3. Asian Financial Crisis: The South Korean Experience

Sang Yong Park*

I. Introduction

Why was it that the Korean economy, which had been envied and imitated by other developing economies for the past 30 years, suddenly spiraled into a currency-induced crisis late in 1997? How was it possible that such a vibrant economy, which had been developing so rapidly, displaying in fact the most rapid development amongst the Asian nations, was suddenly overcome by such a severe economic downturn? Why is that even today, the country’s financial system is still unstable, and why are there still some lingering doubts about a fundamental conversion of the economic system? And what are the lessons for other developing economies craving the pursuit of high growth whilst adapting to the new order of the global economy? This paper attempts to address each of these important issues.

The sudden collapse of the Korean economy was not accidental, nor indeed unforeseeable. Although some economists, notably Sachs (1988), have argued that a great and rapid surge in the short-term foreign capital inflow into East and Southeast Asian economies in the mid 1990s was a principal cause of the regional crisis, as far as Korea is concerned, and as many intellectuals in Korea would agree today, a more fundamental and critical cause of the crisis was the underlying structural weakness. In fact, ever since the early 1990s, a number of Korean economists had been

* Professor of Finance, Yonsei University, Seoul, Korea. E-mail: spark311@yonsei.ac.kr
predicting an eventual breakdown of the Korean economy unless there was fundamental economic reform. This paper will first analyze in detail the fundamental structural weakness of the Korean economy leading up to the crisis of 1997.

As of late spring in 2000, the Korean economy seemed largely to have shaken off the worst effects of the economic crisis. Several indicators of the macro economy, including stock market prices, interest rates, country credit ratings and the size of the country’s foreign exchange reserves, as well as volume of credits intermediated, have now recovered to their pre-crisis levels. The country’s unemployment rate, having peaked in early 1999, is now also declining. The country’s currency, the Korean won, is also appreciating and has regained three quarters of the value lost at the outset of the crisis. The current improvements in the country’s economy can largely be attributed to the intensive efforts of reform and restructuring – as yet unfinished – even in the presence of strong political resistance from those who were to be negatively affected. This paper goes on to describe the process and the general contents of the economic reform and restructuring, particularly of the financial sector and the corporate sector.

Analysis of the structural factors in Korea contributing to the economic crisis, along with the reform and restructuring efforts in the aftermath of the crisis, may help us to generate an understanding of the implications that might prove useful to other developing economies. It is hoped that a number of these important implications derived from the analysis of the Korean experience may provide an insight for development economists and policy makers of other developing economies and, given the increasing cross-border connectedness resulting from the rapid trend towards globalization, the developed economies as well. Thus the final concluding section will include lessons from the Korean experience for consideration by other counties.

II. The Principal Causes of the Korean Economic Crisis

The sudden ebbing away of foreign short-term capital in the autumn of 1997 – after its surge in the mid-1990s – was certainly partly responsible
for the near collapse of the Korean economy in late 1997. This outflow of external capital was nevertheless a triggering factor rather than the fundamental cause of the crisis. Ever since the outset of the crisis, the general consensus in Korea has been that the underlying cause was in the structural weaknesses of the economy. At an absolute macroeconomic level, the inherent structural weakness lay in an economic system which was established during the developmental stage, but which was not subsequently readjusted into a more market-based system mandated by the fundamental transformation of the international political and economic order of the 1990s. At a micro level, the major weaknesses included three fundamental failures: a failure to match the industrial structure with the country’s financial structure; a failure of governance in both financial and industrial companies; and failures of policy, in terms of financial regulation and the sequencing of financial liberalization.

1. The Evolution of Korea Inc.

In examining the macro failure – i.e. the attempt to sustain the old economic model in the new economic era – we should first of all take an overview of the economic developmental path which Korea had followed from the early 1960s up until the crisis in 1997. The term Korea Inc. describes very succinctly how the Korean economy has evolved over the past 30 years. Just like Japan Inc., Korea Inc. has three distinctive characteristics: a political monopoly controlled by a ruling party; industrial policies borne of a commerce ministry; and detailed micro-management of the financial sector by a finance ministry. What do these features mean and how did they come about in Korea? The push for economic development started right after general Park Jung Hee grabbed power through a military coup in 1961. President Park remained in power until 1978; thereafter, his derivative parties ruled the country until 1998 when the current administration of Kim Dae Jung was launched. Thus, a single ruling party has essentially enjoyed a political monopoly for almost 40 years.

President Park had a grand vision to modernize Korea with a notion of Japan as a model on the one hand and as a competitive rival on the other. Thus Korea imitated Japan, pursuing an export-driven growth strategy and supporting firms large enough to be able to compete in the export markets. Having virtually nothing to start with in the early 1960s, the Korean government intentionally cultivated selected industries and a handful of
‘star player’ firms in those industries so that they could achieve certain scales necessary to compete in the world markets. In other words, the state established very detailed industrial policies and implemented them through a series of five-year economic development plans.

The major tool in support of industrial policies was finance. Although the state support provided to selected firms took the form of tax benefits, hard foreign currency, and various business licenses, the most important support was cheap loans. In order to execute its export-driven industrial policies, Korea developed a credit-based financial system as opposed to a capital market-based financial system. In a country with a credit-based financial system, the major financial instruments for household savings are bank deposits and corporate funding bank credits. Korea’s financial system also had other related features generally associated with a credit-based financial system.

- the pricing mechanism is influenced more by administrative guidance than by competitive market forces;
- an important objective of monetary policy is resource allocation rather than stability of the financial system;
- the major tools of monetary policy are financial regulation and administrative guidance instead of monetary aggregates;
- industrial adjustment is often government-led rather than company-led;
- the relationships between government, banks and firms are interdependent rather than arm’s length relationships;
- the major suppliers of long-term funds are specialized banks instead of investment institutions.

In order to use finance as a major tool of industrial policy, the military government nationalized all commercial banks and usurped the independence of the central bank in the early 1960s. As a result, the ministry of finance has become the most powerful ministry in the executive branch.

We have described the essence of the Korea Inc. model. During the 1960s and 1970s when the size of the economy was small and the structure of the economy was rather simple, the Korea Inc. model, i.e., the Korean model characterized by the pursuit of an export-driven growth path with finance as a major tool of industrial policy, was largely successful and
contributed to spectacular growth. This model was nevertheless pushed too far, even after the economy was displaying significant expansion and the basic structure of the economy was becoming rather complex. More importantly, however, the Korea Inc. model was no longer appropriate under the new international political and economic order triggered *inter alia* by the collapse of the Berlin Wall and the ending of the cold war era. Under the new order – which may be symbolized by the WTO and referred to as the era of *globalization* – Korea, one of the hottest military spots in the world, was no longer given special treatment by its major trading partners and thus had to face intense global competition even in the domestic markets. Thus, from as early as the beginning of the 1990s, there was a need for Korea to adapt to the new environment by giving up the Korea Inc. model and adopting a truly market-based economic model. But it did not.

The country’s weak political system is partly responsible for this failure. Ironically, the political democratization of Korea started in 1988 after which its citizens could no longer be repressed and the political voice of the general public was substantially enhanced. The lack of any effective social safety net whatsoever, in an era of new political freedoms, led Korean political leaders and bureaucrats to continue pushing for high growth to maintain the level of almost full employment, even if global competition made it less achievable. But, alas, the old model remained in place because they had neither the skills nor the will to manage transitional problems that are bound to arise when an economic system is fundamentally transformed into a more market-friendly system. We proceed with a relatively micro level examination of the three structural failures already mentioned.

2. **Failure to Match Industrial and Financial Structures**

Until recently, the Korean manufacturing industry was heavily skewed towards heavy and chemical industries rather than light industries. The heavy industries accounted for 77.2 per cent of the total manufacturing output of 1997 with the light industries contributing the remaining 22.8 per cent.\(^1\) The comparable data for the division between heavy and light industries in other countries, based on 1995 data, shows that this focus on heavy industries was much more pronounced in Korea than in other

---

\(^1\) Bank of Korea(1998)
Taiwan, East Asia and Copenhagen Commitment

countries: 64.3% vs. 35.6% in the US; 66.3% vs. 33.7% in Taiwan; and 70.5% vs. 29.5% in Japan.2

This trend towards the growing dominance of heavy industries in the manufacturing sector started in the mid-1970s when President Park pushed for the promotion of heavy and chemical industries as an engine of fast growth, again following the Japanese model. A more important motive for the ‘Big Push’, however, was the political and security situation which Korea was faced with at that time. From the early 1970s, as the US administrations of Presidents Ford and Carter were pushing for the withdrawal of US ground forces from South Korea – at the same time as the military threat from North Korea was intensifying – Korea wanted to build its own self-sufficient defense system. Such a system would require the capability to produce weapons, which in turn would depend upon the capabilities of the country’s industries and their capacity to produce steel, machinery, large ships, and the like. This important security consideration led Korea to venture into heavy industries with an underlying logic which was indeed unique to Korea because at that time, it had neither the financial and technological resources, nor the large domestic markets capable of developing and supporting such industries. In fact, many of the characteristics of the Korean economy could partly be attributed to this intense focus, of a comparatively small and underdeveloped economy, on heavy industries.

Whilst technological complexity is of course relevant with regard to a comparison of the important characteristics of heavy industries in relation to light industries, the more important factors are the large scale and high risk associated with these industries. Korea’s most important heavy industries are automobile manufacturing, shipbuilding, steel, petrochemicals and semiconductors. Such highly capital-intensive industries require, on average, more than US$ one billion per project. Investment projects in such industries also typically require the injection of long-term capital because they have a protracted investment horizon and it would generally take a significant period of time to recover the initial investment. More importantly, these projects require risk capital because invariably business uncertainty is also significant. In the parlance of corporate finance, the operating risk of heavy industries is high and it is generally accentuated by high operating leverage arising from the nature

2 UN-UNIDO(1996)
of large fixed costs in operation. These characteristics of heavy industries – large scale, long horizon, and high risk – demand that the bulk of their funding requirements be financed by equity. The major source of funding, even for Korea’s heavy industrial firms has, however, been debt, mainly in the form of credits from bank and non-bank financial institutions. Let’s examine this phenomenon more closely.

Up until 1985, the proportion of indirect financing in the total domestic external financing of Korean firms was around 60-70 percent. The remaining 30-40 percent was secured through direct financing (i.e., bonds, stocks and commercial papers). From the second half of the 1980s, however, securities became a more important source of corporate funds, their proportion reaching 50-60 per cent of all domestic external financing. Thus, although it appears that the financial system has been involved in the process of transformation into one more akin to a capital market-based system, there is a caveat: the bulk of these bonds and commercial papers, a much more significant source of securities financing in Korea than stocks, are guaranteed by financial institutions. For example, out of 34.3 trillion won of new corporate bonds issued in 1997, only 15 per cent were pure debentures; the remaining 85 per cent were bonds guaranteed by financial institutions such as banks, securities companies, merchant banks and a few specialized guarantee companies. With most corporate bonds, and commercial papers for that matter, being backed by financial institutions, it could be argued that credits rather than securities were still the predominant source of corporate funds in Korea.

The net result of such promotion of heavy industries in a country with a credit-based financial system has been the extremely high financial leverage of industrial companies. Debt-equity ratios of 300-400 percent have not been uncommon, even in normal times. Again, in the parlance of corporate finance, total leverage of large industrial companies in Korea

3 Business risk, or operating risk as is more often referred to, related to the volatility of operating profits. This arises from sales fluctuation due to demand and price uncertainty, cost fluctuation, and operating leverage.


6 Because Korea has maintained a high national savings ratio – an average annual gross savings ratio of 35.8 per cent during the period of 1986-1998 (Bank of Korea 1999) – due largely to its high household savings rate, the bulk of funding for industrial projects could be domestically financed. Alas, the major funding instruments were credits, and thus debt, rather than securities and equity.
has been extremely high because operating leverage and financial leverage were both very high. As a result, corporate profits were phenomenally high in the good times and miserably low in the bad times. In other words, there has been a built-in instability mechanism in the corporate sector as a result of the high leverage, which in turn owed its existence to the fundamental mismatch of Korea’s industrial and financial structures.

How could such a seemingly unsustainable economic structure be sustained, right up until the economic crisis of 1997? The simple answer may lie in cross debt guarantees. There is some conjecture that the practice of cross debt guarantees amongst affiliated companies of the business groups was the key instrument that mitigated, at least until 1997, the enormous vulnerability induced by the extremely high leverage. We will return to this issue later.

3. Governance Failures within Financial and Industrial Firms

Mechanisms for corporate governance have never worked effectively in Korea. The country’s industrial companies have consistently lacked any proper governance structure and have engaged in excessive leverage and over-investment. Korea’s banks have also operated in a governance vacuum and were thus unable to prevent the over-extension of both industrial firms, and indeed, the banks themselves. Although ineffective governance mechanisms had not caused any insurmountable problems during the era of high growth and mild global competition, it did hinder the adaptation of industrial firms and financial institutions to the new economic environment of the 1990s, characterized by low growth, intense global competition and the rapid rate of change in the economic environment. Governance failures and the resultant flaws in the system of capital allocation were indeed the real culprits behind the Korean crisis in 1997. We will first of all examine the practice of governance amongst Korea’s large companies, followed by the country’s banks.

In his critical assessment of German corporate governance, Nobel laureate Merton Miller (1997) wrote:

“… the real, and ultimately fatal flaw in bank-dominated German corporate governance: whatever the original good intentions, the German governance system seems to have evolved into what electrical engineers call a closed-loop system – a system that runs
entirely on its own internal momentum with no outside direction or correction whatever.”

Korea’s corporate governance system was also a closed-loop system, much more so, it should be stressed, than the German or Japanese systems, and the above description applies almost perfectly to the Korean chaebol, a business group consisting of many large firms that are owned and managed by family members in many diversified business areas. To see why, it is necessary to examine both the internal and external governance mechanisms.

Internal corporate governance mechanisms have never functioned in Korea. The commercial code stipulated that there should be checks and balances amongst the three legal institutions of corporations; shareholders’ meeting, board of directors, and internal auditors. As in other countries, shareholders’ meetings in Korea do not represent an effective governance mechanism; however, the board system in Korea also failed to function, because the board of directors invariably comprised exclusively of insider executives, thus it was a puppet institution. What’s more, an internal auditor, although not formally an employee of the corporation, was usually an insider appointed by the largest shareholder. In fact the position of internal auditor was largely recognized as a position between the senior managing director and the senior vice president. Thus both directors and auditors had no independence whatsoever from the controlling shareholders. In practice, a chaebol’s headquarters – which was not legally recognized, and was typically the group chairman’s office – performed the practical functions of both board of directors and internal auditor. As a result, the chairman of each chaebol exercised absolute power and control over the organization, and the capability of the chairman became the limit of the organizational capability.

External governance mechanisms were also non-functioning. In order to encourage the chaebols – those star player firms cultivated by President Park – to go public and thereby to diversify their financing sources without worrying about the potential dilution of control rights, the government also protected the control rights of listed firms through various legal measures. The most notable measures were extremely lax laws in support of minority shareholder’s rights and very restrictive legal provisions for hostile

---

7 For an excellent survey of the role of corporate boards in ensuring good governance, see Kose and Senbet (1998).
takeovers. In fact, prior to 1997 there was neither a single incident of minority shareholder protest nor any attempt at hostile takeover. The domestic competition in the product markets was also weak. In the absence of effective bankruptcy procedures, the principle of ‘too big to fail’ (TBTF) was also in operation. Thus, disciplinary pressure for good governance was neither exerted through product market competition nor capital market forces.

The poor governance practices of banks hindered proper credit evaluation and the monitoring of industrial clients, and thus spurred on the wild expansion of chaebols and the banks themselves. The government, with its policy of promoting industry through bank credits, was responsible for the poor governance of banks. The government has been heavily involved in the internal management of financial institutions in general, and in banks in particular. The popular mechanism by which the government controlled banks was its strong influence over the appointment of the banks’ top managers. This practice continued even after the privatization in the early 1980s of all the commercial banks that had been nationalized in the early 1960s. Although the practice of direct appointment was eventually discontinued in 1993, until recently, indirect influence remained prevalent. With this unwarranted power to exert influence over the senior management of private banks, bureaucrats, and sometimes politicians as well, were able to dictate what banks must do. Most significantly, banks followed various explicit and implicit directives from above to allocate credits to specific companies. When politicians were involved, the loans allocated to specific firms were often linked to bribes or ‘political contributions’ to the politicians involved, by the borrowing firms.8 And since the government possessed the power to replace managers, it could also interfere in the internal management of banks. According to one study, during the period from 1961 to 1994 the average tenure of bank CEO’s was a mere 2.3 years.9 In such an environment, the manager’s decision-making horizon would undoubtedly be very short indeed. Bank managers thus lacked both the managerial freedom and the incentive to pursue painstaking organizational changes that were necessary to adapt to the emerging business environments.

8 In fact, this is often referred to as politics-business cronyism in Korea, an expression for give and take or crony relationship between politicians and businessmen, and involved the granting by politicians of scarce banks loans or business licenses to firms.

9 For details, see Park (1994).
A further unique feature of the Korean banking system was that the government imposed tight restrictions on ownership of the commercial banks. This policy was pursued largely as a means of preventing chaebols from controlling banks. The maximum proportion of shareholding by an identical person had been restricted to 8% until 1993 but was then lowered to 4% in 1993. Therefore, the government forced ownership dispersion, thereby preventing banks from coming under the control of major shareholders. Although it was possible for a few major shareholders, i.e., chaebols, each with a large block of shares, of say 4% each, to form a coalition to exercise control of a bank, no group has ever attempted this because it was clearly against the policy, albeit unwritten, of the government. Therefore, Korean banks have existed in a corporate governance vacuum, which in turn has led to further scope for government interference.

A recurring debate in the Korean banking community has focused on the lack of freedom and accountability of bank management. On the one hand, the bank managers themselves have argued that since they did not have managerial freedom they could not be held accountable for the poor performance of banks. The bureaucrats, on the other hand, would argue that bank managers could not be afforded full managerial freedom because, in the absence of true owners and safety mechanisms, such as deposit insurance or orderly exit procedures for banks, bank failures were ultimately the government’s full responsibility. Whilst such unproductive chicken-and-egg debates of this kind were ongoing, entrepreneurial spirit within the financial industry was stifled and eventually evaporated.


Korea has maintained a fairly antiquated financial regulatory system with regulatory and supervisory agencies not only being highly segmented, but also opaque. The net effect was a ‘veil of ignorance’ surrounding the worsening financial soundness of the country’s financial institutions. Even when the regulatory agencies were aware of a particularly grave situation,

---

10 An identical person is a legal term that includes all individuals or firms under the control of one person, often the largest owner and manager of chaebols. Also, the rule for limiting ownership is subject to some exceptions; notably, the limit for regional commercial banks has been 15%.
they either tried to hide it or simply failed to take the necessary action.

There were some financial sectors for regulatory classification: banks, securities firms, insurance companies, and others. The Monetary Board of the Bank of Korea set in place the policies for the bank accounts of the commercial banking industry, with the Office of Bank Supervision of the Bank of Korea supervising compliance of these policies.\textsuperscript{11} The Securities and Exchange Commission (SEC) set up the regulatory policies for securities firms and publicly traded companies, with the Securities Supervisory Board having supervisory authority. In the case of the insurance industry, the Ministry of Finance and Economy (MOFE) set forth the policies, whilst the Insurance Supervisory Board checked their compliance. There was also the Credit Management Fund which provided a deposit insurance and supervisory function for a large number of community-based, small mutual credit companies. Other financial institutions not covered by these three groups were under the jurisdiction of the MOFE.\textsuperscript{12} Those under the direct control of the MOFE were non-bank financial institutions that included trust accounts of commercial banks, development institutions such as a state-owned development bank and private long-term credit bank, investment institutions such as merchant banks and investment trust companies, leasing companies, credit card companies and other savings institutions such as credit unions. Since the MOFE did not have the necessary infrastructure for detailed surveillance, the surveillance function was in large part delegated mostly to the Office of Bank Supervision.

Although regulatory power appears to have been somewhat fragmented, the MOFE in reality enjoyed monopoly power. In this regard the Korean MOFE was exactly like the Japanese ministry of finance (MOF). The MOFE essentially selected heads of all the regulatory agencies, and these were more often than not former high-ranking bureaucrats from within the MOFE. The same was true for the

\textsuperscript{11} Commercial banks in Korea have two types of operations; commercial and trust banking. Bank accounts come under traditional commercial banking operations. Two types of businesses are separated only on the books. That is, operation-wise, two types of accounts are integrated. The assets of trust accounts exceeded those of bank accounts from the mid 1990s, an anomaly in the Korean commercial banking industry. And yet, the Bank of Korea was given authority to regulate and supervise only bank account activities.

\textsuperscript{12} The Ministry of Finance (MOF) and the Economic Planning Board (EPB) merged in 1993 into the current MOFE, a powerful \textit{monster} as critics put it, with tax, treasury and budgets with in its domain of jurisdiction.
self-regulatory agencies such as the Korea Stock Exchange and trade associations for each type of financial institution. Moreover, CEOs of the three largest investment trust companies with diffused ownership structure were also appointed by the MOFE. The investment trust companies were the major vehicles for the government’s price keeping operations (PKO) in the stock market, operations similar again to those frequently observed in Japan.

The MOFE also dominates the Monetary Board, which is responsible for setting up monetary policy and for overseeing the execution function of the Bank of Korea and the supervisory function of the Office of Bank Supervision. The Chairman of the Monetary Board was the minister of the MOFE and the MOFE essentially selected members of the Monetary Board. This is why the independence of the central bank free from political considerations could never be assured. The rationale for the absolute power of the MOFE was that: (i) in developing economies at least, monetary policies need to be tightly coordinated with fiscal policies; and (ii) in the absence of a deposit insurance scheme and effective bankruptcy procedures, the government has to bear full and ultimate responsibility for failures of private financial institutions. Such rationale may have had some validity in the past. As Korea approached the 1990s, however, the size and the complexity of its economy had outgrown the old rationale, which also tended to be self-serving of the interests of bureaucrats. The government could not prevent concentration of assets into specific sectors or borrowers, dealings of financial institutions with related companies, wild speculation in risky investments, non-transparent and dubious accounting practices, and, most importantly, an enormous amount of bad debt.

13 Although trade associations are private organizations, they have been operating as quasi-governmental entities through which the government could control private industries with more convenience and less transparency.

14 Although the minister of the MOFE is legally the chairman of the Monetary Board, the minister rarely attended the meeting to avoid often physical protests of the central bank’s labor union and thus the governor of the central bank presided over the meetings, another anomaly of the Korean banking system.

15 The Korea Deposit Insurance Corporation was set up in 1995 but will need at least ten years to accumulate the necessary minimum reserves from insurance premiums it collects from member banks.

16 Statistics for non-performing loans by the international standard (loans in arrears for more than three months) of commercial banks were released for the first time in Korea in 1997. The figure was 14.3% in 1996. In the past, the government disclosed only the
The country’s rapid financial liberalization without the overhauling of its financial supervisory system also contributed to the financial crisis of 1997. Financial liberalization started with interest rate deregulation in the early 1990s and proceeded to the removal of entry barriers in selected financial sectors and external capital controls in the mid 1990s. Interest rate deregulation, which began with trust account deposits of commercial banks, contributed to intense rate competition and as a result to deteriorating profitability. In a market where there were not only entry barriers but also exit barriers, low profitability stemming from rate competition led banks to undertake high-risk investments in low quality loans as well as stocks. Removing entry barriers in the merchant banking sector without strengthening the supervisory system also brought about disastrous results. In the mid 1990s, two-dozen short-term investment and finance companies that were purely domestic in operation were allowed to convert to merchant banks engaging heavily in international operations. Most of the new merchant banks raised short-term foreign currency funds, thanks to the lax foreign capital control, and rather foolishly invested in long-term bonds of questionable credit quality in Thailand, Indonesia, Malaysia and Russia. This mismatch in assets and liabilities denominated in foreign currencies was one of the critical triggering factors behind the currency crisis in late 1997.

The deregulation of corporate funding without any prudential supervisory system also contributed to the widening maturity mismatch of corporations. For example, when the government lowered the minimum maturity and the minimum issue size of commercial papers (CP), the total issue of CPs increased from 4.4 trillion won in 1994 to 20.7 trillion won in 1996. As a result, the outstanding CP balance of merchant banks, the main intermediaries for CPs, increased from 6.6 trillion won at the end of 1993 to 17.8 trillion won at the end of 1997, a phenomenal annual growth rate of 28%. This increasing reliance on CPs by heavy industry firms undertaking long-term investment contributed to the widening maturity mismatch of corporate assets and liabilities and made both the corporate sector and the merchant banking sector highly vulnerable to any liquidity shock.

---

17 By May 2000, nineteen merchant banks had closed and three had merged.
III. Economic Reform in Korea

The challenging question with which Korea struggled in the 1990s was how to adopt market liberalization without suffering significant macroeconomic dislocations and inadvertently undermining the competitiveness of Korean industries. As the consultancy group Booz Allen & Hamilton found from a recent study, there had been many good ideas but no real actions.\textsuperscript{19} This was because, as Booz Allen accurately pointed out, most calls to action had run into a number of insurmountable transitional issues, which included the concentration of economic power in chaebols, systemic risk in the financial sector, and widespread bankruptcies in the manufacturing sector. However, the IMF’s bailout package and the reform-minded President Kim Dae Jung’s election – watershed events for Korea – provided momentum for action. As a result, revolutionary changes have been taking place in Korea since the onset of the crisis.\textsuperscript{20}

At a higher level of abstraction, these changes embody a belated recognition of the two philosophies. First, the crony capitalistic system of the past could no longer support the rapid growth of an economy and the welfare of its people. In the words of President Kim Dae Jung, “democracy and market economy could be enhanced only hand in hand”. Second, an unfriendly attitude toward foreigners does not have any place in the era of globalized world economies. Various regulations, whether intended or otherwise, which make it difficult for foreigners to do business in Korea are being rapidly removed, and this will also have a profound impact on the regulatory landscape for domestic economic agents.\textsuperscript{21}

Post-crisis reforms are taking place mainly in the four sectors of: financial, corporate, labor and public. The major focus of reform, however,

\textsuperscript{19} Booz Allen & Hamilton (1997).

\textsuperscript{20} Although the financial reform process launched in January 1997 brought about positive changes, implementation of the major reform measures recommended by the Presidential Commission for Financial Reform and additional reforms of a ‘Big Bang’ nature were made possible only after the financial crisis took place.

\textsuperscript{21} It is interesting to note that, observing the troubles that Korea was going through as of May 1997, Clifford (1998) wrote, ‘… a wholesale reorientation of the economy to focus more on productivity and profitability is not likely to happen until Korea gets closer to the brink of a major financial crisis than it is to date’. Many Korean intellectuals would agree that the IMF crisis, as it is called in Korea, provided a once-in-a-life-time opportunity to embark upon a fundamental transformation process of the society and the economy.
IV. Financial Restructuring

Immediately after Korea started receiving the IMF’s bailout fund to overcome a systemic banking crisis in December 1997, the country embarked upon financial restructuring on a massive scale. This restructuring has evolved in four different stages. In the first stage, the Korean government guaranteed virtually all of the major savings instruments, even if some of them, such as life insurance policies, were not legally covered by the deposit insurance scheme. This was to prevent ‘investor runs’ and a collapse of the system.

In the second stage, the Korean parliament passed various laws to establish legal and institutional infrastructures necessary to establish the integrity of the financial system. The bulk of the legal and institutional setup was actually made within the first few months of the crisis. This was made possible because the Presidential Financial Reform Committee had been working on this issue for the entire year of 1997. In this regard, Korea was very fortunate, and contrasts sharply with Indonesia and Thailand, which took almost a year to initiate the legal and institutional infrastructures necessary to undertake financial restructuring. Korea also had a deposit insurance scheme, unlike Indonesia and Thailand.22

In the third stage, the balance sheets of financial institutions were restructured after closing the non-viable banks and the merchant banks. Massive public funds were still being injected at this stage. The fourth stage, which is planned to be of a much longer-term nature than the other three stages, involves the operational restructuring of financial institutions. Such operational restructuring involves the transformation of strategy, decision-making, performance evaluation, reward systems and the like, that are designed to improve efficiency and profitability. Korea is

22 This is why Korea, which received IMF support later than Thailand and Indonesia, could embark upon financial restructuring earlier than these two countries.
Asian Financial Crisis: The South Korean Experience

1. Consolidation of Financial Regulatory Agencies

In April 1998, the Financial Supervisory Commission (FSC) was established. This powerful new agency was placed under the jurisdiction of the Prime Minister instead of the finance ministry (MOFE). The Commission comprises of nine members and holds the highest and ultimate authority to set up all the regulatory policies of the financial industry, which used to be the domain of the three separate policy making institutions; the MOF, the Monetary Board of the Bank of Korea, and the SEC. The MOFE still retains the authority to make legislative proposals regarding financial policies; however, the FSC sets regulatory policies and conducts the necessary supervisory examinations to ensure the safety and soundness of the financial system. In addition, the authority to grant and revoke business licenses was transferred in May 1999 from the MOFE to the FSC.

Under the Commission, the Financial Supervisory Services (FSS) was created as an executive arm of the FSC. The FSS in turn is an organization that consolidates four supervisory agencies: banking, securities, insurance and mutual credits. Thanks to this consolidation, the regulatory structure could shift from ‘institutional regulation’ to ‘functional regulation’. Thus, supervisory policies, licensing polices, examination procedures and remedial measures and penalties could also be standardized across the banking, securities, insurance and other financial sectors.

The revised *Bank of Korea Act* provided the Bank of Korea with its status of independence and autonomy, which the central bank had fought to achieve, against the ministry of finance, for over 30 years. The Chairman of the Monetary Board, the highest policy making body of the central bank, is now the governor of the central bank instead of the minister of the MOFE. The central bank’s primary mission is unequivocally stated as ensuring price stability. In other words, maintaining a sound banking system is not one of the primary missions of the central bank under the revised law. The Bank of Korea in turn had to transfer to the new Commission the supervisory authority along with the Office of Bank

---

23 The institutional structure of the regulatory authority took the form of a committee in order to assure both fairness and independence.
Supervision for banking accounts of commercial banks.

There has been general consensus in Korea over the need for the independence of the central bank. With regard to the consolidation of the regulatory agencies, however, there were hot debates, even intense bickering. To discuss in detail the pros and cons of consolidation is beyond the scope of this paper. Suffice it to say here, though, that under a consolidated structure, information on all of the financial institutions is centralized by one agency; this agency is then able to check whether the diversification requirements of the financial institutions are properly set up and enforced. As Caprio and Vittas (1997) noted, “officials intent on reforming their financial system should keep in mind that most banks - and banking systems - encounter solvency problems (or bank crisis) because they fail to diversify”.24 Thus the centralization of information is one of the great advantages of the consolidated regulatory structure because the concentration of credits and funds into a small number of large companies has indeed been a very serious problem in the past. The concentration of credits into the hands of a few borrowers by an individual financial institution is obviously a serious problem. More importantly, however, the concentration of the aggregate amount of credits or securities financing provided by different financial institutions into a handful of large chaebols is an even more serious problem, which eventually endangered the safety of the Korean financial system.25

2. Deregulation/Restructuring of the Financial Industry

It is widely recognized in Korea today that unless there is a well-functioning and efficient financial industry, the efficient allocation of resources and ensuring corporate accountability are both impossible. The same has been said many times before. The recent economic crisis, however, not only reinforced this thought, it also forced various reform

---

25 As an example, the bank accounts of commercial banks were regulated and monitored by the Office of Bank Supervision of the central bank and the trust accounts of the same commercial banks were regulated by the MOFE with very weak monitoring capabilities. For all practical purpose, bank loans and trust loans are almost perfect substitutes; therefore, large firms often obtained loans from the trust accounts when the loan limit from the bank accounts was almost exhausted. Since the MOFE and the Bank of Korea were not on amicable terms, the necessary flow of information between the two agencies was hampered. In other words, there was a built-in failure mechanism in the old regulatory framework.
measures into existence. Financial reform measures in this regard can be classified into two types; long-term deregulation and short-term restructuring of the financial institutions.

With a consolidated regulatory structure, which it is hoped, should be more effective than the previous structure in ensuring the safety and soundness of the financial system, the system is shifting from a repressed regime to a more market-oriented system. The overall directions for efficiency improvements are the enhancement of competition and the improvement of incentives for both owners and managers alike. More concretely, the old regulatory practices are being eliminated. First of all, any remaining pricing regulations on financial products, such as brokerage commission, were entirely eliminated. Foreign exchange controls were also lifted from April 1999. Thus capital inflows and outflows have been fully liberalized. Next, the entry barriers are now much lower than they were years earlier. The capital requirements for establishing a new brokerage firm or an investment trust company are now more realistic, i.e., much smaller. In addition, the ownership restrictions on commercial banks were relaxed from 4% to 10%, subject to approval by the Financial Supervisory Commission. Also, compartmentalization amongst banking, securities and insurance is being loosened to move towards a universal banking system in the longer term. The impact of the deregulation so far described is bound to be of a more long-term nature because deregulation essentially involves changes in the financial infrastructure as well as changes to the business culture.

The more immediate issue was the restructuring of the financial institutions’ balance sheets because there have been a number of very weak financial institutions in Korea. Between December 1997 and December 1999, 114 of the country’s 437 financial institutions were either closed or merged. Thus 26.4 percent of Korea’s financial institutions left the financial sector. During the same two-year period, bank branches were reduced by 21.6 percent whilst the labor force of the nation’s banks fell by 26.7 percent. Any of the financial institutions that failed to meet the capital adequacy requirements, such as the BIS ratio or its variant, by June

---

26 Foreign financial institutions can own up to 10% of Korean commercial banks without obtaining approval from the regulatory authorities. The ownership of more than 10%, however, has to be approved. As an example, Goldman Sachs was allowed in June 1999 to hold up to 17.6% of Kookmin Bank, the second largest commercial bank, by buying shares and subordinated convertible debentures.
Taiwan, East Asia and Copenhagen Commitment

1998, had to make the painful choice between new equity infusion, merger or closure. The government has so far injected about 80 trillion won of public funds in order to clean up the troubled financial institutions. An additional 30 to 40 trillion won will be required in order to complete the planned financial restructuring. The total cost to the nation will amount to around a quarter of the country’s annual GDP.

The Korean government also instituted various prudential supervisory measures to enhance the safety of the financial system. First to be introduced was a system of Prompt Corrective Action (PCA), which consists of three step-wise supervisory actions, for virtually all types of financial institutions. The credit limit was also tightened to prevent concentration of credits. The early warning system based on the CAMEL criteria was also introduced to virtually all types of financial institutions. Moreover, the system of classifying asset quality was strengthened based on the so-called forward-looking criteria (FLC).

Financial restructuring has, to some extent, been successful and helped to improve liquidity in the financial markets. Ever since the onset of financial crisis in the autumn of 1997, a vicious cycle had been developing and by mid-1998 the financial intermediation process had virtually broken down. In response, the central bank increased the money supply; money, however, did not flow into firms. As Mark Twain once put it, a cat once burnt would not sit on a stove again, even a cold stove. Financial institutions did not have the credit evaluation skills and thus could not establish who was creditworthy and who should receive loans. Even chaebols were not invulnerable any more. Furthermore, assets needed to be shrunk to meet the BIS requirements. All these led to a contraction of credit to firms, which, combined with the extremely high interest rate levels, led to rising corporate defaults, which in turn aggravated the bad asset problem of the financial institutions.

Financial restructuring in the form of closing non-viable institutions

---

27 The full-fledged Big Bang for the restructuring of financial institutions started on 29 June 1998, the same day as the five weakest commercial banks were closed to be taken over by the five strongest commercial banks under the ‘purchase and assumption (P&A)’ formula. These represented the five weakest of the twelve banks that could not have met the 8% BIS ratio at the end of 1997. The remaining seven were allowed to continue operating with the following condition: the adoption of drastic restructuring measures including mergers with sound banks and/or infusion of foreign equity capital, and replacement of all the incumbent executives responsible for mismanagement.
whilst injecting public funds into troubled, but viable, institutions helped to turn the tide and the financial intermediation process improved rapidly from the autumn of 1998. The dismantling of Korea’s third largest chaebol, Daewoo, in July of 1999, however, again placed tremendous strain on the financial system. With the due diligence of Daewoo group, the net worth was found to be negative, by approximately 30 trillion won (-26 billion US dollars)! The resultant loss was to be shared amongst financial institutions, including investment trust companies that had issued beneficiary certificates that were not legally covered by the public deposit insurance. In order to prevent systemic risk, however, the Korean government injected public funds, amounting to 8 trillion won, into the country’s two largest investment trust companies.

As of June 2000, Korea was once again in the midst of a mild financial crisis because of the so-called ‘ITC (Investment Trust Companies) problem’. ITCs have been strange animals in Korea. Although they are investment institutions, they have behaved like, and were perceived by investors as, savings institutions because bonds in their assets were not marked to the market! In March 1997, the ITCs’ total assets were 104 trillion won. At their peak in July 1999, which was immediately before the start of the demise of the Daewoo Group, it was 276 trillion won, a 165 percent increase in less than two and half years! By May 2000, however, it stood at around 150 trillion won because of the slow but steady investor runs. The slow run on the ITC industry is imposing tremendous strain on the financial system because ITCs have played a significant role in funding corporate bonds. In fact, Korea’s corporate restructuring of 1998 and 1999 was only made possible largely because firms could raise unprecedented amounts of funding in the securities market where the ITCs are pillar institutions.28

V. Corporate Restructuring

1. Chaebol Reform

28 In the two-year period, 1998 to 1999, the total proceeds from corporate securities offerings amounted to 142 trillion won, almost equal to the combined total of 148 trillion won in the previous five years.
Soon after the presidential election in December 1997, President-elect Kim Dae Jung invited the chairmen of the five largest chaebols for a meeting to discuss the need for and the direction of chaebol reform. The meeting, which was held on 13 January 1998, resulted in agreement on five major reforms, an agenda that later gained the agreement of other chaebols. The agenda consisted of the following:

a. From 1998, 30 chaebols will prepare Combined Financial Statements and make every effort to enhance management transparency.

b. By March 2000, cross debt guarantees amongst member firms will be entirely eliminated and the practice of cross subsidies amongst member firms will cease from April 1998.

c. By the end of 1999, debt-equity ratios will be reduced to 200%.

d. Chaebols will focus only on core businesses and strengthen cooperation with small and medium-sized companies.

e. Chaebols will assure the accountability of the large owner-managers.

If fully implemented, this agreement – a brief examination of which follows – would lead to de facto dissolution of the chaebols. First of all, the combined accounting system is the most important tool for bringing about the transparency of corporate management. The combined financial statement includes all member firms in a chaebol group where a membership is defined by the Fair Trade Act to be any firm under the control of an identical person. The usual consolidated financial statement, by Korean accounting standards, includes only a fraction of member firms in a group because the requirements for inclusion in the consolidated statements were rather tight. Under the combined financial statement system, all the intra-group transactions were to be disclosed and also netted out to reveal the real picture of each group.

Cross debt guarantees, as discussed already, were the most powerful tool binding member firms together. Without cross guarantees, member firms would have to undergo evaluation in the financial markets on a stand-alone basis. If the practice of giving cross-subsidies in other forms were also stopped, which could be enforced with a new combined accounting system, each member firm would become independent in the

---

29 The broad directions were agreed at that meeting, but the actual figures and implementation deadlines were later selected by the government.

30 New cross-debt guarantees were entirely prohibited from 1 April 1998.
A weak firm would not be able to obtain capital just because (or even if) it was a chaebol affiliate. In this way, over-investment would be less likely to occur and thus more efficient allocation of capital could be ensured.

A further mandate forced upon chaebols was the dramatic improvement of capital structure. As noted earlier, the 30 chaebols’ debt-equity ratio at the end of 1997 was 519%. Reducing the debt-equity ratio from 5:1 to 2:1 during times of low profitability would be an extremely difficult challenge facing the 30 chaebols. In fact, the Korean government was forcing chaebols into dramatic business restructuring because without it, the country would be less likely to be able to overcome the current crisis and prevent any future recurrence. Fortunately, as a result of the stock market boom in 1999, many large firms were able to reduce their leverage by issuing new equity. The debt-equity ratio of the four largest chaebols actually came down from 352% at the end of 1998 to just 174% by the end of 1999.

The mandate to focus only on core businesses – however it may be defined – also forced chaebols into downsizing and restructuring. Each chaebol was in fact required to submit a restructuring plan to its principal transaction bank.32 The restructuring plan was finalized with an agreement from a principal transaction bank, which was then required to monitor its implementation on a six-monthly basis. In a sense, banks are now expected to play a prominent role in ensuring effective corporate governance, as do banks in Japan and Germany. It is very doubtful, however, whether Korean banks have the capability to play such a role, effectively, in the immediate future.33

---

31 From 1 April 1998, new issues of cross-debt guarantees were prohibited. Also, approximately 10 trillion won, about 30% of the outstanding volume of cross guarantees of the 30 chaebols, has been defeased by March 1998 (see the report by the Presidential Council for Economic Policy Coordination dated 20 May 1998).

32 The principal transaction bank system is a very weak version of the Japanese main banking system, which ties firms and banks through cross ownership and board members. The Korean system originated from the need to constrain credits to chaebols. The Office of Bank Supervision officially designates one commercial bank to each chaebol.

33 Anyone claiming that the German-Japanese model of bank-based governance system could work, or indeed be superior to the Anglo-Saxon model of a securities-market-based system should be able to first of all show how governance of the banks themselves works effectively in Germany and Japan. Korean banks lacking good governance structure would not be able to effectively play the role of watchdogs for corporate wealth.
The government is introducing various measures to facilitate chaebols’ restructuring whilst also restoring foreign investors’ confidence. In their efforts to put greater focus on their core businesses and to reduce their financial leverage, many chaebols were attempting to sell real estate and to divest any non-core member firms or divisions. Very few were successful, however, because virtually all the chaebols were trying to sell a large chunk of their businesses at the same time. There were two avenues available to the government to help, or to force, the chaebols to restructure. One was to bring in foreign capital; the other was to pour in public money. In order to encourage foreign capital, the limit on foreign ownership of listed companies was raised from 26% to 55% in December 1997, and from 25 May 1998, the limit was repealed entirely. Hostile takeovers by foreigners were also allowed from May 1998. In addition, various regulations, both implicit and explicit, inhibiting foreign direct investment (FDI) were dismantled, and the government announced that most of the state-owned enterprises would be privatized. Even partial control by foreign investors of the significant enterprises, such as the giant Korea Telecom or the Korea Electricity and Power Corporation, would be allowed. All of these measures contributed to the restoration of confidence amongst international investors. More importantly, they helped or indeed forced through the restructuring of chaebols, although this restructuring was still quite incomplete as of June 2000.

Another available avenue in helping firms to restructure was the establishment of the Corporate Restructuring Fund, launched in June 1998 with initial capital of 10 trillion won. The fund consists of two sub-funds; the American-style mutual fund for securities investment, mainly for large firms, and the equity investment and debt-restructuring fund, aimed at providing equity and long term loans, mainly to small and medium-sized business groups. In addition, the government changed the tax law to eliminate any tax disadvantage through restructuring, for example, by allowing tax exemptions on capital gains from the sale of real estate or divisions.

The government has been twisting the arms of banks and chaebols in order to force them into voluntary corporate restructuring. There were two very interesting events observed in June 1998. One was the death list of the 55 troubled firms released by the Financial Supervisory Commission.
on 18 June 1998. The list included 20 of the firms within the five largest chaebols. Banks would no longer provide new credits or extend the existing loans of those firms on the list, which resulted in either the liquidation or merger of these firms. Banks were forced to come up with this list because both the banks and the chaebols were throwing good money after bad into non-viable firms; banks, in order to disguise the extent of the bad debt problems, and chaebols, in order to delay the painful process of the restructuring of non-viable affiliates. Since the cost of keeping non-viable firms afloat is mostly and ultimately borne by taxpayers, the government forced the above dramatic action. The other event was the public discussion on the so called Big Deal, the swapping of capital intensive businesses such as auto, semiconductors, electronics and petrochemicals, amongst a few of the largest chaebols which were in a state of global glut. President Kim very forcefully encouraged the Big Deals and most of them were consummated by the end of 1999.

2. Corporate Governance Reform

A corporate governance revolution is taking place in Korea based on a broad consensus that corporate governance reform cannot be delayed any longer. The development of such a consensus was in turn affected by observation of the following three factors. First, poor corporate governance was one of the critical factors that led Korea into economic crisis in 1997. Second, the Korean industrial structure, which is skewed heavily toward heavy industries, requires, for reasons described earlier, a capital market-based financial system, which in turn could be well developed only where an effective system of corporate governance was in place. Third, foreign investors who have increased portfolio investments as well as FDI and, as a result, their influence in Korea, have demanded governance reform.

Although a series of legal, institutional and regulatory measures for improving corporate governance had been adopted following the onset of the economic crisis in 1997, the recently published ‘Code of Corporate

34 Korea Times, June 18, 1998.
35 It appears somewhat ironic that the events were orchestrated by President Kim, who has always been a strong advocate of the free-market system. These examples, therefore, illustrate how difficult it is for a country to shift from a state-controlled economy to a free market economy in times of crisis when market mechanisms, poor in the first place, are even more shaky, and moral hazard behavior is more likely to be rampant.
Governance’ (hereafter ‘Governance Code’) intensified the legal and other institutional initiatives for improvement in corporate governance practices.

Corporate governance mechanisms can be classified as either internal or external. External mechanisms refer to the external pressures exerted upon corporate managers to manage firms efficiently. These external pressures mainly emanate from competitive forces from product, capital and managerial labor markets, and more credibly from markets for corporate control. Internal mechanisms relate to institutional arrangements such as shareholders’ meetings, boards of directors, audits, performance evaluation and compensation. The most notable reform in Korea’s external governance mechanism was the total elimination of restrictions on share ownership by foreign investors and the removal of restrictions against hostile takeovers by both foreign and domestic investors. As yet, there has not been even a single attempt by foreigners to take over a Korean company in a hostile manner, but the growing influence of foreign investors, who are continually increasing their investment in the Korean stock market, has made a huge difference. As of March 2000, foreigners held 27 percent of all the shares in Korea’s listed firms. Furthermore, in excess of 50 percent of shares of many of the blue chip companies, such as Samsung Electronics and the Korea Housing Bank, are currently in the hands of foreign institutional investors. Foreign investors have recently started to exert pressure on Korean companies, not only to improve efficiency but, more importantly, to refrain from subsidizing the ailing chaebol affiliates.

The improvements in the internal governance mechanism focus mainly upon board reform, audit reform and other reforms aimed at strengthening the rights of minority shareholders. There have been two major changes in the board reform. One was the decision to force listed companies to elect outside directors. The stock exchange of Korea revised its listing requirements in 1998 so that all listed companies were required to elect at least one outside director. From 1999 at least a quarter of the board was to be composed of outside directors. The recently published ‘Governance Code’ recommended that large listed companies elect a majority of outsiders, i.e., over 50 percent, to the board. The government revised the corporation law in 1999 to the effect that all companies with asset size larger than two trillion won should have at least three outside directors in year 2000, and thereafter majority outsiders. Listed firms
Another significant change to the board system was the introduction into the corporation law of the concept of *shadow director* and a director’s duty of loyalty or fiduciary duty. The concept of shadow director enhances the legal accountability of the controlling owner, i.e., the chairman of each *chaebol*. As noted earlier, chairmen of *chaebols* had full control through informal control of boards of many member firms without even being a director themselves, which made it difficult to impose any legal responsibilities upon the chairman. Moreover, the corporation law specified for the first time directors’ fiduciary duty in addition to a duty of care. Although the current fiduciary duty of directors is not legally specified in detail, and thus rather symbolic in nature, it is expected to be more detailed in the next revision of the corporation law.

The audit function in listed companies will also be strengthened significantly. First of all, the accounting profession is under pressure to improve accounting transparency; the Korean Financial Supervisory Commission has strengthened its monitoring activity and penalty criteria for external auditors. For example, an accounting firm working as an external auditor for Kia Motor Company, a near bankrupt company in 1997, was suspended from the auditing task for six months, which led to the accounting firm’s eventual liquidation. On the recommendation of the IMF, the Korean Accounting Standards Board, similar to the US FASB, was launched in 1999. Secondly, internal audit functions are also being reshaped. Internal auditors, one of the three legal institutions of a corporation in Korea, had previously not performed their duty, largely due to their lack of independence from controlling owners. Now with the revision of the corporation law, large listed companies are mandated to establish an audit committee within their corporate boards. At least two thirds of the audit committee must comprise of outside directors. Firms that establish an audit committee in this way do not need to appoint an internal auditor.

There are other changes aimed at improving the legal protection of minority shareholders. One notable measure here is the relaxation of the requirements of shareholders’ derivative suits against board members. In the past, the ownership requirement for a derivative suit was ‘more than

36 It should be noted that from 1996 all commercial banks were already required by the Banking Act to elect the majority of their boards from outside.
one percent’ and this minimum ownership had to be maintained throughout the suits. These requirements of ownership size and holding period effectively discouraged derivative suits. In 1998, the corporation law was revised to essentially eliminate the requirement for holding shares until the end of suits. The Securities Act also relaxed the qualifications for derivative suits against directors of listed companies. Following the Act, anyone who held over 0.01% of shares for at least six months before the suit would be allowed to initiate a derivative suit. In addition to derivative suits, there is intense continuing debate surrounding whether shareholders should be allowed to undertake collective action suits.

The voice of institutional investors’ in corporate governance is likely to increase substantially in the future. The critical decision in this area will be allowing first time institutional investors to vote in shareholders meetings. Institutional shareholders have in the past been prohibited from exercising their voting rights in order to protect founding families’ control rights. In addition, the problems of non-performing assets and the resultant restructuring of firms and investment companies exert considerable performance pressure on institutional investors. The institutional investors in a less liquid capital market cannot invoke the so-called ‘wall street rule’, i.e., simply walk away from potentially underperforming portfolio companies by selling shares. Therefore, they are bound to rely more on ‘voice’ than on ‘exit’.

VI. Conclusions:
Lessons for Other Countries

Korea is waking up from a long but unsustainable period of prosperity based on crony capitalism and the protection of its domestic markets. There is now an alternative growing consensus that the era of input driven growth and international competitiveness based on low factor costs is over, and that productivity is now the only source of sustainable growth and international competitiveness. Urgent matters on the agenda for Korea’s transformation into a more productive economy include the reform of its financial sector so that financial institutions can compete in allocating resources to efficient firms without impairing the safety and soundness of the financial system. Financial reform is also necessary for the reform of corporate organization and governance structure, which are no longer
capable of serving the *chaebols* themselves, let alone the economic welfare of the nation.

This paper began by describing those structural weaknesses of the Korean economy which contributed to the economic crisis in 1997. Although the previous system and structure did provide some useful contributions in the earlier stages of economic development, the old institutional setup was shown to be inadequate in a large and complex economy exposed to global competition. The paper then summarized the major elements of the ongoing financial and corporate reform processes that have a direct bearing on the recent economic recovery. The main focus of the reform was the elimination of moral hazard and the creation of an incentive-compatible business environment. The existence of *chaebols* has proved to be a bottleneck in the country’s attempts to move towards a full free-market system because incomplete reform was very likely to further increase the concentration of economic power. The country’s *chaebol*-dominated economic structure needed to be, and will be, dismantled. Thus, corporate reform is moving in the right direction.

However, the financial reform, a precondition for successful corporate reform, remains in a stage of infancy for three reasons. First, the current magnitude of the country’s bad debts equates approximately to a quarter of Korea’s annual GDP and is thus large enough to constrain policy options. In addition, the various methods for undertaking the badly needed de-leveraging of the corporate sector are subject to potential political backlash. Second, it is not yet clear how the governance of the banks themselves can be improved. Since the securities markets are weak and therefore credits, rather than securities, will continue to provide a major source of corporate financing in the foreseeable future, banks have to continue playing an important role in ensuring the efficient and effective governance of industrial companies. Some attempts were made from 1996 to improve the banks’ corporate governance, for instance forcing banks to elect a majority of their directors from outside. However, this does not appear to have had exactly the desired effect. Another factor rendering the current financial reform incomplete is the lack of efficient bankruptcy procedures, not only for financial firms, but also for industrial firms. Unless Korea develops an effective and efficient bankruptcy mechanism, problems of moral hazard may well persist because Korea will continue to rely heavily on the large financial and industrial firms, relative to the size of the economy.
What are the implications of and the lessons from the Korean financial crisis for other developing economies? First of all, the industrial structure of a nation should be congruent with its financial structure. If the financial infrastructure of the economy is not sufficiently developed to provide a well-functioning stock market, then the economy is likely to be operating under a credit-based financial system. If such an economy promotes heavy industries and large enterprises as a matter of industrial policy, corporate leverage, both in operations and in finance, is bound to be very high, which inevitably creates economic instability and also severe problems of moral hazard, including considerable over-investment. It is important, therefore, for such economies to promote a well-functioning stock market and also to encourage less capital-intensive light manufacturing industries, as well as small-medium sized enterprises, in order to pursue a balanced path of economic growth.

Secondly, until the modern financial infrastructure is set up, the capital account convertibility should be delayed and the government should control short-term capital flows. As the IMF unequivocally stated, “in Korea, however, capital account liberalization was not well sequenced nor accompanied by the reforms and strong prudent supervision of the financial system”. It is tempting for economists to argue that capital liberalization would facilitate the necessary reform process. Although such an argument is true in principle, it is nonetheless a naïve argument pursued by economists who tend to underestimate what is involved in implementing institutional reform and setting up the necessary infrastructure; accounting transparency, legal protection of investors, prudential regulations, and the like. Even with the strong political will to reform, it will take at least a decade. But in a country where capital account liberalization has already been adopted, and thus the country is already exposed to the new global capital system, a decade is indeed a long run, during which, according to Keynes, we could all be dead. Therefore, recommendations for the proper sequencing and control of short-term capital flows cannot be overemphasized.

Thirdly, all developing countries must develop efficient capital markets. Global competition mandates the improving efficiency of

---

38 For one of the best arguments against premature capital account liberalization, see Rodrik (1998).
corporate resource allocation which might well be better intermediated at lower cost by the securities markets rather than credit markets. In addition, if any country is to develop a knowledge-based economy, it must have a well-functioning securities market as a precondition. This is because dot.com type firms with little hard tangible assets of any resale value cannot finance their investments by obtaining credit. In other words, venture businesses can be developed only if security markets are well developed. For this reason also, improving corporate governance is of critical importance.

References


Joongang Ilbo (1998), daily newspapers on the various dates.


Korea Times (1998), June 18.


