Financial Crisis and Transformation of Korean Business Groups

The Rise and Fall of Chaebols

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Introduction

From Asian Miracle to Asian Crisis

FROM ASIAN MIRACLE TO ASIAN CRISIS

Korean citizens will never forget November 21, 1997. People were dismayed by what they heard from the media that day. There had been rumors of skyrocketing foreign exchange rates. Then the minister of finance and economy resigned. Chang-Ryol Lim, the succeeding minister, immediately announced that he would request funds from the International Monetary Fund (IMF). Korean media kindly added commentaries that their country was about to go bankrupt and was seeking a bailout by IMF. A few days later, Michel Camdessus, the IMF's managing director, visited Korea to announce that the IMF would assist Korea, provided that the government would restructure Korea's economy.

Koreans were proud of their economic achievements and were shocked by this turn of events. The per capita income in Korea had increased from $82 in 1961 to $10,315 in 1997.[1] The World Bank, a sister organization of the IMF, had published a book, *Asian Miracle*,[2] that praised Korea as an exemplar of economic development. Yet something was wrong with the Korean economy. The Hanbo, Jinro, and Kia Groups, all members of Korea's top thirty business groups, termed chaebols, went bankrupt earlier in 1997. Bankruptcies of large chaebols were unprecedented in Korea because the government had traditionally rescued large chaebols from bankruptcy; most Koreans believed that the bigger chaebols were, the less likely they were to fail.

Yet informed citizens knew that these bankruptcies augured a situation that was not "business as usual." In fact, the "Tiger Economies" of Asia were all on edge. The foreign exchange crisis in Asia, which started with the plummeting of Thai baht in July 1997, spread quickly to Indonesia and Malaysia within two weeks, and other Asian countries were bracing for the worst. Unstable foreign exchange rates caused a dollar exodus from the region, resulting in sweeping instability throughout Southeast Asia. The Korean government had aggravated this instability by implementing the so-called antibankruptcy agreement after Hanbo, Jinro, and Kia went bankrupt. This agreement effectively blocked banks from demanding payments of overdue debts by already insolvent companies and forced these banks to provide insolvent firms with additional financing. Fearing further losses, commercial and merchant banks in Korea reacted to these policies by recalling loans to other companies that had financial problems. The resulting contraction in the financial market drove additional companies into bankruptcy.

Observing these events, foreign investors began reexamining the fundamentals of the Korean economy. They then started withdrawing their funds from Korea en masse, liquidating their investments at a loss and converting them to dollars. Foreign financial institutions also sharply reduced advances to Korean companies and then began calling in their loans to financial institutions in Korea. These actions in turn created even larger contractions in the stock and foreign exchange markets and induced the bankruptcies of larger Korean firms. The Bank of Korea vainly intervened in the market to protect the won's value, thereby reducing its foreign currency reserves to $5 billion at one point.[3] Yet it continued supplying funds to financially troubled banks, which now owed large debts to foreign creditors. Foreign exchange rates soared from 864 won per dollar in January 1997 to 1,695 won per dollar by December 1997 (see Figure 1.1). The Korean stock exchange index tumbled from 669 to 390, and the number of Korean companies that went bankrupt increased from 1,000 per month to 3,500 per month. The Korean

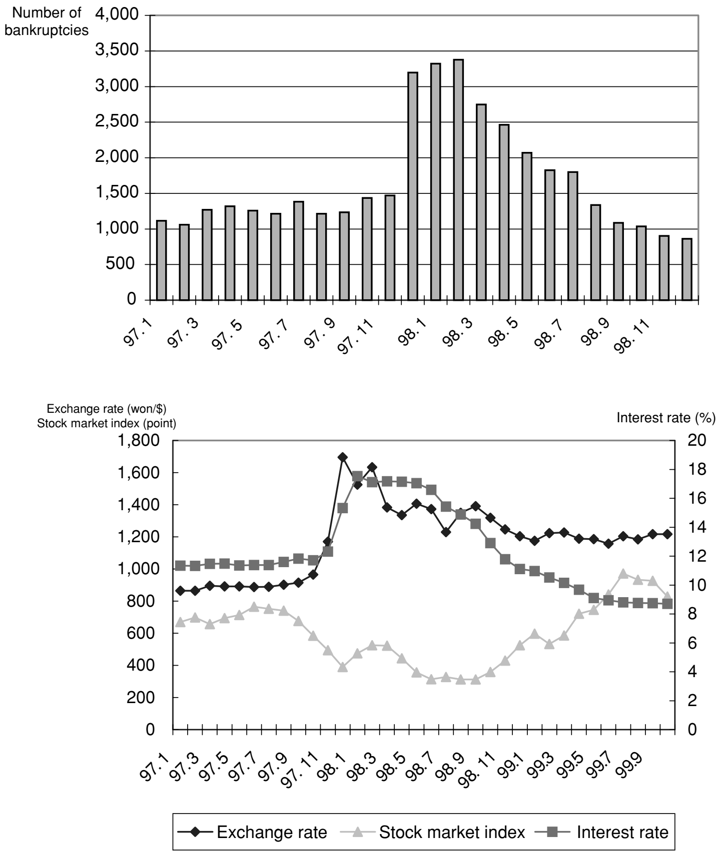

Figure 1.1. Movements of exchange rates, interest rates, stock market index, and number of bankruptcies. *Source:* Bank of Korea, *Economic Statistics Yearbook.*

economy, which had created the miracle on the Han River from the ashes of the Korean War, returned to ashes.

The IMF demanded that the Korean government adopt draconian measures in return for the relief fund. It wanted to restore confidence in the Korean economy and to fundamentally restructure Korea's financial and corporate sectors. To achieve the first goal, it raised short-term interest rates to 25% and ushered in a floating exchange rate regime. These initiatives resulted in soaring exchange rates, and their effectiveness was questionable. Notable economists, including Joseph Stiglitz, the vice president of the World Bank, and Jeffrey Sachs, publicly criticized the high interest rate policy because it triggered more bankruptcies and insolvencies.[4]

To achieve the second goal, the IMF pushed the Korean government to reorganize the chaebols. To do so, the Korean government first rescued virtually insolvent banks with an injection of public funds. It then sought to reorganize the chaebols financially by leveraging the banks to help chaebols lower their debt–equity ratio. Second, it forced the so-called Big Deal, which required the chaebols to swap and reorganize their businesses so that each chaebol would focus only on a select few lines of business. Various problems, however, beset this project. Chaebols initially objected to the plan by arguing that it was impractical for them to reduce their debts so quickly. They then tried to politicize the Big Deal to delay being restructured.[5]

Despite the government's failure to restructure the chaebols promptly, the Korean economy gradually recovered from the shock of the foreign exchange crisis. The source of the relief was rather unexpected. The Asian economic malaise started to infect first Russia and the South American countries, and then finally even the advanced countries, including the United States. For example, one of the biggest hedge funds in America, Long-Term Capital Management, was saved from the verge of insolvency by the U.S. government in 1998. As the crisis in a few Asian countries began to snowball globally without control, the Federal Reserve Bank of the United States hurriedly lowered the interest rate to cool down the situation.[6] Other countries followed suit. As a result, the exchange rate of the Korean won stabilized at 1,100 won per dollar by the end of 1999, market interest rates decreased to less than 10%, and the stock exchange index surged past 1,000 by the middle of 1999. Further, the Korean government announced in November 1999 that it wished to repay the IMF relief fund ahead of schedule and that additional assistance would be unnecessary.

Many have speculated about why Korea got caught in the Asian crisis.[7] Some have speculated that the flood of "hot money" heightened the instability of the foreign exchange market and ultimately led to the crisis.[8] There is room for debate about how deeply short-term speculative funds contributed to this crisis throughout Asia. Also, the IMF pointed out several mishaps by the Korean government that made Korean financial institutions vulnerable.

> Until the financial crisis in late 1997, Korea had experienced a long period of rapid growth, low inflation, and a sustained improvement in the standard of living. Prudent macroeconomic policies and high domestic savings and investment contributed to the rapid transformation of Korea into an advanced industrial economy in four decades. The government had begun an economic reform program – which gained momentum in 1993–96 – to gradually liberalize financial markets and the capital account. Capital account liberalization, however, was not well sequenced nor accompanied by the necessary reforms and strong prudential supervision of the financial system. The vulnerabilities of the economy to external events stemming from weaknesses in the corporate and financial sectors were not fully recognized. Controls on short-term external borrowing by

> banks were eased, but controls on medium- and long-term capital remained in place.[9]

The Western popular press and financial community, however, blamed chaebols for being the main culprits of the crisis.[10] They argued that chaebols are analogous to cancers that pursued purposeless growth and thereby killed neighboring cells before consuming themselves. The IMF's assessment was worded more mildly, but it also identified the debt-ridden chaebols with an unholy alliance with financial institutions as the root cause of the crisis:

> In 1994–96, Korean conglomerates undertook an aggressive investment drive financed by large increases in borrowing from domestic banks, which, in turn, sharply increased short-term external borrowing. During 1997, an unprecedented number of highly leveraged conglomerates went into bankruptcy as the buildup in capacity proved unviable owing to the depreciation of the yen, a sharply adverse movement in Korea's terms of trade, and the slowing of domestic demand in 1996. The bankruptcies resulted in a severe deterioration in the balance sheets of Korean financial institutions.[11]

Even now, after the apparent recovery, the crisis raises many questions about how robust Korean economic institutions are. Chief among these institutions is the chaebol, which is a major force in the Korean economy. Some have argued that chaebols drove Korea's rapid economic growth.[12] Could they have caused the foreign exchange crisis? How then, did they come to be the destroyer of their own creation? Several questions may also be raised about foreign financial institutions. Why did they continue providing loans to chaebols prior to the crisis, knowing that chaebols were heavily leveraged? How did chaebols and the Korean economy recover so quickly after the crisis even though they did not change much? Was the crisis an unforeseeable random event where investors and creditors showed a herd reaction? Were chaebols simply susceptible to external turbulence? If so, what is the real problem with the chaebol phenomenon? What are their strengths and weaknesses? Should they be dissolved as argued by the Western critique? Should the Korean government force them to restructure further? If so, what would this restructuring involve? Can chaebols once again continue to grow and prosper?

Numerous books look at chaebols. Most focus on how they were formed and their relationship to the government. None, however, pursues chaebols in sufficient depth to show how they operate. This book thoroughly examines chaebols' internal operations and evaluates their performance prior to the crisis and their subsequent restructuring. In doing so, it offers the broad, in-depth perspective necessary for answering the questions set out earlier. It also considers how chaebols might be restructured and whether they can once again become major players in the world market.

CHAEBOLS: THE KOREAN BUSINESS GROUPS

The Role of the Chaebol in the Korean Economy

As mentioned, a chaebol is a Korean business group. It encompasses many subsidiary firms under the same name. Chaebol originally meant money clique in Chinese and was used to refer to a group with a vast fortune. Some chaebols, such as Hyundai, Samsung, LG, Daewoo, and SK, are well known in the West.

There are many Korean companies with more than two subsidiaries that are controlled by one family, but the Korean government and media typically use "chaebols" to denote the thirty largest Korean business groups. The Korean government annually identifies the thirty largest business groups and publishes a listing of their affiliates under the "Monopoly Regulation and Fair Trade Act" (known as the Fair Trade Act) to block any anticompetitive behaviors. The act defines chaebols' affiliates as those for which "either more than 30% of whose issued shares are owned by one person, his relatives, or a company controlled by him, or whose management such as appointing its officers is substantially affected."[13] This book uses that definition. Table 1.1 briefly describes their size, the trend of their intra-group business transactions, ownership of shares, and debt guarantees.

The chaebols play a critical role in Korean markets. Figure 1.2 shows the portion of the Korean gross national product (GNP) attributable to the thirty largest chaebols from 1985 to 2000. To make these data comparable to GNP data, we calculated the value-added production of chaebols by adding up income before taxes, wages to workers, various financial expenses, and depreciation of all chaebol firms in our database except those in financial services and several small affiliates that were not "statutory audited firms."[14] In 1995, chaebols accounted for approximately 16% of the Korean GNP, and this portion would be much bigger if it included all the chaebols' affiliates. Figure 1.2 also shows two important trends. First, it indicates that the chaebols' share of the national GNP increased from 12% in 1985 to 16% in 1995, which proves that the national wealth had been increasingly concentrated into a few chaebols' hands during the period. Second, it shows that almost all this increase during this time (an increase from about 6% to about 10%) accrued to the

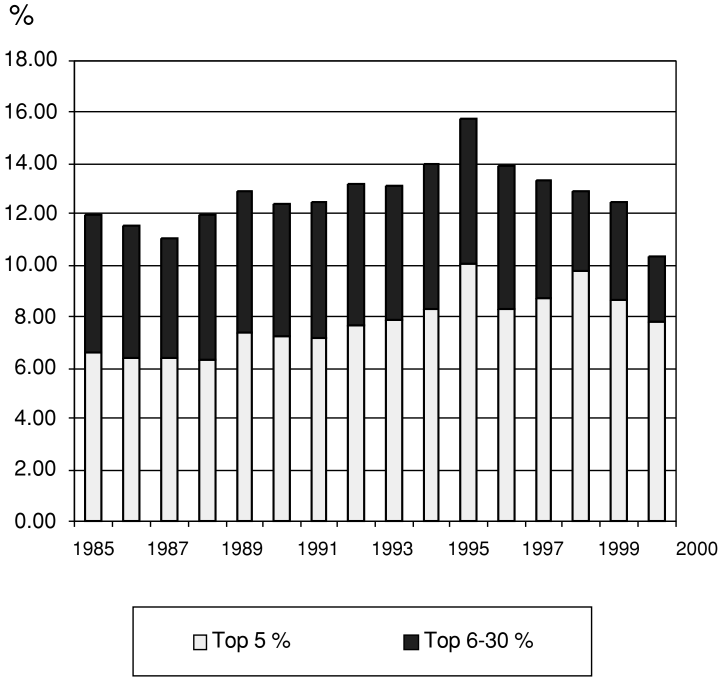

Figure 1.2. Shares of Korean GNP held by the top thirty chaebols, 1984–2000.

top five chaebols. There is a big difference between the sizes of the five biggest chaebols and those of the other twenty-five chaebols. In studying the chaebols, we shall thus focus on understanding the operations of the five biggest chaebols – Hyundai, Samsung, LG, Daewoo, and SK.

The chaebols are also major global players (Ungson, Steers, and Park, 1997). As of 1997, ten affiliates of the top thirty chaebols made the Global Fortune 500 listing. The chaebols aggressively pursued globalization strategies during the 1990s: they engaged in various kinds of direct investments, mergers, and

Table 1.1. *The listing of the top thirty groups in 1997*

1997 ranking	Business groups	#. of affiliate firms	Assets (billion won)	Sales (billion won)	Equity (billion won)	Debt–equity ratio (%)	Intragroup trade (%)	Debt guarantee/ equity (%)	Family ownership (%)	Affiliated ownership (%)
1	Hyundai	57	52,821	67,990	9,842	436.7	31.6	102.5	13.8	41.6
2	Samsung	80	50,705	60,113	13,809	267.2	28.2	17.6	3.5	42.5
3	LG	49	37,068	46,674	8,302	346.5	23.7	28.1	5.4	34.0
4	Daewoo*	32	34,197	38,243	7,817	337.5	35.6	129.4	6.1	31.2
5	SK	46	22,723	26,640	4,703	383.2	21.4	16.8	14.1	30.1
6	Ssangyong	25	15,804	19,445	3,102	409.5	35.4	92.5	3.6	37.5
7	Hanjin	24	13,907	8,708	2,118	556.6	8.3	385.9	18.7	20.3
8	Kia*	28	14,121	12,001	2,289	516.9	33.8	110.8	20.8	9.6
9	Hanwha*	31	10,592	9,657	1,244	751.4	20.2	159.3	5.9	26.7
10	Lotte	30	7,753	7,192	2,654	192.1	11.6	20.8	3.4	19.4
11	Kumho	25	7,399	4,443	1,281	477.6	7.1	121.4	2.0	37.8
12	Halla*	18	6,627	5,293	306	2,065.7	31.0	891.0	18.8	30.5
13	Dongah*	19	6,289	3,885	1,383	354.7	2.6	202.4	12.0	42.2
14	Doosan	25	6,369	4,042	808	688.2	15.8	88.1	13.4	35.9
15	Daelim	20	5,849	4,832	1,118	423.2	26.4	256.2	8.8	25.1
16	Hansol	23	4,214	2,513	1,075	292.0	26.8	50.8	3.7	33.2
17	Hyosung	18	2,131	5,477	879	142.4	14.5	42.1	13.5	30.7

18	Dongkuk	17	3,698	3,075	1,161	218.5	6.3	56.1	15.6	32.5
19	Jinro*	24	3,826	1,391	99	3,764.6	8.6	473.3	16.6	28.3
20	Kolon	24	3,840	4,134	919	317.8	7.7	84.8	7.6	36.5
21	Kohap*	13	3,653	2,521	529	590.5	50.5	80.3	8.5	30.8
22	Dongbu	32	3,423	3,154	946	261.8	7.2	92.8	12.8	33.2
23	Dongyang	24	2,631	1,847	646	307.3	16.4	91.9	4.8	44.0
24	Haitai*	15	3,398	2,715	448	658.5	8.9	57.0	3.9	24.9
25	Newcore*	18	2,797	2,279	211	1,225.6	28.3	172.5	36.4	62.3
26	Anam	21	2,638	1,984	456	478.5	55.9	361.3	9.8	32.0
27	Hannil*	7	2,599	1,277	384	576.8	6.8	215.8	11.2	25.2
28	Keopyung*	22	2,296	1,058	513	347.6	22.1	354.3	17.4	41.5
29	Miwon	25	2,233	2,114	432	416.9	26.5	150.4	15.7	36.2
30	Shinho*	25	1,139	1,210	362	214.6	16.9	300.1	9.9	23.3
Top 30 average		27	11,159	11,864	2,328	600.7	21.2	173.5	8.5	33.7

Notes: 1. * denotes firms either bankrupt or under the bank-sponsored workout program as of December 1999.
2. The group-level sales, asset, equity, debt–equity ratio, intragroup trade, and debt guarantees include nonfinancial services companies only.
3. The average family ownership and cross ownership figures are the weighted average of the top thirty chaebols with the equity capital of individual chaebols as the weighting factor, following the FTC convention.
4. Hanbo Group went bankrupt in early 1997 and was therefore excluded in the FTC listing of the top thirty groups.
Source: Fair Trade Commission and Korea Information Service.

acquisitions throughout the world. For example, Samsung, LG, and Hyundai all enlarged their semiconductor production capacities and acquired such American companies as AST Research, Zenith, and Maxter, respectively. Daewoo Motors acquired FSO of Poland and constructed large auto manufacturing plants in India, Uzbekistan, and Romania.

The Performance of Chaebols Prior to 1997

Although "hot money" and inappropriate government policies contributed to the crisis in Korea, the chaebols' performance had greatly deteriorated before the financial crisis began. Chaebols were thus vulnerable to external events. Figure 1.3 shows that the profitability of the thirty largest chaebols, gauged by the return on invested capital (ROIC), had fallen steadily since the mid 1980s. The ROIC is defined as the sum of net income before tax plus interest payments, deflated by total assets, to provide a return metric that is comparable across firms. This measure of performance assesses operating efficiency without being biased by the relatively high debt–equity ratios common in Korean firms. The higher profitability of the chaebols during the late 1980s was due primarily to external factors such as low oil prices, low interest rates, and undervalued currency. In many cases, chaebol affiliates were not profitable enough to cover even their financing cost, which is calculated by dividing interest payments by interest-bearing liabilities. This statistic suggests that many affiliates were very inefficient.

The figure also shows that the profitability of the top thirty chaebols was quite low relative to firms in other countries.[15] The top thirty chaebols were sometimes less profitable than were smaller groups and independent companies, although the statistical analysis in Appendix 2 indicates that this difference

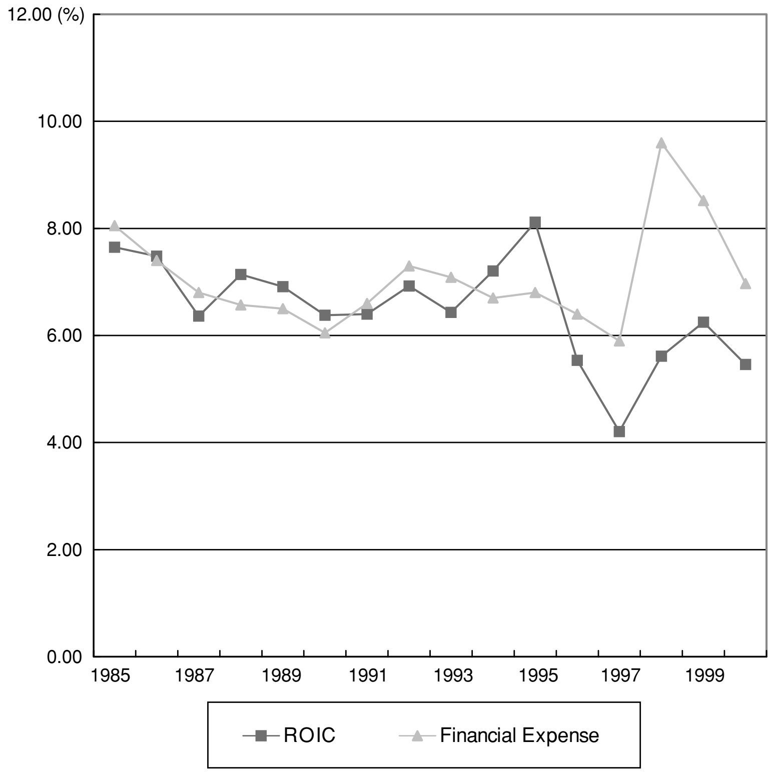

Figure 1.3. The profitability of chaebols, 1985–2000.

may be due largely to industry factors and various internal transactions. Many chaebols were in low-profit industries such as heavy equipment and chemical industries, which had chronic overcapacity. Because chaebols often used cross-subsidization through various forms of international transactions, it is hard to compare the profitability of chaebol and nonchaebol firms. Figure 1.3 also shows that the profitability of chaebols declined during the 1990s.

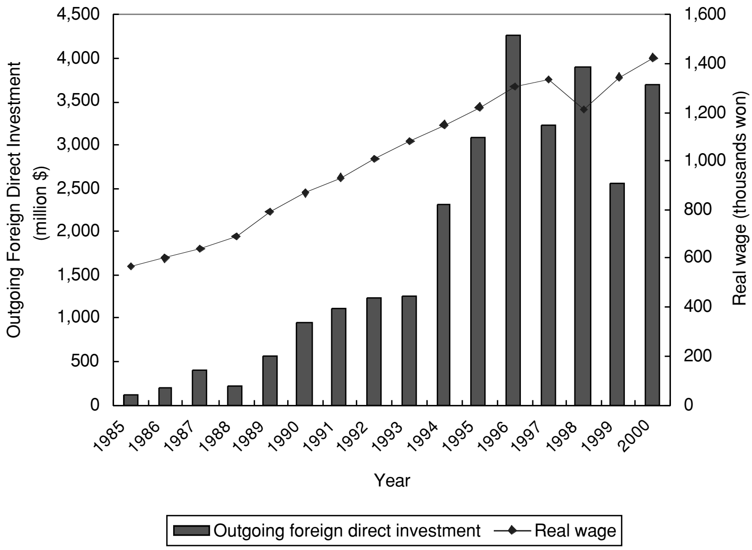

Figure 1.4. Real wages of Korean workers and outgoing foreign direct investment. *Source:* National Statistics Office.

There are three apparent reasons for this decline. First, Korean companies became uncompetitive in both low-end and high-end exports. After economic liberalization in the early 1980s, labor disputes intensified. As a result, Korean workers' real wages doubled between 1985 and 1995 (see Figure 1.4), thus making Korean exports less competitive than were their equivalents from developing countries such as Indonesia and China. To make things worse, the Korean won was overvalued. Figure 1.5 displays the trends of the exchange rates for the won and the Japanese yen, as well as the surplus/deficit on capital and current accounts. Many Korean products directly or indirectly compete with Japanese counterparts in the world market. The sharp appreciation and eventual overvaluation of the Japanese yen against the U.S. dollar during the late 1980s generated huge