite robust, as noted in the previous chapter. Kang Sam-mo, Wang Yun-jong, and Yoon Deok-ryong (2002) demonstrate that in fact the recovery from the 1997 crisis has been unusually rapid when compared with the rates at which other countries have recovered following a major financial crisis. It is probably not a stretch to argue that Korean recovery has occurred because and not in spite of the serious reform that has been implemented. Nevertheless, further reform is almost surely needed.

First, reform of the Korean financial sector must continue, so that the institutions in this sector not only intermediate savings into investment efficiently (something that has not happened in Korea as well as it should, as we have seen) but also monitor the performance of firms that receive funds and take steps, where necessary, to improve flagging performance. This development, as will be elaborated below, implies more than just further reform of existing financial institutions, as has been the post-crisis focus: whole new institutions must be created in the financial sector.

Second, still higher standards of transparency must be developed and implemented. Indeed, this is an area in which efforts in Korea have been somewhat lagging, though recent US experience demonstrates that it deserves priority. In fact, lack of transparency arguably has been the single factor most responsible for the difficulties in which much of corporate America now finds itself. Moreover, Americans have been largely blind to this problem until recent months, largely because most believed that standards of transparency in the United States were quite high—and have been shocked to discover otherwise. Koreans, by contrast, have long known that companies in Korea do not function under high standards of transparency, though some steps have been taken to raise them. The American experience might serve to convince Koreans that this particular bar needs to be raised yet higher.

Third, the reform of corporate governance in Korea has a long way to go. In particular, the incestuous relationships among the various affiliates of the chaebol should be further reduced, with the ultimate goal that major affiliates should operate entirely independently of one another. Indeed, one big issue facing Korea today is whether the remaining chaebol simply should be broken up. Because a breakup of what had been the largest of the groups, Hyundai, has largely already been achieved, one matter to be watched closely is whether the smaller groups that once constituted the Hyundai chaebol do, in fact, perform better as independent units than they might have been expected to perform within a larger group.[1]

Other issues involving corporate governance in Korea include the need for greater accountability of management to shareholders of firms, particularly to "minority" shareholders. In this case, "minority" is placed in quotes because so-called minority shareholders in Korea sometimes in fact have in total more funds invested in a firm than do the "majority" shareholders—most often members of the founding family of the firm—who have effective voting control over the company. One consequence is that in many Korean businesses minority shareholders and majority shareholders have divergent interests, but management serves the interests of the latter and not the former. (Similar divergences lie behind some of the problems in US firms as well.) Some way must be found by which the interests of minority shareholders are better represented in management decisions than currently is the case.[2]

Fourth, still better means for resolving bankruptcy must be implemented in Korea. As already noted, bankruptcy resolution in Korea remains extremely slow; and making this problem worse, many firms in Korea, in spite of the remarkable recovery of the economy as a whole, remain on the verge of bankruptcy. Nonresolution of insolvent firms creates considerable drag on an economy. How great this drag can be is evidenced by the experience of Japan, where the root of much of the current economic malaise is nonresolution of many firms that are bankrupt or close to it. The risk is high that without further reform of bankruptcy resolution, this drag could grow in Korea, slowing or even stalling future growth.

Fifth, the policy of "too big to fail" must be abandoned in fact as well as in rhetoric. Despite much lip service paid by the government, some of

1. For a thoughtful assessment of these issues, see Ehrlich and Kang (2002).

2. See Jang (2002) on this issue.

its actions have nonetheless revealed that this approach is not yet wholly dead in Korea. The big test in this regard surely will be how Hynix is resolved. At the time of this writing, the Korean government has pledged that it will not grant any further subsidies to Hynix. Sticking to this pledge would likely give credence to the proposition that the notion of some companies being too big to fail has indeed been discarded.

Sixth, and perhaps most important, Korea needs a social safety net better than what currently exists.

Further carrying out these reforms (which, in most cases, are already under way) will help Korea cope with other policy issues—for example, what to do about the falling off of foreign investment coming into Korea. This falloff, as argued below, has in large measure occurred precisely because the reform process in Korea has not proceeded far or fast enough.

Let's examine each of these areas of needed further reform in some detail.

Financial Sector

Exactly how much progress has been made in financial sector reform in Korea is, at the time of this writing, difficult to judge. Nonviable financial institutions have been shut down or merged into more viable ones, and weak institutions have been recapitalized and reorganized. In April 2001, a large financial holding company, the Woori Group, was created in an experiment to create a more advanced financial institution in Korea, but this was essentially a merger of a number of existing institutions.

Despite the progress made in this sector, there were some indications that Korea might slip back into its earlier practices that had gotten the country into trouble in the first place. As noted in the previous chapter, when Hyundai Engineering and Construction Company found itself in trouble in 2001, a consortium of financial institutions was formed essentially to bail HECC out. The bailout was not handled quite as it might have been some years earlier. It was centered around a debt-for-equity swap that, when fully carried out, would largely strip Chung Mun-hoon of control of the firm and give it to the consortium. In the past, in contrast, HECC might simply have received "evergreen" loans from its creditors, who would have acted under pressure from the government. Nonetheless, elements of the old system clearly persisted. According to newspaper reports, financial institutions that were reluctant were pressured into the arrangement by the government; among the unwilling was First Korea Bank, which is now under foreign control and which reportedly did not want to participate. Indeed, First Korea Bank was said to view this pressure as being in violation of an understanding between the government and the foreign investors that the bank could make its decisions free from government influence.

In the end, the refinancing of HECC departed significantly from "the bad old days" in positive ways. In particular, the resulting change of ownership control of the firm is almost surely a good thing for Korea, as it suggests that economic considerations, rather than political ones, might now play a greater role in decisions regarding such restructuring than they had in the past. Nonetheless, the heavy hand of the government in attempting to force all financial institutions with a stake in HECC to participate in a government-sponsored plan was disturbing.

The main issue in financial sector reform at the moment is how to reprivatize the banks, a question not yet decided in Korea. What clearly is needed is that banks, as well as other financial institutions, be independent of control both by the government and by the chaebol. But in March 2001 the finance minister of Korea suggested that to reprivatize the banks that had been effectively nationalized as the result of the banking sector recapitalization and reorganization undertaken in 1998, the government might lift limits on ownership of banks by nonfinancial companies. As noted in the financial press, this action would open the way for chaebol-affiliated firms to gain control of banks, and thus make possible exactly the same kind of abuses that got Korea into trouble in the first place—in particular, massive use of debt from captive financial sources to finance low-return expansion.[3] The finance minister who issued this trial balloon was surely well aware of the dangers of such backsliding, but he appears to have made the proposal for a purely pragmatic reason: no institutions in Korea other than the chaebol (or individuals other than owning families of these groups) have the means to buy the banks from the government.

One alternative might be to encourage foreign ownership of the banks. However, this approach is not sufficient in itself. While foreign participation in the banking sector would be desirable for many reasons (e.g., increased competition might force local banks to adopt best practices), foreign ownership of the entire banking sector in Korea almost surely would be unacceptable on political grounds alone. Another alternative might be to fashion a means by which banks could pass into broad-based private ownership. Korea now lacks institutions that might enable small investors to pool resources so as to become major shareholders in large organizations. Thus, the creation of such institutions could solve the problem of who can buy the banks.

Once the banking sector is privatized, the process of building the organizational capabilities of the banks must continue (and indeed one major objective of creating large financial holding companies such as the Woori Financial Group seems to be to foster greater organizational capabilities). As noted by James Rooney (2002), Korea's banks are still beset by poor lending practices, themselves the product of banking personnel's lack of relevant skills, particularly in the area of risk management. Also, banks in Korea remain undifferentiated. Thus, depositors in Korea generally do not

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3. See the editorial "The Limits of Korea's Reforms: Will the *Chaebols* get Their Piggy Banks Back?" *The Asian Wall Street Journal*, June 21, 2001.

play what in other countries can be an important role: that is, to shift funds out of badly managed banks and into better-managed ones and thereby provide inducement to the former to transform themselves into the latter. Here we have come full circle, because much of the reason for lack of distinction among them is the extensive state control of the banks, which stifles innovation and actually discourages differentiation.

Apart from bank reform, a well-functioning equities market is a top priority, as Catherine Mann (2000) notes. In the case just cited, that of bank privatization, if the equity market were functioning better in Korea, the government could simply float shares of the banks on the market. One reason for the stock market's weakness, as suggested in previous chapters, is that it has historically been something of a casino; in particular, in a number of incidents equity prices have been manipulated in ways that damaged the interests of small investors to benefit large ones. The Korean stock exchange is thus not an institution in which Koreans have confidence. That is truly a shame, because the end result is to effectively deprive most Koreans of the chance to own equity in the large enterprises—both financial and nonfinancial institutions—that dominate their own economy, leaving ownership instead concentrated in the hands of very few. This situation also reduces the flexibility of the whole financial system, making it difficult for firms to raise new equity capital. But entry of new firms into the Korean economy and their expansion, which both require new equity, are essential if the economy is to achieve future growth (on this, see Yusuf and Evenett forthcoming).

Thus what is needed now is the creation of large institutional investors—for example, mutual funds and pension funds—that act on behalf of smaller investors. Although institutions that call themselves "mutual funds" have appeared recently in Korea, these have proven largely to be vehicles for stock market manipulation by large investors. In fact, in an article written several years ago (Graham 1999), I suggested that proper mutual funds and pension funds could play important roles in industrial sector restructuring. The idea was that banks and other lenders would engage in debt-for-equity swaps in order to reduce the overall indebtedness of the Korean industrial sector; the rate of exchange would be determined by independent assessment of the true worth of an individual company. But given the current institutional structure, such swaps would make banks and other lenders major shareholders in many chaebol-affiliated firms, a situation that seemed no more desirable than the chaebol being the major shareholder of the banks (in either case, an incentive is created for the banks to lend to the chaebol on preferential terms). Thus, I proposed that equity be bought by newly organized and wholly independent equity funds, both mutual and pension funds. They would be independent in the sense that they would not be controlled by the chaebol or the banks. In fact, such equity funds themselves could become the owners of banks as the banks are reprivatized.

These institutions would in no way be forced to buy any security that they did not wish to hold but rather would buy equities in open trading. The funds would receive their own funding from Koreans who wished to have somewhere to hold their savings other than the current institutions—the banks, investment trust companies, life insurance companies, and so on. This alternative might be attractive because a well-managed mutual or pension fund could potentially offer higher returns to small investors. Also, risk to the investor would be reduced by proper management: the portfolio held by the fund would be diversified so as to eliminate non-systematic risks to the shareholders.

In 1999, following publication of the article, I was informed by a very senior Korean government official that these ideas were too radical and "probably illegal" in Korea. But in 2001, two years after I was told this, at least one element of this radical and illegal scheme is actually beginning to be implemented in Korea: creditor institutions, which mostly are banks, are now requiring debt-for-equity swaps as a condition for any major loan renegotiation where the borrowing firm is in difficulty. But this in turn leads to a problem: what to do with the equity that the bank acquires? It probably is not desirable for Korea to become a bank-based economy such as Germany, where banks are the major equity holders in industrial firms. One answer is to sell the shares to the public, but in a form that allows the small shareholder to hold a diversified portfolio. And, once again, this implies the creation of new types of institutional investors.

Yet it might not be easy for institutional investors to establish themselves as credible alternatives to banks—as institutions to which small investors will entrust their funds. To address this problem, it might be possible to relax the stricture that current financial institutions not be allowed to control institutional investors, so that a financial group such as Woori could create and operate an equities fund. Such a fund would not actually be owned by the financial group; rather, ownership would reside in the shareholders in the fund, and the financial group would simply provide professional management and lend its name to the group for purposes of establishing credibility. If this sort of arrangement were to be permitted, it would be desirable for credible firewalls to be created between the equity and nonequity operations of the financial group so that decisions taken in one area would be independent of those taken in the other.[4] It might also be desirable that the groups be required to spin off their equities funds at some time in the future.

A key value of such institutional investors to Korea, beyond their potential to give households more alternatives for investing savings, is that they potentially can play a much stronger role than other financial institutions

4. The lack of such "firewalls" seems to be at the heart of problems at Citicorp, being reported in the US financial press just as this book is going to press.

in monitoring corporate performance. Such a role has in fact in recent years begun to be played by creditor institutions in Korea, meaning once again mostly banks. But this function tends to be carried out only after a firm whose debt is held by the banks gets into significant trouble. Institutional equity holders would have an incentive to monitor firms and correct incipient problems at an earlier stage, for the simple reason that they are shareholders in the corporations in which they invest. As shareholders, they hold voting rights and thus, unlike creditor institutions, have some say in the conduct of the corporation on a day-by-day basis. In countries where these institutions are strong, such as the United States, they have been known to force major changes in management of companies that have performed poorly (e.g., in the early 1990s, institutional investors played a major role in a management shake-up at General Motors Corporation).

Most often, this role is manifested simply by the investor selling the equity of firms in which there is no confidence, sending a negative signal to the management of such firms.

Thus if, for example, in the future some firm were to seek, Daewoo-like, to invest in a project with unpromising returns using borrowed money, an institutional investor might quietly suggest to management that the project be reconsidered. If management pressed ahead, the institutional investor might then send a strong signal to the market that something was amiss by selling its shares in that firm. As a practical matter, institutional investors monitor each other's behavior, and such a sell-off might trigger further sell-offs. Management might find, in these circumstances, that it indeed should reconsider its plans.

It should go without saying that institutional investors must be completely independent of the firms in which they invest in order to avoid conflict of interest. But in Korea, even in the post-crisis period, those nonbank financial institutions that have existed have mostly been chaebol-controlled mutual funds and other institutions that have functioned as piggy banks for the groups. This problem has been discussed in earlier chapters; here we need simply note that the creation of major institutional investors that are not under chaebol control remains a desirable but unfinished task in Korea.

Transparency

Financial transparency implies simply that financial and economic information pertinent to the operations of an enterprise is thorough, accurate, truthful, complete, and readily available to all interested parties. Transparency is important because if a market economy is to function well, all agents participating in the market must be well informed. (Market efficiency in fact depends on this fundamental premise; it is thus remarkable that in Korea but also in the United States and elsewhere, those political figures who profess a belief in the market economy have often sought to suppress regulations that would provide for more and better financial transparency.) If the contrary prevails—if, say, a lender believes that a borrower is earning profits when in fact that borrower is incurring losses, or the lender believes that the borrower holds only half the debt that is actually being held—then bad economic decisions can be made: good money might be thrown after bad by investors who act on the basis of what amounts to false information. The consequences of such bad decisions do not affect just the lender and the borrower. Rather, bad economic decisions adversely affect an entire economy and, indeed, an entire society.

In Korea, the failure of the sale of Daewoo Motors to Ford Motor Company illustrates this last point. The failure of this deal to be concluded derived in large measure from lack of transparency. "Due diligence" (itself essentially an effort to confirm the veracity of information presented by a firm, and to correct errors or omissions in that information) revealed not only that the entire group was deeper in debt than had been reported when the group failed in mid-1999 but also that the Daewoo Motor Company was subject to certain specific liabilities—some of these contingent liabilities (e.g., penalties in India for nonperformance)—that previously had not been disclosed. Following the cancellation of this sale, problems of transparency plagued the subsequent negotiations over the sale of Daewoo Motors to General Motors. In the end, the sale was completed in the spring of 2002, but by that time Daewoo Motors had lost most of its original value. As discussed above, the Korean firm was thus finally sold to General Motors for about $400 million; GM had two years earlier bid almost 10 times this amount.[5]

The specific loss of value of Daewoo Motors was not the only cost to Korea. Since the collapse of the Ford takeover of Daewoo, foreign direct investment in Korea has dropped markedly. One reason commonly mentioned in the financial press is, again, lack of transparency. In fact, the international accounting firm PriceWaterhouseCoopers in 2000 examined accounting practices in 35 major countries and found that Korean practices were the least transparent of the 35 (reported in OECD, *OECD Economic Surveys: Korea 2001*). When foreign investors examine an asset that might be for sale, they worry that the asset might somehow have a set of nondisclosed liabilities attached to it. Because meeting those liabilities would create costs, they of course diminish the true value of the asset. But, perhaps worse, the uncertainty regarding the value of the asset deters would-be buyers from purchasing it in the first place. Thus, uncertainty over the true value of Korean assets might very well be at this time the

5. Factors other than lack of transparency also contributed to this collapse of value.

biggest single obstacle to foreign direct investment in Korea, simply because foreign investors are wary that assets they seek to buy might come with nondisclosed, nontransparent liabilities.[6]

Obviously, an economy cannot function well if financial information pertaining to enterprises that operate in that economy is routinely inaccurate or fraudulent. Therefore, it is a legitimate role of government, even in free-market economies whose governments in principle largely avoid economic intervention, to enforce requirements for transparency. But unfortunately, there are numerous reasons why persons, firms, and even governments might seek to reduce rather than enhance financial transparency. Most of these reasons fall into two categories: to cover up mistakes or to hide dishonest or illegal actions that serve to benefit certain insider parties. Sometimes the reason boils down to the simple desire of an asset's seller—whether a private agent or a government—to realize as high a price as possible for the asset and thus to hide any bad news that might adversely affect that price. To be sure, such attempts at concealment can be shortsighted, at least from the viewpoint of the overall interest of investors in these assets. But as the recent corporate scandals in the United States make clear, persons whose job it is to manage an asset (a task that includes disclosing to investors proper information regarding that asset) can face conflicts of interest that lead them to hide bad news to benefit themselves. For example, management of several firms in the United States, where top managers often have been compensated by means of stock options on the common stock of the firm, discovered that by manipulating both reported earnings and balance sheet items, they could drive up the price of the common stock and cash in their options before the investor community at large realized that the reported financial information was bogus. In the case of Korea, as suggested above, the motivation for misreporting financial information has often been to try to obtain from a foreign investor a higher sale price than would have been paid had the information been correctly reported.

The enforcement of requirements for transparency has been more difficult in Korea than in many other nations precisely because of the structure of business. Following the practice in the United States, Korea long ago enacted laws requiring firms that are listed on the stock exchange to publicly report certain basic financial information, including balance sheets and income statements. Unlisted firms do not face similar requirements in either country. However, unlike large firms in the United States, Korea's chaebol evolved not as single corporate entities but as loosely affiliated groups of firms, where each affiliate was listed separately or not at all. Furthermore, because of various intricate connections among affiliates, information that was specific to one affiliate might have bearing on some

6. A recent assessment of FDI into Korea is provided by Kim June-dong (2002).

other affiliate's performance. If the former affiliate were unlisted, that information might be "opaque" to anyone but insiders who worked for the group, even if the latter affiliate were listed and hence financial information pertaining to it was in principle "transparent." Thus, for example, as noted in the previous chapter, the true debt-to-equity ratios of all of the chaebol, as publicly revealed during the summer of 2000 when the requirement for consolidated group information came into effect, proved to be significantly greater than what the groups had claimed up until that time. Banks lending to the groups therefore simply did not know their true indebtedness, though this information is highly pertinent to loan decisions. In addition, the lack of transparency often has served to benefit inside parties (e.g., the founding families of the chaebol) at the expense of outside parties (e.g., so-called minority shareholders, including foreign shareholders). One example of how such benefits arise has already been noted in previous chapters: loans or loan guarantees from an established chaebol affiliate whose stock is widely owned are used to finance the creation of a potentially high-return but risky affiliate whose equity is largely held by inside investors. The problem with this sort of arrangement is not that funds are put at risk; in fact, such risk might be a good thing, because it can create new activities that lend dynamism to the economy. The problem, rather, is that the minority shareholders of the established affiliate, without transparency, do not know that their money is being put at risk in such a way that there is (for them at least) no offsetting participation in what could prove to be a high-return venture.

The good news for Korea is that much progress has been made in achieving a greater degree of financial transparency than has prevailed generally in Korea. This includes the identification of out-and-out fraud and the impositions of sanctions on those who commit it. Thus, for example, in February 2001, as discussed in the previous chapter, a warrant was issued for the arrest of Kim Woo-chung, the former head of Daewoo who is currently a fugitive from justice, on grounds that he deliberately defrauded investors. In April 2001 the Financial Supervisory Service (FSS) was authorized to impose larger fines and penalties on accounting firms for improper audits, and these firms were made liable for damages that might be incurred by third parties (i.e., minority shareholders) as the result of such improper audits. In November 2001, the Financial Supervisory Commission (FSC) indicted the accounting firms that had audited Daewoo for collaborating with the firm to falsify accounts. In July 2002, the Korea Deposit Insurance Corporation announced that it would file suit against five of these firms to compensate for losses of public funds resulting from "improper accounting" of Daewoo and also of the Kohap group. Separately, the KDIC announced that it would sue the chairman of Kohap for inflating reported profits in a bid to receive public funds. Also during July 2002, the FSS appointed external auditors to 100 companies suspected of posting improper financial statements (auditors are customarily appointed by firms, not by government supervisory agencies). During the first seven months of 2002, a total of 27 executives from 10 different companies received jail sentences for accounting fraud or misuse of public funds, and investigations of similar fraud in 10 additional firms were under way.

The FSS had previously taken steps to strengthen the role of auditors by requiring that they notify the FSS of illegal transactions detected at financial institutions. This followed on a decision of the FSS in April 2002 to seek a new law that would ban auditing firms from offering management consulting services to clients. The FSS had already determined that about one Korean firm out of five received management consulting services from the same company that performed the firm's auditing services. A similar ban has, of course, been discussed in the United States following the Enron debacle, although at the time of this writing it has not been formally proposed by any agency of the US government. Nor has any such law actually been passed in Korea, though its enactment was expected by the end of 2002. Moreover, beginning in 2001, the FSS investigated 72 firms that failed to receive "satisfactory" ratings by their auditors for that year; in April 2002, it decided to force the delisting from the Korean stock exchange of 11 of these firms.

The release in the spring of 2001 of consolidated financial statements for the year 2000 by the 30 largest groups was a clear step in the right direction; the only shame here is that it was so long delayed. An earlier release might, for example, have enabled the emerging problems at Hyundai (discussed in chapter 5) to be identified sooner and thus have increased the odds for a favorable outcome. Consolidated financial statements were released for 2001 in May 2002, and these showed again that the consolidated debts of listed chaebol-affiliated firms were greater than reported on a nonconsolidated basis, as were the debt-to-equity ratios. But also, when compared with 2000, the debt-to-equity ratio of the large groups declined somewhat. In July 2002, the Korea Fair Trade Commission asked a total of 80 affiliates of Samsung, LG, and SK, and the three Hyundai successor groups to present detailed financial data on intragroup transactions. This move apparently was triggered by fears that a "borrow and expand" strategy among the big groups was beginning to reemerge.

As noted in previous chapters, in fact, reform to improve accounting and transparency standards began to be implemented in the wake of the 1997 financial crisis. Beginning in 1998, an independent body (the Korea Financial and Accounting Standards Committee) was appointed by the FSS to recommend appropriate standards for accounting practices in Korea. In 1999, the Korea Accounting Institute (KAI) was created to rewrite Korean standards. In July 2002, the KAI announced that new standards would be phased in from 2003 through the first half of 2004. These would be based on the International Accounting Standards (IAS) as formulated by the International Accounting Standards Board (IASB), a multinational group of experts.[7] The IAS are in the process of being adopted in most European nations. The KAI explicitly rejected the Generally Accepted Accounting Principles (GAAP) as widely used in the United States, noting that the GAAP contain many loopholes that have figured in the recent corporate scandals in the United States.

Progress to date in Korea, while in the right direction, is nonetheless arguably not yet adequate. Further improvement is especially needed in the performance of auditors themselves. One problem as identified by the KAI is lack of qualified personnel; Korea simply does not have enough trained financial accountants and auditors at the moment to do the job as well as it should be done.[8] Another problem is that even at the time of this writing, the need for more transparency is not fully acknowledged. For example, at a meeting held in late July 2002, the Federation of Korean Industries (FKI), the umbrella organization of the large chaebol, stated that "enterprises fundamentally cannot be transparent and any attempt to impose democracy on corporate management would kill the enterprises."[9] The immediate target of this declaration was the Korea Fair Trade Commission, which only a few days earlier had asked that details of financial transactions among affiliates of six large chaebol be disclosed. At the same meeting, Korean Deputy Prime Minister Jeon Yunchuri defended the KFTC request, noting that it had been undertaken in part to ensure that there were no "bookkeeping scandals" similar to those occurring in the United States.

But as several observers point out, it is not just private groups in Korea that could stand more transparency. In particular, transparency would benefit the government. Marcus Noland (2001) notes that the true costs of programs in North Korea should be identified. While agreeing that the government of South Korea "may well" have a strong and legitimate national interest in carrying through with such projects as a means of promoting integration with the North (or at least reducing hostility between the two Koreas), he stresses that more transparency might actually make this whole process more efficient and more effective.

Certainly greater transparency is still called for in the financial sector, where at least three missions are not yet wholly accomplished. The first is to identify remaining problem cases where, in effect, good money is being poured after bad; the second is to resolve these cases; and the third is to take steps to change behavior so that similar cases do not arise in the

7. Although the IAS is generally associated with the European Union, it is worth noting that of the 14 experts who constitute the IASB, 7 are US nationals.

8. In 2001, about 750 persons passed the accountancy exam in Korea to qualify as professional accountants. This number was probably not enough to meet needs, though it was up from about 350 in 1996 (OECD 2002, op. cit.).

9. "Conglomerates Facing Government Squarely on Intra-group Transactions," *The Korea Herald*, July 29, 2002.

future. Resolution of these cases almost surely will entail that investors suffer further losses on past investments. But the alternative is worse: to continue to pump funds into those troubled firms, in effect "evergreening" the loans, is necessarily to prevent those same funds from being available for more productive end uses (Krueger and Yoo 2002).

Improving transparency in the corporate sector goes hand in hand with further reform of the financial sector. Reform of the financial sector as discussed above implies that firms that are subpar simply must not be allowed to access credit on any but commercial terms. But, of course, this restriction requires transparency so that subpar firms can be identified as such. Denied access to credit on preferential terms, at least some subpar firms will go under, and these then become "mission 2" cases that must be resolved. It is to be hoped, however, that some large portion of currently subpar firms will be willing and able to take those steps necessary to turn themselves around. Noland (2001) uses the colorful term "zombies" to describe such firms. In 2002, the FSS reported that perhaps 15 percent of firms in Korea did not generate enough cash flow to cover debt service charges, thus almost surely qualifying as zombies. Noland believes that the future health of Korea depends on the zombies being killed off, but this position might be a bit extreme. In fact, in 2000 as many as 25 percent of Korean firms were zombies by the above definition, and most of the reduction of this percentage occurred because firms improved themselves enough to be taken off the "zombie list." The zombies must be eliminated, but killing them off is not the only option. They can instead be turned into more vital institutions: indeed, there are many cases of firms worldwide that have had near-death experiences but have been able somehow to "reinvent" themselves and emerge as healthy and useful enterprises. But for some firms a successful turnaround is unlikely. An honest triage to separate the incurable from the curable zombie is thus needed, and this requires transparency.

Corporate Governance

Closely tied to the issues of financial sector reform and improving transparency is that of corporate governance. In fact, two of the five reasons offered by Joh Sung-wook (2001) to explain why corporate governance has been weak in Korea are poor transparency and inadequate monitoring of the corporate sector by financial institutions. It follows that if one seeks better corporate governance, one must also seek more transparency in both the corporate and financial sectors and better functioning of financial institutions.

But other reforms in corporate governance might also be needed. In this regard, it is instructive to examine the other three reasons given by Joh for poor corporate governance. These are no "credible exit threat"—

that is, large failed firms in Korea do not leave the market (a problem addressed, according to Joh, by better resolution of bankruptcy, discussed later in this chapter); few legal rights or protection for minority shareholders; and negligent boards of directors. In this section, we concentrate on the latter two points.

At the moment the FKI seems to fighting to prevent minority shareholders from gaining legal rights and protection, which the government, in the final months of the Kim Dae-jung presidency, has stepped up its efforts to increase. The current moves should be seen in light of a long-term process by which, as Hugh Patrick (2002) notes, family control of large enterprises in many countries tends gradually to yield to public control; control is "public" when it is ultimately vested in shareholders and no one group of these shareholders either holds a majority interest or is able to block the majority in a shareholders' vote. Most of the Korean chaebol seem to be in some sort of middle ground between family control and public control. For example, the chairmen of the top 10 groups in Korea on average in 2002 owned only slightly more than 2 percent of the total equity of their groups; as reported in previous chapters, total family control for these groups is almost always below 30 percent. And yet, according to Lee Nam-ki, chairman of the Korea Fair Trade Commission, the chairmen of these groups remain "all-powerful."[10] Some evidence for his claim can be gleaned in reports that nepotism abounds in the Samsung group, reputedly one of the best-run of the top 10. For example, Samsung chairman Lee Kun-hee's first son was appointed in 2002 as assistant executive director of Samsung Electronics Company. This created consternation among a minority shareholder group, who feared, according to an unidentified spokesperson, that "slip-ups" by the junior Lee increased the risk of "inflicting losses on all the investors." Samsung Electronics vice chairman Yoon Jong-yong defended the move, stating that Lee was "one of the most competent people in the company and he just happens to be the son of the Samsung Group chairman."[11] Earlier, Lee's second daughter had been appointed general manager of Samsung Fashion Institute, an affiliate of Cheil Industries, the Samsung-affiliated textile firm that had performed so well in the 1960s during the first five-year plan under President Park Chung-hee. Lee's eldest daughter was the manager of the luxurious Shilla Hotel in Seoul, also affiliated with Samsung.

The dispute over whether Samsung chairman Lee's eldest (but still rather young) son is qualified to hold a high executive position at Samsung Electronics falls somewhat outside the scope of this study. But his appointment raises a key question: Does family control over the large chaebol

10. Quoted in "Tycoons Own Just 2 Percent of Top-10 Conglomerates," *The Korea Herald*, June 3, 2002.

11. Quoted in "Samsung under Fire for Appointing Chairman's Sibling to Key Post," *The Korea Herald*, June 17, 2002.

serve Korean interests, especially now that the founding families are minority shareholders of the firms that constitute these groups? There is clearly a constituency in Korea that feels that the answer is "no." However, defenders of the current system of corporate governance might note that the Samsung group, which appears to have continued family control more thoroughly than most other chaebol, is also overall the best performing of the top 10 groups (or at least this is true of Samsung Electronics). I shall address this line of defense in a moment.

A question closely related to that of family control is whether the large chaebol, or what is left of them, should simply be split up. The answer is "yes," for reasons that have been stressed throughout this book. The chaebol as presently constituted have acted to create the problems that have characterized the Korean economy in recent years, as their structure has helped to give rise to the perverse incentives that have encouraged overexpansion into activities with low rates of return. We have already delved into this matter in some detail, of course, but two main factors are responsible: the moral hazard created when the groups are considered "too big to fail" and the groups' willingness, rooted in the mechanisms of family control, to use high-return activities to subsidize low- or negative-return ones. Consequently, the groups still suffer from diseconomies of scale and scope. Strong evidence of their weakness is that listed chaebol affiliates that are well-run, high-return operations typically have total market values that are lower than indicators of performance would predict.

Thus, for example, as just noted, Samsung Electronics is consistently rated among the world's best-run companies, and it earns high profits; yet its stock price is low, as measured by the price-earnings ratio of its shares. This ratio, calculated by dividing the closing price per share of common stock on the last day of 2001 by earnings per share reported in 2000, was 2.6. The price-earnings ratio for listed US firms historically has been about 20 (rising during the recent bubble to about 30—but that figure, we can assume, was unnaturally high). So, accepting the P/E of 20 as "typical," the market value of the equity of Samsung Electronics seems to have been only about 15 percent of the value expected. To be sure, one reason for a low valuation of Samsung Electronics is that its earnings are heavily dependent on sales of dynamic random access memory chips; these, as noted in earlier chapters, are subject to very cyclical demand, which leads to volatility in earnings.[12] However, a bigger reason for Samsung Electronics' low valuation is that its earnings have been routinely used to prop up low-performing affiliated firms in the Samsung group.[13] Samsung Electronics was hit particularly hard in late 2000 when

12. See "Samsung Jitters," *Far Eastern Economic Review*, September 14, 2000; however, it should be noted that Samsung's earnings and its share price both have risen during 2002.

13. See "Lessons Unlearned," *Far Eastern Economic Review*, September 21, 2000.

newspaper reports revealed that substantial funds it generated had been used to support the stock price of Samsung Electro-Mechanics Company (SEMCO), which in turn had been using cash to cover the debts of Samsung Motors (now under the control of the French firm Renault). Thus, the best affiliate of Samsung has been penalized—severely—for feeding what had been one of the worst of these affiliates.

Such transactions have hurt the minority shareholders of Samsung Electronics, whose holdings of stock in this firm should be worth much more than they are. Indeed, one movement that gained strength in Korea in recent years advocates the stronger exercise of minority shareholders' rights. Yet one of the leaders of this movement, Jang Ha-sung, notes that most minority shareholders in chaebol affiliates are still reluctant to vote against the management, even when management acts against their interests (Jang 2001 and 2002).

Ironically, the low valuation arguably has adverse effects on the interests of the controlling family as well. The members of the Lee family who control Samsung are, of course, wealthy people by any measure. But they would be much wealthier if Samsung Electronics were valued 10 times higher by the market than it is—an increase within the realm of possibility were it not for the tangled connections between this firm and a host of other affiliates in the Samsung empire.

Though the stock market seems to penalize good firms in Korea because of their chaebol affiliation, it is also true that the stock market seems to reward such firms when they free themselves. The best example, discussed at length in chapter 5, is provided by the Hyundai Motor Company, whose sales have been rising and which has effectively declared its independence from the remainder of the Hyundai group: its common stock price rose 127.6 percent during the first half of 2001. The overall market value of the Hyundai Motor Group, which includes Kia as well as Hyundai Motor Company, rose more than 72 percent during that same time. In spite of some dilution of the holdings of chairman Chung Mun-koo because of increased foreign investment in the group (by Daimler-Chrysler) and some resulting loss of control, the value of those holdings (including stock both in Hyundai Motor Group and in Hyundai Motor Company) rose by 112 percent, increasing his personal wealth by almost $100 million.

In contrast, the combined market value of the SK group companies actually declined during the first half of 2001, despite good performance of the telecommunications affiliate. This might be because the consolidated financial statements required by the Korean government (as described in chapter 5) revealed that the total debt of the SK group was significantly greater than previously reported. Indeed, it has been reported that since 1998, the aggregate value of non-chaebol-affiliated firms on the Korean stock exchange has increased significantly more than the total value of firms affiliated with these groups (OECD, *OECD Economic Surveys: Korea 2001*).

Furthermore, and more important, for a profitable firm to subsidize the losses of some other firm is as harmful to society as for the government or for the banking system (by evergreening its loans) to subsidize a loss-making operation. In each of these cases, the net outcome is the same: financial resources that could be used to create high-return ventures that would boost marginal productivity of labor and capital (and hence contribute to rising real wages and growth) are instead used to "feed the zombies."

The answer to the question "should the chaebol be broken up?" is thus crystal clear: "yes, unequivocally." It only remains to be determined how this should be done.

One approach that does not seem to have worked is reforming the chaebol from the inside. For example, since 1999 firms affiliated with the chaebol have been required to appoint outside directors who are intended represent the interests of parties other than the founding families. This requirement has been met in principle, but apparently not in spirit. A survey by the KOSDAQ Listed Companies Association (cited in OECD, *OECD Economic Surveys: Korea 2001*) indicates that in 2000 about 80 percent of the supposedly outside directors in the major chaebol were in fact nominated either by the main shareholder (the chairman) or the group's management (under the control of the chairman). To be sure, the figure was down from about 98 percent in 1999, the year in which the requirement was put in place, but it nonetheless suggests that most of the outside directors are insiders' choices.

Also ineffective would be attempts to prevent continued expansion by invoking the Korean Antitrust Act, which is the wrong tool for the job. The KFTA is an antimonopoly law, intended to protect the economy from the ills that monopolization creates—specifically, abuse of market power. But the "chaebol problem" does not especially concern abuse of monopoly power, as has long been recognized (Chang 1996). Antimonopoly law in fact has little to say about diseconomies of scale or scope, even when those diseconomies are so large that they create significant costs that hamper an entire national economy, as has been the case in Korea. Thus, for example, antimonopoly authorities can (and do) block mergers where these are deemed to create the risk of abuse of market power. But the same authorities cannot block mergers that are just plain bad for the merging firms because some sort of diseconomy is created. We might regret their inability to do so, because diseconomies are probably created by mergers more often than market abuses. Nonetheless, it is not clear how antimonopoly law can be enforced effectively to break up a conglomerate that suffers from internal diseconomies.

To find approaches that will in fact work, it is instructive to see what actually is working. In particular, the Hyundai chaebol today is already partially broken up, with further separation of the Hyundai affiliates likely. This action is under way largely because the shareholders of Hyundai's different affiliates have realized that their interests are not served by the old way of doing business, in which one affiliate might be called on to lend some help to another affiliate without expecting a reward commensurate with the level of assistance given. In effecting this shift, it did not hurt that there was considerable divergence in views among the sons of the founder regarding where the interests of the various affiliates might lie. At the same time, it did not help that the Korean government more than almost any other institution in many ways resisted the breakup, or at least the most desirable aspect of the breakup—that one affiliate would no longer be liable to aid another affiliate in trouble.

At the moment, some of the successor entities of the old Hyundai empire are faltering. But the future of other Hyundai firms now is almost surely brighter than it once was. Thus if, for example, the Hyundai Engineering and Construction Company were to fail, its collapse would not bring down or otherwise punish the Hyundai Motor Company, as might have happened two years ago.[14]

In other cases, the assertion of rights by "minority" shareholders (e.g., those shareholders that do not belong to founding families but today most often collectively hold majority equity positions in chaebol-affiliated firms) is the likely means by which chaebol will be broken up. The shareholders of one affiliate simply have no interest in the transfer of resources, without any promise of commensurate reward, from that affiliate to other affiliates of the same chaebol. It is in their interests that each affiliate behave instead as an independent entity. Thus, the goal of chaebol breakup is closely linked to the movement to enable minority shareholders in Korea to force changes in corporate governance.

The creation of large institutional investors, who act on behalf of small investors on the basis of transparent financial information, therefore will hasten the breakup process. These investors will demand that well-performing affiliates of chaebol in which they hold equity interests not be used to finance losing operations. If, as should happen, significant amounts of debt held by the surviving chaebol are in fact converted to equity, these investors will come to hold substantial shares of the equity of affiliates—and, with these shares, voting rights.

The key to chaebol breakup is simply that the shareholders of these groups act in their own interests in an environment in which failure is not rewarded with a government-backed bailout. Of course, such an environment presupposes that the government fully jettison the "too big to fail" mentality that has been behind the various de facto bailouts (a point discussed below). Furthermore, only shareholders who can stand up to financially irresponsible management can ensure that the chaebol affiliates act in shareholders' interests. For them to succeed, progress must be made in the areas of reform already discussed. For example, for shareholders to

14. See Ehrlich and Kang (2001), op. cit.

be able to end financially imprudent practices, they need to be informed as to what imprudent practices have transpired; thus, continued improvement in financial transparency is essential.[15] But also, these shareholders must be sufficiently well organized to feel confident in asserting their voice. Forcing the chaebol to convert their excessive debt to equity, and then putting this equity in the hands of large institutional investors who act on behalf of smaller investors under the principle "united we stand, divided we fall," is a potentially effective way to achieve this level of organization.

Resolution of Bankruptcy

Korea's bankruptcy procedures are themselves bankrupt, according to a number of analysts (OECD, *OECD Economic Surveys: Korea 2001*; Chopra et al. 2002; Mako 2002a, 2002b). In fact, almost every major firm in Korea that has technically gone bankrupt since 1997 is still operating, including all large units of the failed Daewoo group. In the case of Daewoo, the continued operation of its constituent firms would not necessarily be a bad thing if those firms had been successfully turned around and put on a sound footing. But this does not seem to be the case. Of 12 Daewoo companies that were put into workout programs when the group failed, 10 remain in such programs, indicating that there has been no turnaround or resolution. In fact, rather than resolving the problems of failed firms, drawn-out bankruptcy procedures in Korea seem to impede resolution. One consequence has been to introduce new weaknesses into the financial system, because in most cases in which bankruptcies have failed to be resolved, the value of assets (mostly loans) held by financial institutions in bankrupt firms has dropped (OECD, *OECD Economic Surveys: Korea 2001*).[16] Thus, it would have been in the financial institutions' interests to have sold these assets quickly, even if in doing so they had incurred significant losses. Because they did not sell, their losses have been magnified.

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15. In fact, shareholders' groups have become active in Korea in the years since the 1997 crisis, especially the group People's Solidarity for Participatory Democracy, headed by Korea University professor Jang Ha-sung. For an account of some of the work of this group, see Jang (2001). In 1998 it won a proxy battle against SK Telecoms and, in alliance with three foreign funds, was able to place outside directors on SK Telecoms' board of directors. Nonetheless, in spite of numerous reported actions of chaebol that would hurt shareholders (OECD, *OECD Economic Surveys: Korea 2001,* from KFTC reports), there have been only a small number of minority shareholder legal actions (OECD, *OECD Economic Surveys: Korea 2001*). Perhaps shareholders are dissuaded by the substantial legal costs of bringing such actions to court, which they might be unwilling to incur even in the expectation of net gain from bringing suit against management. Again, large institutional shareholders could help to solve this problem, as they would not be deterred by a large initial outlay to gain a financial reward in excess of the costs.

16. This statement appears to hold true for KAMCO as well as for other financial institutions.

That bankruptcy procedures in Korea have been rather ineffective is a legacy of Korean history, for traditionally bankruptcy was mainly handled not by formal legal procedures but rather by nonjudicial governmental intervention. Consider the resolution of Kukje, the largest bankruptcy in Korea until 1997, which took place under the authoritarian Chun Doo-hwan regime. As described in chapter 3, the method used—essentially, pieces of the Kukje group were sold to individuals with close ties to the regime—was arguably effective but highly unfair. In Korea today, such an approach to bankruptcy resolution is no longer acceptable, but no effective alternative has been found to replace it. The preferred route for resolution of large firms in trouble has been the nonjudicial "workout program": that is, nonlegal agreements between creditors and these firms. But by and large, these workout programs have not worked out. Thus, of 104 large impaired firms placed in the workout program under the government-instigated Corporate Restructuring Accord in 1998, as of the end of 2000, only 36 had "graduated," or been restored to some modicum of health; 34 remained in the program. Fifteen firms have been merged into other firms, without necessarily resolving the problems that brought them into the program to begin with (e.g., LG Semiconductors is now part of the distressed Hynix Corporation). Seventeen firms exited the program, similarly without any satisfactory resolution. Only four firms have entered into judicial bankruptcy proceedings.

In a word, the results have largely been paralysis. Unresolved bankruptcies result in situations where firms that are unviable are neither shut down nor subjected to measures needed to make them viable. Thus, of the two options mentioned at the beginning of this chapter to resolve an unviably high-cost firm (either exit the market or take steps, such as reducing costs, to become competitive), neither is exercised. The remaining option is that the firm continues in operation as a de facto subsidized entity. As Chopra et al. (2002) put it with some understatement, "in some respects, the difficult part of corporate restructuring still lies ahead—non viable firms need to be closed, and viable but distressed companies should be subject to rigorous workouts[.]" But of course, the whole point here is that nonjudicial workouts have failed—the companies that have entered into workouts have not, as it were, been forced to work out hard enough to lose weight as needed.

The alternative to workouts is more effective judicial procedures for the resolution of bankrupt or impaired firms. Breaking the bankruptcy logjam by instituting and implementing legal procedures that can actually resolve bankrupt firms thus is a major unfulfilled goal for Korea.

Some progress has been made, to be sure. In particular, a "prepackaged" bankruptcy system was introduced in March 2001 that enables creditors holding a total of at least half the debt of a distressed or bankrupt firm to negotiate an out-of-court settlement with the firm, which is then submitted to bankruptcy court for approval. Under earlier law, the votes of 80 percent of secured creditors and 66 percent of unsecured creditors were needed to approve a debt restructuring plan; thus the prepackaged system allows a smaller number of creditors, presumably the biggest ones, to negotiate such a plan without having to gain the approval of smaller creditors, who in the past often withheld approval in order to obtain special treatment. Also, under the new scheme, court procedures must be completed within five months. The limit is meant to break the judicial logjam in which cases often became embroiled, as they endured very long waits for court action.

The time limit on judicial procedures notwithstanding, if legal procedures for resolution of bankrupt firms is to be more widely employed in Korea, further improvements are necessary. In particular, corps of judges with experience in bankruptcy must be created. The Seoul District Court has handled about half of all bankruptcy proceedings, and two bankruptcy divisions have been established within this court. However, as noted by Ralph Carr (2001; reported in OECD, *OECD Economic Surveys: Korea 2001*), this court's work is hampered by the frequent rotation of judges. Carr observes that judges who handled the Kia and Hanbo bankruptcies no longer are involved in such cases. A start has been made: an experienced professional staff is now on hand in the court to assist judges (Oh S. 2001; reported in OECD, *OECD Economic Surveys: Korea 2001*). Nonetheless, it is clear that more needs to be done, as these procedures still lead to long delays in bankruptcy resolution.

The "Too Big to Fail" Doctrine

As has been stressed throughout this book, the government's implicit doctrine of companies being "too big to fail," with the moral hazard that it creates, has been at the heart of much of what has been wrong in Korea. In fact, this is the consensus view in Korea itself. "Too big to fail" thus was formally renounced by President Kim Dae-jung when he was inaugurated in 1998 and formally is no longer Korean policy.

The problem is that this renounced and denounced doctrine has not yet really disappeared. Indeed, judging not by what the Korean government says is policy but rather by what it is actually doing, the doctrine seems to be making a comeback. Thus, for example, the underwriting by the Korea Development Bank in the spring of 2001 of 1.6 trillion won in bonds for six firms (four of them Hyundai affiliates), accounting for about 80 percent of the value of bonds of these firms maturing during the first quarter of 2001, is widely perceived as intended to prevent the failure of these firms.[17] Without the intervention, it is unlikely that new

17. The underwriting of bonds to benefit Hynix has been challenged by the US government and the European Union as a subsidy to that firm's exports possibly inconsistent with the requirements of the World Trade Organization.

bonds could have been placed in private markets to finance the maturation of the outstanding bonds. The government argued that the underwriting was justified because the firms were viable but at risk of failure for two reasons: the bonds' maturation was concentrated in a narrow time window and Korea's bond market is underdeveloped, with no effective market for bonds below investment grade (such as the bonds in question). But were in fact the firms that benefited from this underwriting "impaired" (viable in the long run but facing short-run difficulties), or were they nonviable? The government in fact never demonstrated the former. Furthermore, such a rescue arguably reduces the pressure for corporate restructuring. Plainly put, in the past few years the government has seemed to be in the business of bailing out large firms that are high-cost suppliers to their markets, with the result that these firms neither exit the market nor take steps to make themselves competitive—despite numerous pronouncements that the "too big to fail" doctrine is now dead.

The bond underwriting is not the only example of the doctrine's reemergence. As discussed in the previous chapter, Hyundai Engineering and Construction Company (HECC) continued to be supported by financial institutions that, apparently under government duress, granted credits to cover massive losses during much of 2000. In the fall of 2001, this firm had negative net worth even as reckoned by Korean accounting standards and was incurring large losses. Yet it was set to receive financial assistance, including debt-for-equity swaps, equity injections, corporate bond purchases, and fresh loans. None of this would be bad, of course, if private financial institutions were advancing all of this assistance voluntarily. However, few analysts believed that such was the case.

The big test, as of the time of this writing, is how the Korean government will handle the continuing deterioration of Hynix. The signs thus far are promising. The government has repeatedly stated that no further bailout of Hynix is forthcoming and that the company's fate lies largely in the hands of its creditors, who are free to act without government direction or intervention. Of course, there still are those in Korea who believe that Hynix should receive further bailouts, arguing that a complete failure of the firm could put the country's entire economy at risk. But the risk of a Hynix failure is overstated; the Korean economy is large and could absorb even a series of big failures, let alone the demise of just one firm. In fact, the risk in the other direction is much greater: while the systemic risk created by Hynix failing is quite manageable, the risk of Korea becoming a stagnant economy in which noncompetitive giants survive only because of government support could be significant. The urgent priority facing Korea today is thus to end "too big to fail" as an operational policy of the Korean government once and for all, and to demonstrate that end by action as well as proclamation.

The Social Safety Net

As with other areas of reform, Korea has made significant progress in expanding the social safety net. Prior to the 1997 financial crisis, business enterprises themselves were the main vehicle by which benefits were provided to workers who lost their jobs. Indeed, within the chaebol workers who lost jobs because one affiliate contracted could often find employment in some other affiliate of the same group. But the high rates of corporate bankruptcy and of workers' unemployment accompanying the 1998 recession that followed the 1997 crisis brought a realization within Korea that some better form of safety net was required. Thus, the government significantly expanded public efforts to provide income support for workers who had lost their jobs. Additionally, new mechanisms were put into place to help laid-off workers find new employment (Chopra et al. 2002; OECD, *OECD Economic Surveys: Korea 2001*); these included wage subsidies to firms that hired new workers. The government also provided some wage subsidies to firms to retain workers that might otherwise be laid off. Finally, new schemes were introduced to provide some minimum income for the truly needy in Korea, including the aged and children of the unemployed. Expenditure on such social safety schemes went from 0.6 percent of GDP in 1997 to 1.6 percent of GDP in 1999. Not included in these figures were public works projects initiated by the government in 1998 that were intended to absorb laid-off workers. In late 2000 many of the new programs, which mostly had been introduced on an ad hoc and temporary basis, were made permanent under the Basic Livelihood Security Act, which also created a larger pool of resources on which the safety net can draw.

Thus, Korea has made substantial progress in expanding the social safety net. Nonetheless, there is more to be done. Further reform, including the revamping of some existing programs, should be directed toward making labor markets in Korea more flexible. To this end, a first step is to expand coverage of the present system of unemployment compensation, which currently covers only slightly more than three-fourths of Korean employees, regular and nonregular.[18] In particular, many categories of nonregular workers (i.e., those who are not full-time employees, where "full-time" is defined not only by hours per week employed but also length of employment) are not covered. But the use of nonregular workers in Korea is growing, and so the percentage of workers not covered by unemployment compensation is also growing.

The increasing number of nonregular workers might be seen as positive, because rules pertaining to regular workers employed by large firms

18. Given that the substantial numbers of individuals who are self-employed or who work in small family-owned businesses are not counted either as regular or nonregular employees, less than half the total workforce in Korea is covered by unemployment compensation.

introduce undesirable rigidities into the Korean labor market (Lee C. 2002). But at least some regulations pertaining to nonregular workers have created similar rigidity—for example, employers face restrictions in laying off such workers early; a reasonable step might be to combine an easing of regulations with greater participation of nonregular workers in unemployment compensation programs.

Wage subsidies directed to employers to retain otherwise unneeded workers might have been useful in 1998, when unemployment was rising faster than at any other time in Korea since the Korean War; but in the long run such a scheme, for obvious reasons, is likely to lead to labor market rigidity. Wage subsidies amounted to almost one-third of all subsidies granted in 2000, and they should be phased out and replaced by an expanded unemployment compensation scheme. Such expansion should entail both coverage of more individuals (as discussed just above) and longer duration of benefits. At the present, benefits last only from three to eight months, with the precise length for any one worker determined by strict eligibility criteria (OECD, *OECD Economic Surveys: Korea 2001*).

To Conclude the Conclusion

One problem that has not been touched on thus far in this chapter is corruption at the highest levels. In Korea, such corruption has been part of the scene throughout the years following the Korean War, and it has led to two former Korean presidents spending time in prison as well as the imprisonment of a son of the first fully democratically elected president, Kim Young-sam. Alas, the story of former presidents, or close relatives of sitting presidents, being indicted for corruption did not end with Kim Young-sam. In 2002, two of Kim Dae-jung's sons were convicted by Korean courts for illegal activities. One son is, at the time of this writing, serving jail time, while the second is under a suspended sentence. A third son (the eldest of the three) is a member of the Korean National Assembly and not likely to be indicted.

Corruption at the highest level is not a problem unique to Korea, of course; in one form or another, high-level corruption has broken out in almost all nations. Clearly, given its presence in Korea throughout the miracle years, this corruption has not drastically curtailed economic performance, although arguably it has contributed in the past to periods of political unrest. But corruption does have the potential to create economic problems, as is apparent from the experiences of many countries other than Korea (see, e.g., Tanzi 1998); indeed, there probably is some relationship between a nation's poor economic performance and its high levels of corruption, though the evidence on this is mixed and direction of causality difficult to determine (but on this, see Wei 2000). One thing is clear: a certain amount of disillusionment has set in among the Korean people as the result of revelations that close relatives of the two Kims who have been president—both of whom were pro-democracy advocates during the non-democratic years in Korea—have engaged in corrupt activity. Under such circumstances, Koreans might very well be asking themselves how different democracy really is from autocracy.

What to do about high-level corruption is a difficult issue at best; prison sentences for former heads of state of Korea who have proven corrupt has not, it would seem, acted as much of a deterrent. Perhaps this is then the place to conclude, by saying "this sort of thing simply must end."