Korean *Chaebols* in Transition: Road Ahead and Agenda

Edited With An Introduction By
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Preface

The business environment of the *chaebol*, the large Korean business groups, has changed drastically since the financial crisis of the end of 1997. The introduction of market-enhancing institutions and the digital/network revolution has led to a dramatic fall in transaction costs and also increases the importance of market transactions vis-à-vis intra-group transactions. Most of these changes are market-conforming, which inversely acts to increase the costs of running a number of businesses under a sole umbrella. The *chaebol* need to fundamentally change the way they run their businesses to survive in the future, considering the important changes in markets and institutional contexts that are taking place.

The government policy toward *chaebol* is critically reviewed by the authors of this book, who also evaluate whole *chaebol* restructuring process. They suggest desirable restructuring strategies and investigate the interaction of economic institutions with the *chaebol*'s incentive structure and management behavior. This volume is composed of eight papers. The papers were prepared individually by the authors and then discussed at the Korea Economic Research Institute or at academic conferences. The authors incorporated the comments and suggestions made by discussants into the final version of their papers.

I am hopeful that this book will be a road map or a guide for the Korean *chaebol* and government in this period of transition. I would like to thank all contributors for their hard work. I would especially like to thank Dr. In Kwon Lee and Dr. Jae-Woo Lee, all of whom contributed a great deal of effort in organizing this project and in publishing this book.

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Introduction

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Korea's long standing economic miracle, driven by its rapid export-oriented development, high levels of saving and investment, moderate inflation and large government financial surpluses was shattered in the wake of the severe financial crisis that hit just one year after Korea joined the OECD. It is widely accepted that certain structural weakness in the corporate and financial sectors have made Korea vulnerable to the financial disturbances that swept through Asia during 1997. The financial system, already weak and operating inefficiently, was further weakened by a series of *chaebol* bankruptcies in 1997. The corporate sector was characterized by excessive debt and low returns, reflecting the tendency of the *chaebol* to diversify into capital-intensive heavy industries using short-term bank loans through a system of cross-debt guarantees between affiliated firms.

The business environment of the *chaebol*, the large Korean business groups, has changed drastically since the financial crisis of the end of 1997. To remedy the structural weaknesses in the corporate sector, the Korean government has launched a rather aggressive *chaebol* reform package, supported by the IMF and other international agencies. The main objective of *chaebol* restructuring is to restore the competitiveness of the corporate sector and to bring business conditions in Korea in line with international practices and standards. The five tasks established to reach this objective are as follows: improvement of the corporate governance framework, enhancement of management transparency, elimination of cross-debt guarantees, improvement of the capital structure of firms, and greater concentration in core businesses. In each of these areas, significant changes have taken place. The *chaebol* need to fundamentally change the way they run their businesses to survive in the future, considering the important changes in market and institutional contexts that are taking place. The *chaebol* have actually gone through considerable governance, capital, and business portfolio restructuring. The new market-oriented institutions have sped up this restructuring process. However, the government has been prone to rely on intervention in the process of corporate restructuring, just as in the past.

In this volume, composed of eight papers, we critically reviewe the government policy toward *chaebol*. We evaluate whole *chaebol* restructuring process and also suggest desirable restructuring strategies, and investigate the interaction of economic institutions with the *chaebol*'s incentive structure and management behavior.

I. Government and *Chaebol* : General Perspective

Government policies are critically reviewed and evaluated in the two papers by Sung-hee Jwa and Jungwhan Suh, and Ha-Joon Chang and Hong-Jae Park. Sung-Hee Jwa and Jungwhan Suh note that the strategy of government-led economic management has contributed to economic growth in the early phases of Korean economic development. However, extensive government intervention has brought about problems to the smooth operation of the market economy. Before the crisis, the government actively intervened in every phase of market operation. Entry and exit barriers and financial and tax supports were the tools of industrial policy. Entry barriers basically allowing only the existing large corporations to enter the targeted industries and policies designed to support these corporations contributed to the rise of big diversified enterprises, the Korean *chaebol*. Moreover, exit barriers erected as a result of active governmental intervention in industrial and corporate restructuring inhibited the natural flow of economic resources from non-viable firms to viable ones. Financial support included loans of scarce financial resources at preferential, subsidized rates with long maturity periods to corporations chosen to operate in selected industries. These practices resulted in biased resource allocation.

The authors also note that post-crisis corporate restructuring has proceeded under strong governmental guidance. There has been progress in corporate governance and financial and business structures. However, they argue that the process of restructuring is reminiscent of the interventionist industrial restructuring attempts of the 1970s and 1980s. Furthermore, the measures adopted in the restructuring process could raise doubts as to the consistency of government policy. This restructuring process, according to the authors, has paid too much attention to changing outward symptomatic characteristics rather than setting the correct underlying institutional and incentive structures. Jwa and Suh recommend that the new direction of industrial policies follow a shift of philosophical background in economic management on the part of the government to nurture and preserve the smooth operation of market mechanisms.

Ha-Joon Chang and Hong-Jae Park note that the financial crisis of 1997 has brought about a sea of change in the prevailing view on the Korean economy. Nowhere is this about-turn more apparent than in the analysis of the Korean big businesses and their relationship with the government. Once seen as highly effective, if somewhat idiosyncratic, protagonists of the country's impressive industrial catching-up, the authors argue that the *chaebol* are now regarded as pathological business organizations that are responsible for the downfall of the economy. Likewise, the cooperative government-chaebol relationship, which was previously regarded by most as one important ingredient in the country's economic success, is now condemned as a corrupt league that hampered economic efficiency in the country.

Chang and Park point out that some of the allegedly pathological features of the *chaebol* – extremely low profitability, excessively high leverage, and excessive aversion to financing through the stock market – are based on weak empirical bases. Some other features – such as excessive diversification and high concentration of insider ownership – are partly true, but they are not as problematic as they are often thought to be. More importantly, the authors argue, the currently dominant view fails to understand the nature of the investment-growth dynamics that has characterized the Korean economy during the last few decades, of which many of the allegedly pathological features of the Korean *chaebol* were integral. Therefore, the authors argue, the currently dominant corporate reform agenda is very likely to weaken the "traditional" Korean economic system, such as the ability to mobilize "patient" capital. Moreover, it is argued, the currently dominant corporate reform agenda will not be able to address what the authors think are the real problems posed by the *chaebol* – namely, their tendency to over-invest and the possible abuse of their enormous economic and political powers. Chang and Park argue that addressing such problems requires a revival of judicious and forward-looking industrial policies and financial regulations, as well as the restructuring of the government-chaebol relationship in a more consensual and accountable way.

II. *Chaebol* Restructuring Policy and Evaluation

Chaebol restructuring process is comprehensively evaluated in the papers by Jae-Woo Lee and In Kwon Lee. Jae-Woo Lee performs a comprehensive examination of *chaebol* restructuring in his paper. He argues that the *chaebol* need to change the way they do business to survive in a transition era characterized by market and institutional changes. In addition, the digital revolution has led to a dramatic fall in information costs, which are a major component of transaction costs. This will have a great impact on group management. While the IT (information technology) revolution acts to expand the boundaries of firms, it also increases the importance of market transactions vis-à-vis intra-firm transactions. Overall, the former effect will be more important than the latter. In the end, most of these changes will be market-enhancing, which inversely acts to increase the costs of running a number of businesses under a sole umbrella.

The most influential factor for changing the cost structure of business group management, argues the author, is competition in the marketplace. Both in domestic and international markets, *chaebol* groups are being exposed to stronger competition than ever. The increasing pressure from global competitors forces the *chaebol* to face an "inflection point" where those giant groups must give up their old habit of top-down management by owners or founding managers and their excessive levels of conglomeration and financial leveraging.

However, Lee does not advocate that the *chaebol* become the opposite of what they are now: extremely specialized companies (no diversification at all) with purely equity-financed capital structures (no debt at all). It would be premature to foresee in what ways the *chaebol* will react to the changes in the constraints or choice set. However, according to the author one thing that is certain is that internally-organized transactions are more costly than market-type transactions. Hence, market transactions will increase to a great degree. Responding to market pressure, the *chaebol* will have to go through a dismantling phase, ultimately becoming a federation of affiliated subsidiaries, which will be more loosely linked than ever.

More specifically, many subgroups will be spun-off from the chaebol, a process termed FBO (Family Buyouts). Furthermore, traditional MBOs (Management Buyouts) and EBOs (Employee Buyouts) will be popular at the firm level. Professional managers and their managerial authority will gain importance. Direct subsidization disregarding profit will not be allowed any more. In addition, non-performing divisions will be shed or spun-off.

In addition to refocusing, most of the functionally or vertically integrated networks inside the *chaebol* will be dismantled. For example, several *chaebol* subsidiaries that performed special functions in the past will be spun-off to become subcontractors or will be replaced through independent outsourcing. Any function such as advertising, R&D, finance, labor management, intermediate parts and material procurement, and general management can be considered as candidates for outsourcing.

The refocusing and de-leveraging trends are linked to more stringent market discipline on the part of current management. For example, debt-equity conversions, which have been popular in debt restructuring, ultimately affect the ownership structure of enterprises. Many founding managers have already lost control rights owing to the dilution of ownership. Furthermore, legal protection of small shareholders is given more attention than ever. Internal trades among subsidiaries will be strongly regulated by *chaebol* watchdogs such as the Fair Trade Commission and the Financial Supervisory Commission. As a result, according to Lee, managerial and accounting transparency will be enhanced.

In Kwon Lee notes in his paper that chronic excess capacity or over-investment has been a key issue whenever Korea goes through an economic crisis. In 1998, the government came up with the "Big Deal" policy, in which the 5 largest *chaebol* were asked to swap 8 businesses among themselves in key industries to alleviate chronic excess capacity in these businesses, which was pointed out as one of the key factors in brining about the financial crisis of 1997. Looking back on past industrial policies vis-à-vis excess capacity since the 1980s, the latter has continuously been mentioned at the center of industrial policy and without exception the government has taken an active part in reallocating resources to solve that problem.

Based on the statistical analysis of a panel data composed of financial information from 26 firms over the sample period of 1988-1998, Lee rigorously examines whether chronic excess capacity has existed or not and which factors determine the scale of excess capacity. The statistical evidence indicates that structurally excessive capacity due to continual over-investment far in excess of growing aggregate demand over the sample period has existed in the auto, aerospace, railway vehicle, and power-generator/ship-engine industries.

From the statistical analysis in his study, Lee concludes that it is not feasible to attain the policy goal of successfully restructuring industries using government intervention as a tool for resource allocation since the government cannot ex-ante control a variety of strategic behavioral patterns on the part of competing firms in an oligopolistic industry. A firm's strategic decision to maximize profits subject to the constraints existing in its business environment is rational at the firm level even if it may bring about excess capacity at the industry level ex-post, according to the author.

The statistical results in Lee's study verify the theoretical inference that an excess capacity strategy may enable incumbents to threaten to expand output and cut prices following a competitor's entry, thereby making entry unprofitable. It is also worth noting that this statistical result is partially attributable to incumbents' exploitation of entry regulation policies. Incumbents benefit from the government's entry regulations by intentionally keeping a certain level of excess capacity whenever a potential competitor tries to enter the market. If this inference holds true, entry deregulation will significantly reduce incumbents' incentives to take advantage of entry regulations and engage in the socially wasteful expansion of facilities.

III. *Chaebol* Survival Strategy

Restructuring strategy is the subject taken up in the paper by Hicheon Kim, Jung Wha Han, and Robert Hoskisson and the one by Ji-Hwan Lee and Costas Markides. Hicheon Kim, Jung Wha Han, and Robert Hoskisson evaluate the theoretical underpinnings of the diversification strategy of business groups in Korea and suggest future directions. Underlying their analysis are two theoretical propositions about the economics of diversification strategy: the value-creation potential of diversification depends on the quality of the underlying economic institutions supporting the economy; and the strategy-structure fit is a key determinant of the performance of diversified firms. As a consequence, they take into consideration institutional contexts and organizational arrangements in evaluating the diversification strategies of business groups. The business group is an organizational solution to overcome problems stemming from poor economic institutions. In the early stages of economic development, capital, labor, and intermediate product markets were non-existent or performing poorly and, as a result, companies had no choice but to generate these resources internally. In this context, internal market capabilities based on diversified business structures were a source of competitive advantage and growth for business groups. However, as external markets develop and become efficient, such internal market capabilities decline in strategic significance and diversified business structures come to be perceived as a cause of inefficiency.

With the development of economic institutions and competitive environments, the significance of generic resources (capital and human resources) declines and that of specialized resources (technological and marketing skills) increases as sources of competitive advantage. From the standpoint of specialized resources, the business portfolio of the business group is often unrelated, but the group still continues to be managed in a top-down fashion. As such, the strategy-structure relationship becomes misaligned. Kim et al. insist that Korean business groups' problems lie not so much in the unrelatedness of business portfolios as in the strategy-structure misfit. Unrelated diversified firms can sustain a corporate advantage if aligned with appropriate organizational systems. They note that related and unrelated diversification aim at different economic benefits, which impose different, often conflicting, organizational requirements on firms. There is no best formula for the strategy of diversified firms. There are multiple ways of creating value while pursuing a diversified business portfolio and each business group should design its own model of corporate strategy.

Ji-Hwan Lee and Costas Markides note that restructuring towards core businesses seems to have been the hallmark of corporate activity on the part of the Korean chaebol preparing for the new millennium. In this refocusing wave, the economic giants are being instructed to merge, close, and/or exchange affiliates that are not related with the core ones, relying largely on our common sense of industries and businesses.

However, a key question to ask is: "What is related and what is unrelated?" In a similar vein with previous research by Markides and Williamson (1994, 1996), the authors argue that SIC-based measures may lack the qualities necessary to recognize the similarities between industries because they do not distinguish non-strategic from strategic assets. At the heart of the matter is the fact that these measures cannot properly value those assets that underpin a firm's cost or differentiation advantage and are imperfectly substitutable, imperfectly tradable, and not easily duplicable. In addition, traditional measures also tend to fail to capture the dynamic competencies to improve, accumulate and create strategic assets.

In an empirical study, the authors collected data from an Internet-based survey as well as from secondary sources. Using a multivariate statistical technique of cluster analysis, they reclassify industries based on structural indicators of strategic assets in each industry. The results show which industry segments are related with each other and thus have greater potential for realizing the benefits of sharing resources, skills and knowledge (economies of scope). It also reveals what kinds of strategic assets and competencies are important for competitors in each industry cluster and, in turn, have implications on the business-level competitive strategy as well as corporate-level portfolio restructuring.

Ⅳ. Institutions and *Chaebol* Behavior

Economic institutions, incentive structures and *chaebol* behavior are the subjects discussed in the papers by Sung-Hee Jwa and In Woo Jun on the one hand and Dong-Won Sohn and Jin-Yeong Kim on the other. Jwa and Jun have empirically investigated the business diversification behavior of firms and the effects of economic institutions on economic growth through a cross-country analysis. From these analyses they have expected to derive several policy implications for the Korean economy with regards to chaebol diversification.

The cross-country analysis has confirmed that, in general, a secure property rights system encourages the formation of large firms with more diversification while increased market competition tends to discourage unrelated diversification, though the latter effect is a little weak. On the other hand, both turn out to be strong positive contributions to economic growth. Some aspects of corporate governance systems are seen to be important determinants of diversification and economic performance. The legal commercial system under the Roman law tradition tends to discourage diversification while the one derived from the common law tradition encourages more diversification. On the other hand, the common law system turns out to have a positive contribution on economic development, contrary to the Roman law system. It seems the case that strong shareholder rights do not have any discernable effects on diversification behavior but have very strong positive effect on economic growth.

Using the estimated coefficients of the regression model, they have projected the level of diversification for Korean firms. Although there are some differences depending on model specification, they have found that the actual level of diversification in Korean firms turns out to be lower than the projected level. However, the level of diversification of the *chaebol*, measured by counting the number of affiliates listed on the stock market and avoiding double counting where a chaebol has more than one affiliate operating in the given industry, seems to be rather high and is actually the highest among countries in our sample where diversification is measured as the degree of product line diversification.

In general, the empirical results may be interpreted to support the arguments that stress the importance of secure property rights, the reform of corporate governance structure and market competition, including market opening, in formulating chaebol policies to discipline their behavior, including diversification. Therefore, Jwa and Jun have drawn the policy implication that the government should focus on establishing the proper economic institutions and economic environment, not on interfering with chaebol diversification directly.

Dong-Won Sohn and Jin-Yeong Kim address the transformation of the Korean *chaebol*, a process that is placed at the center of Korean economic reforms. They assume that the Korean economy's future is highly dependent on the balance of two forces, one force being global convergence pressure and the other being past behavior that is intrinsically path-dependent and resistant to change. While the first force is driving the system to reform toward global convergence, the latter is a countervailing one. The co-existence of two forces implies difficulties in the transition of the Korean economic system and, accordingly, in *chaebol* reform.

Based on the institutionalist idea that *chaebol* reform has to be aligned with institutional changes, Sohn and Kim analyzed Korea's formal and informal economic institutions. Of the formal institutions, the financial and labor markets, government regulations and legal aspects were particularly emphasized, while informal institutions were investigated through the business system framework proposed by Whitley (1992). They found a high level of institutional complementarity and path dependence from the analysis, in other words, a low degree of absorptive capacity by Korean institutions for global convergence. Findings would suggest that it is appropriate to promote simultaneous change along economic institutions and *chaebol* behavior because both of them co-evolve.

The authors specifically examine two important areas for discussing the desirable direction of the *chaebol*: organizational restructuring and governance structure reform.

First, with respect to *chaebol* restructuring, they argue through a close look at the Korean institutional context that to adopt the core competency strategy by reversing diversification is not a good policy for the Korean *chaebol*, although it is good for firms in advanced institutional contexts. They also believe that a holding company structure would contribute to promoting transparency and accountability and to building weak network forms by eliminating cross-holdings and cross-guarantees among firms. More focus on related businesses and the elimination of unrelated ones are recommended, along with institutional evolution.

The authors also evaluated the *chaebol*-related reforms of the Korean government in order to obtain desirable policy directions with regard to corporate governance. The overall policy tone of the Korean government on corporate governance is interventionist and content-specific. They argue that among two predominant models of corporate governance, the American market-based and Japanese network-based models, the Japanese model seems to be more valid in the Korean context. They recommend some ways to make up for the shortcomings of the Japanese style of corporate governance.