

THE CHANGING ROLE OF CHAEBOL

Multi-Conglomerates in South Korea's National Economy

The chaebol (財閥, 재벌) multi-conglomerates were instrumental in the development of the South Korean economy and will continue to be a source of great economic strength in the future. However, a weak system of corporate governance has exacerbated past financial failures in South Korea and leaves the Korean economy at future risk. To ensure Korea's success in an increasingly globalized world the South Korean government should continue to streamline past reform and introduce new legislation to encourage a culture of better corporate governance among the chaebol conglomerates.

Charlotte Marguerite Powers

Georgetown University

Estimations about the future value of South Korea's massive multi-conglomerate corporations, commonly called the *chaebol* (財閥, 재벌), tend to be a function of the past roles they've played and failures they've caused in Korea's economy. In similar ways, South Korea's economic system under the *chaebol* has often been criticized as too corrupt or antiquated for the welfare of Korea's modern economy. Some *chaebol* executives have abused the influence of their positions, and financial and structural features unique to the *chaebol* have created or exacerbated repeated financial failures in Korea. Although useful during Korea's industrialization and economic development, many agree that now the *chaebol* are only a hindrance to national progress; speeches by South Korean President Lee Myung-bak have suggested to some that Korea's economic future relies on the prosperity of small and medium-sized firms, rather than the *chaebol*.¹ However, the importance of the *chaebol* for South Korea's future economy has been too quickly dismissed. Given trends of the international economic system, the *chaebol* will remain the heart of South Korea's economic prosperity for a long time to come, so long as the government encourages the continued development of good corporate structure.

This paper will argue that the development and protection of good corporate governance among the *chaebol* is necessary for South Korea's successful integration into the increasingly

globalized international economy. Past policies intended to encourage better corporate behavior have been piecemeal, with gaps and redundancies, and were enacted only as reactionary reform in specific instances of economic failure. Instead, reform should be part of an ongoing, cohesive effort to create self-governing norms of corporate behavior which encourage good business within and among firms. Such good corporate governance is essential for Korea's successful integration into the increasingly globalized world. Toward this end, the Korean government should focus specifically on improved implementation of policies meant to ensure managerial and financial transparency and the accountability of firms and individuals within the *chaebol*.

This paper will present this argument for better corporate governance and the importance of the *chaebol* in five parts: first, a historical review of Korea's industrialization and the origins of the *chaebol* to explain both the strengths and weaknesses that define the *chaebol* today as well as their central role in the Korean economy; second, a brief review of previous studies and theoretical work related to what defines corporate governance, and exploration of the specific benefits for Korea's development of good corporate governance; third, the 1997 Financial Crisis and the subsequent reforms passed by the Korean government; fourth, the effects of reforms in restructuring the *chaebol* and possible areas where further policies could be used to supplement

past reform will be discussed, as well as insights into the future of the Korean economy found through analyzing the 2008 global financial crisis; lastly, recommendations and my concluding arguments.

History of the chaebol and their role in Korea's economic development

Korea at the beginning of the 20th century was an agricultural nation that by choice engaged in little interaction with the nations beyond its borders, stifling the importation of technology and industry necessary for the development of a more modern economy. Following annexation of the Korean peninsula in 1910, the Japanese had to build for themselves all factories and machinery required to exploit the natural resources relatively abundant in Korea. Under the colonial rule of the Japanese, Koreans neither held ownership of Japanese firms nor were allowed to work in the high levels of management and so few had the opportunity learn about the technologically sophisticated methods and machines used by the Japanese. This changed following Japan's surrender after the end of World War II in 1945. Japan withdrew from Korea and Manchuria, leaving behind the factories and machinery it had built without any formal management or ownership. Although most of these industrial and infrastructure facilities were either located in the northern half of the peninsula or destroyed in the subsequent Korean War (1950-1953)², assets located in the south created opportunities for some South Korean businessmen to start up new companies. The first of the businesses that eventually developed into the *chaebol* had their beginnings after the Korean War through these assets left behind by the Japanese occupiers.

The next big step toward South Korea's industrialization followed the military coup that overthrew the First Republic. By the beginning of the 1960s, the Syngman Rhee (Yi Seung-man) administration, elected into office through the United Nations-moderated elections in 1948 and then able to return with the United States' support following the 1953 ceasefire³, had be-

come notoriously corrupt.⁴ President Syngman Rhee himself was accused of creating ethically questionable financial agreements with the businessmen and industrialists of the post-war period. The few economic plans he did pursue were intended to maintain the flow of more foreign aid into the Korean government and did little to bolster Korean economic development.⁵

The military-dominated government which installed itself after the coup in 1961 quickly announced an end to the corruption of the First Republic and its intention to use economic growth and development through industrialization to legitimize its authority.⁶ The following year saw the first of six sequential five-year plans passed by the Korean government to develop South Korea's industrial base, setting the stage for South Korea's economic prosperity.⁷ Underlying each of these five-year plans was a long-term course of economic development set in place by the government's economic planners.

The government planners made two decisions that greatly influenced future corporate and financial structure in Korea. First, the government decided it would choose which markets should be developed by Korean firms and allow entry to only a select number of firms. These firms were chosen from a relatively small group of companies cultivated by the government to be used as tools for Korea's state-run development. Financial incentives offered by the government, such as low-interest loans, tax breaks, and other benefits, made it easy to recruit businesses willing to cooperate.

The second significant economic decision made by the government's planners was to focus market development through export-oriented industrialization.⁸ Export-oriented industrialization is a method of industrialization that focuses on the production of goods in which a country has a comparative advantage. Rather than investing time and money to build up domestic demand for goods, Korean companies concentrated on exporting products to established markets abroad. As the South Korean government controlled firms' market entry through control of

investment capital in Korea, the exported products were all manufactured by various branches of the *chaebol* conglomerates. Korea's economy came to depend heavily on its export industries and, by extension, on the *chaebol*. This method of industrialization produced magnificent economic growth for South Korea, but export-oriented industrialization by nature also increased Korea's market vulnerability by creating a heavy reliance on the stability of international markets and external demand for goods. This sensitivity exacerbated the other economic problems of the 1997 Financial Crisis.

Although the social costs of Korea's path of industrialization were significant, Korea's economy successfully developed over the course of five short decades into the 14th-largest economy in the world today.⁹ External factors helped to facilitate Korea's economic rise, including normalization of relations with Japan, inflow of foreign aid and investment, and the fall of the Soviet Union, which created South Korean construction jobs in many new, formerly Soviet states.¹⁰ Close direction by South Korea's authoritarian government made it possible for Korea to quickly develop its economy over a few short decades, but government planners' use of export-oriented industrialization to fuel market development had significant effects on the resulting structure of Korean corporations.

Firms that received the government's preferential treatment were allowed exclusive entrance into Korea's emerging markets and accumulated enormous wealth and size. These corporations were left to themselves so long as they continued to expand, create jobs, and follow the government's course of industrialization. They developed with little actual business risk due to various financial safety-nets provided by the government and the state-run banks. Rather than worry about the profitability of business ventures, these firms instead eagerly sought entry into any market possible.¹¹ Firms diversified through a wide range of completely unrelated goods, spreading tentacles into many markets. For example, a ship-building firm might have a branch that

produces cosmetics, or a clothing producer could have a branch in pharmaceuticals. When a firm failed beyond what the government judged redeemable, its branches were forcibly divided and distributed among the other *chaebol*, eager to snap up these assets. In this manner the *chaebol* conglomerates grew so large that the top fifty *chaebol* had sales equivalent to almost 94% of the total national GDP by 1984.¹²

Besides diversification in unrelated markets, the *chaebol* structure was defined by centralization of ownership around a single founding family. Through either direct ownership of the *chaebol* and all its branches, ownership of a nucleus company which then owned various subsidiaries, or ownership by which control of one particular member company was granted control of the other companies through inter-locking cross-shareholding¹³, members of the firm's founding families were able to maintain their positions in ownership if not direct management at the heads of their respective corporations.¹⁴ Centralization of *chaebol* control within a relatively small, cohesive family facilitated the implementation of governmental economic direction; assuring the cooperation of a wide range of corporate managers would have been much more difficult.

A third defining outcome of South Korea's government-led economic development was the massive amount of debt accumulated by the *chaebol* to fund their investments. In 1961 the Korean government nationalized all banks, controlling interest rates and loan allocation. The state was able to maintain power over the supply of credit and, therefore, the increasingly large and indebted *chaebol*. During instances of financial failure the government could adjust the interest rate or otherwise manipulate the financial market to keep important companies from falling apart. Government-led industrialization had meant the *chaebol* had not developed according to predicted profitability of market entry, but rather to secure investment from the government. Through borrowing from Korean banks, which in turn controlled allocation of all foreign investment that flowed into Korea,

corporate debt-equity ratios rose to a staggering 348.4 by 1985, about three times greater than the ratios for similar firms in the United States and Taiwan.¹⁵ This ratio continued to grow until the 1997 Asian Financial Crisis forced the Korean *chaebol* to reform.

Corporate governance

Corporate governance is composed of the relationships and established norms of behavior between the various agents of a limited liability corporation. Such agents include managers, shareholders, employees, creditors, important customers and other relevant communities, who together determine the strategy of a company. Rules and behavioral standards that frame such interaction can be grouped together under the category of corporate governance.¹⁶

The core principle of good corporate governance can be generalized as encouragement toward establishing a healthy, competitive corporate sector, the prosperity of which forms a center of national economic growth.¹⁷ As defined by the Organization for Economic Cooperation, goals of good corporate governance fall into five groups: (1) protection of the rights of shareholders; (2) the equitable treatment of shareholders, including minority or foreign shareholders, which includes the ability to challenge decisions that violate their rights; (3) encouragement for shareholders to take an active role in corporate governance; (4) greater disclosure and transparency of all material matters regarding the firm; and (5) protection of this framework through monitoring by management boards, which are themselves held accountable to the company and its shareholders.¹⁸

Reflected in the Organization for Economic Co-operation and Development's (OECD) guidelines is the current popular conception of corporate governance that places primary importance on protecting shareholders' ability to direct firm behavior. Shareholders are the legal owners of a company, and their interests align with the prosperity of the firm, as firm profitability means larger received benefits. Shareholder interests no

matter how diverse must "not only be assured, but also harmonized. [...] One organization is likely to create more wealth, for itself and for the whole of society, by an ethical strategy, and this will gain the corporation an integrity reputation."¹⁹ A reputation of integrity is important as trust reduces certain transaction costs between firms; one feels relatively assured of both adequate compensation and a stable partner in future cooperation.

Transparency and accountability are the other two aspects that are key to good corporate governance. Weak governance manifests in financial and managerial information opacity²⁰ which may benefit firms in the short run by protecting businesses from external competition. In the long run, however, this opacity creates a moral hazard that undermines the health and stability of a firm. Shielded from accountability to monitoring individuals and agencies, individual and minority interests can usurp majority interests and the welfare of the firm as a whole. Informational transparency can occur only when no agent can stand as an obstacle to the flow of information between all the agents within a given system.

Managerial boards should be maintained separately from ownership of the actual company in order to maintain the transparency and accountability which protects the interests of shareholders within corporate structures. These boards must be impartial toward the different investors of a company as they provide an important service in monitoring the performance of a firm and interpreting shareholder demands to direct its future actions. By keeping a few outsiders on the board, individual managers can serve as whistleblowers to keep the firm in line.

Good corporate governance is useful in cultivating mutually beneficial relationships among firms and individuals within firms. The imperative for coordinated corporate cooperation through a thoroughly developed system of corporate governance becomes stronger as globalization raises structural interdependence between firms.²¹ Globalization creates the need for new political and social structures to normalize

behavior, which encourages cooperative efforts between countries and individuals and further creates the need for economic structures to do the same between businesses. Through pursuing greater development of corporate governance within the world market, the significance of comparative institutional advantages is enhanced for all firms.²²

The 1997 financial crises

Korea experienced similar economic troubles in 1972, 1980 and the late 1980s, before the Asian Financial Crisis of 1997. In each of these instances, deterioration of firm profitability, over-investment, and worsening financial structures were exacerbated by the internal weaknesses of Korea's economic structure and external economic shocks, resulting in a Korean economic slowdown.²³ In response, the Korean government passed policies to superficially patch immediate issues without any cohesive plan of reforming the underlying structures responsible. Heavy-handed measures, such as adjusting monetary policy to reschedule outstanding loans and manipulating interest rates to artificially encourage investment and reduce debt, ultimately deepened the structural weaknesses which had led to the crises, and helped pave the way for yet another in 1997.

The first overt signs of trouble in Korea became evident in 1996. The current account deficit had grown from 2% of GDP in 1995 to 5%, and the rate of growth for exports had slowed from 31% to 15%.²⁴ This sudden slowdown was symptomatic of a much larger crisis felt across East Asian nations, which would eventually destabilize Korea's economy.

In 1997 and 1998, South Korea was drawn into international events that negatively impacted its export markets. Due to the larger East Asian crisis, the Japanese *yen* (JP¥) declined significantly in value, causing relative appreciation of the South Korean *won* (KR₩) and giving Japan a competitive edge. Recessions in Japan and Europe caused demand to shrink for Korean exports, and prices dropped for many of the goods

South Korea exported, including ships, automobiles and computer chips.²⁵

The 1997 crisis continued to balloon as shrinking exports revealed the financial instability of the *chaebol*. Since their beginnings, the *chaebol* had financed their development by borrowing large amounts of money then used to fund risky business ventures to increasing market shares; by 1997, the average debt-equity ratio for manufacturing was estimated, conservatively, at an absurd 458%.²⁶ The sudden market squeeze in 1997 led to a raised interest rate, which put further pressure on the heavily indebted *chaebol*.

The deterioration of profits exacerbated by internal economic weaknesses and the external shocks that formed the 1997 Financial Crisis in Korea is reminiscent of the economic failures of 1972, 1980, and the late 1980s. During these previous crises, the Korean government had enough autonomous financial influence to fix the immediate causes of economic failure without much difficulty and had not yet undertaken any sort of comprehensive structural revision. By 1997, important social, political, and economic changes in South Korea had made systemic reforms more difficult for the government.

In the decade or so leading up to the 1997 crisis, there had been great strides in Korea's democratization as well as financial liberalization. This greatly diminished the aspects of authoritarianism which had allowed the Korean government to deal with previous economic failure through forceful corporate restructuring and market manipulation. The movement for democratization in South Korea began in the 1980s, as by this time Korea's economic prosperity had led to the creation of a middle class in Korean society.²⁷ Over the next two decades, the movement for democratization became stronger, and by the 1990s saw real progress despite instances of brutal governmental repression. With the 1992 presidential election of Kim Young-sam, South Korean governance was returned into the hands of civilians, an important moment in Korea's democratization.

Financial liberalization came partially in re-

sponse to pressure following the 1980 market failure. Confronted with economic difficulties arising from financial structural problems, the government tried to fix some of the structural problems within Korea's financial system. The General Banking Act in 1982, along with the launch of a new five-year economic plan in the early 1980s, eased direct government controls over banking practices, and permissible banking activities were expanded.²⁸

The 1992 election and 1982 General Banking Act represent larger trends within Korean society and the waning grasp of economic governmental power. However, within the economy no new method of market discipline existed to replace close government direction. Strong market regulation and supervision of the financial and corporate systems had not had the chance to develop, leaving the *chaebol* swamped with debt they had no way of paying back.

South Korea's banking sector found itself burdened with non-performing loans. The *chaebol* debt from funding aggressive expansions could be neither paid nor supported by the banks; many businesses suffered major failures, either losing subsidiary branches or going bankrupt altogether. The International Monetary Fund quickly provided debt relief at the request of the Korean government,²⁹ but this financial bailout could mitigate only some of the economic fallout; eleven of the *chaebol* conglomerates were allowed to collapse in 1997, among them being Kia and Hanbo Steel.³⁰ Ten other *chaebol* from among South Korea's fifty largest were at risk of bankruptcy. Korean stock values dropped to almost nothing as investors began to withdraw their money, scaring away more investors.³¹

Public backlash against the incumbent government overseeing the economic failures led to administrative changes: Kim Dae-jung of the Millennium Democratic Party won the 1998 Presidential election, making Kim the first non-conservative head of the South Korean government since the Korean War.³² He was a staunch opposition leader during the previous authoritarian, conservative administrations, and his

inauguration marked Korea's very first peaceful and democratic power transfer from a ruling to an opposition party.³³ Under Kim, a number of important reforms were enacted to fix the accumulated imbalances of Korea's economic structures responsible for the 1997 crisis. Structural issues centered mainly around the financial and corporate sectors³⁴, so subsequent reform focused specifically on these two areas. The *chaebol* in particular received much of the blame for the 1997 crisis and thus received much scrutiny from reform-minded politicians.

Reform policies enacted under Kim's administration focused on five goals: (1) increase managerial transparency; (2) pressure corporations to focus on core businesses and divest themselves of unrelated enterprises; (3) improve financial health; (4) end loan guarantees among affiliates; and (5) increase accountability of *chaebol* leaders for their performances. Three more policy goals were added in 1999: (1) prevent industrial capital from dominating finance, (2) discourage circular investment between *chaebol* affiliates, and (3) prohibit nepotistic transfer of management or ownership to family heirs.³⁵ This "5+3 rule" of policy goals was based on IMF guidelines given to Korean politicians in charge of reformation.³⁶ The prescribed structural changes reflected the two long-term political objectives of the post-crisis period: moving the Korean economy toward a more liberal, market-driven economy and strengthening financial sector resilience to market fluctuations. Policy implementation followed a moving-target approach, namely policies were changed to respond immediately to problematic structural issues.³⁷

Implicit in these reforms was the effort to create a new form of corporate governance that was less reliant on direct government regulation. In February 1998, the Korean government mandated appointment of outside directors, members of a corporation's board of directors who are neither employees nor hold operational responsibilities, for listed companies. This increased accountability of majority shareholders and managers in directing the *chaebol*, as outside directors could

serve as whistle-blowers when inside managers attempted to abuse their influence for personal gain. Increased managerial transparency creates a less uncertain environment for investors and encourages investment.³⁸ In April 1998, legislators passed a law to reduce the minimum shareholding requirement for actions such as filing lawsuits, requesting the dismissal of directors, or calling for a meeting of general shareholders.³⁹ This strengthened minority shareholder rights and was an improvement from before 1997, when such power was held almost exclusively by founding families who had retained majority ownership of the *chaebol* conglomerates.

The government also began a program of restructuring the five largest *chaebol* groups. Due to development of unrelated market diversification, these corporations had acquired inefficient and unprofitable subsidiary branches that created a dead weight dragging down more successful subsidiaries. Rather than force the discarding of unprofitable branches, the “government asked *chaebol* to restructure their businesses” themselves.⁴⁰ To induce cooperation, government aid was conditional on voluntary reform. The five conglomerates were required to communicate their plans for reconstruction to their creditor institutions to make sure reorganization followed rational market principles. As another safeguard, all exchanges of businesses among the *chaebol* groups had to be agreed upon by other industry leaders.⁴¹ Samsung, the largest of the *chaebol*, gave up its automobiles branch⁴² to focus on its more established and profitable companies. Though this was ultimately a good business decision and Samsung’s entry into the automobile market had been warned against by other industry leaders from the beginning, the automobile branch had been a pet project of Chairman Lee Kun-hee and was a personally difficult decision to accept.⁴³

Post-1997 structural changes and the 2008 financial crisis

Korea’s corporations today look very different; *chaebol* debt-equity ratios are far lower than their late-1990 levels⁴⁴, Korea’s economy has

returned to phenomenal annual growth rates⁴⁵, and *chaebol* corporate development has changed to reflect sound business decisions. Before 1997, the void following the end of government-led economic development had created a gap between the growing democratization of Korean politics and struggling corporate liberalization. Over the past decade, however, a normalized system of interaction has begun to develop among the Korean *chaebol*.

The principles of transparency and accountability guided Korean financial and corporate reform following the 1997 financial crisis, and they remain essential to encourage good corporate governance in Korea. However, the reforms themselves have been too piecemeal and reactive to fix all the underlying corporate structural issues they were intended to correct. Also, implementation of reform meant to encourage development of good governing corporate structure has been too weak. “The establishment of a sounder corporate behavior requires not only improving the overall corporate governance and restructuring frameworks but also diligently maintaining the current rules or introducing new direct prohibitions and interventions.”⁴⁶ The pre-1997 aspects of corporate structure that reform has failed to fix still prevent good corporate governance. Further reform toward transparency and improved implementation of existing policies is necessary to better protect shareholders’ rights and foster good management.

Toward transparency, more needs to be done to defend the rights and influence of smaller shareholders. Decreasing the minimum percentage of shares required to vote in 1998 was a good start but only the first step. The Korean government must tighten regulations to prevent circular shareholding within conglomerates, as regulations passed after 1997 have been too lax and poorly enforced.⁴⁷ Exemptions based on “business needs, industry characteristics and government initiatives, including [...] attracting FDI, economic cooperation with North Korea and promoting industries identified as ‘growth engines’”⁴⁸ has resulted in only half of the *chaebol*

shareholding which would otherwise fall under government regulation being held accountable.

Circular shareholding describes the ambiguous and complex web of ownership when different companies buy stock from each other. Founding families have used circular shareholding to obscure the true range of their control by owning a small amount of stock outright through which they hold many shares legally owned by their companies. Managerial structure becomes opaque, leaving an opportunity for abuse by the shareholder who effectually holds control. Circular shareholding also undermines the rights of smaller shareholders by indirectly increasing the influence of controlling shareholders. Stocks might be given to affiliates without requiring cash outlays or other payment, artificially reducing relative voting shares and infringing on the rights of minority shareholders.⁴⁹

Additionally, circular shareholding makes it difficult to hold abusers responsible by removing them from positions of authority within corporations. The reforms of the late 1990s have done little to limit founding families' control through cross-shareholdings of *chaebol* affiliates; this undermines good corporate governance as it compromises both accountability of agents and the transparency of corporation management.⁵⁰ In the scandal leading to the resignation of former Samsung chairman Lee Kun-hee, the chairman was accused of creating a slush fund through bribed prosecutors and other government officials. Although Lee Kun-hee did resign from his position as chairman, there are reasons to doubt any sort of change in his ability to exercise control within Samsung. As said by Ahn Young-hoe, chief investment officer at Seoul-based fund manager KTB Asset Management, through tangled cross-shareholdings of affiliates "Lee Kun-hee will remain as a major shareholder and his family will wield influence in one way or another".⁵¹

Poor regulation enforcement has been another problem blocking the success of the 1998 and 1999 reforms. For example, after the government mandated that corporate boards include a

percentage of outside directors, some firms appointed much higher numbers of directors from outside their companies than policymakers had intended. This is problematic because rather than being just monitors of good corporate governance, outside directors gain more influence in managerial decisions than is best for the company. This precludes the initial purpose of these members as minority whistle-blowers.⁵²

These issues stand in the way of strong, healthy corporate governance in Korea, which is important for South Korea's ability to meet the economic challenges of increasing globalization. Globalization in terms of economics describes the process of closer integration of world financial, product, and labor markets.⁵³ In the past half-century, the pace of globalization increased due to technological and social developments facilitating greater communication and exchange. Good corporate governance guarantees the foundation for corporate success and integrity⁵⁴ and is thus critical for reaping the benefits of globalization. "Increased global competition makes continued corporate governance reform necessary"⁵⁵ as good corporate governance will be able to maximize the relative competitiveness of Korea's corporate sector.

By virtue of their size and capital reserves, the *chaebol* will be Korea's key asset as globalization brings international firms into constant contact with one another. Although small and medium-sized firms are important for the national economy's internal stability⁵⁶, their growth and success will not necessarily compete with the *chaebol*.⁵⁷ "In the globalized economy size matters"⁵⁸, and the *chaebol* conglomerates enjoy the distinction of being among the largest in the world. Where small firms would have difficulty funding the research and development necessary to produce globally competitive goods, the *chaebol* have ready access to the capital and manpower required to constantly develop new and more efficient ways of manufacturing goods to export. Besides being able to organize the large investment necessary for foreign market entry, *chaebol* are also large enough to absorb potential market

entry failure; smaller firms might just collapse. As globalization creates increasingly competitive markets and greater interdependency between countries, the importance of the *chaebol* for Korea's economy will grow. As in the 2008 global financial crisis, the *chaebol* have proven themselves able to globalize and take advantage of foreign market openings.

The 2008 financial crisis and "its impact on global economic confidence and growth prospects have highlighted the great relevance of corporate governance, and its key contribution to stability".⁵⁹ More specifically, it has illustrated the ways in which South Korea might benefit if it does pursue better corporate governance through better enforcement and protection of those transparency-inducing mechanisms in place. "While discussing the implications of the [2008] American financial crisis, President Lee Myung-bak [...] said that in normal circumstances, it was difficult to catch up with advanced countries, but this kind of crisis provides an opportunity to move up a step in economic rankings".⁶⁰ So long as good governance allows the *chaebol* to adapt according to market fluctuations, economic downturns can create opportunities rather than just highlight institutional flaws. For example, economic downturns in 2008 can be used boost Korea's intra-regional trade as the *won* drops in relative value.

External economic fluctuations can create openings in foreign markets, which can be exploited by Korean firms, leading to greater diversity in the products and destinations for Korean trade.⁶¹ Hyundai's performance in the United States automobile market is an example of a financial crisis helping Korean relative competitiveness. Hyundai entered the US market more than two decades ago and has done a much better job weathering the recent financial crisis than American car manufacturers.⁶² The failure of the US auto industry in 2008 created an unprecedented opportunity for Hyundai to increase its market share. General Motors and other major US car companies posted billions of dollars in losses, declared bankruptcy and required govern-

ment bailouts to keep from liquidation in 2009. Meanwhile, Hyundai, as well as Kia, was one of the few car manufacturers that made a profit. For 2010, Korean automakers are both expanding goals and aiming for greater market shares as they introduce more new vehicles.⁶³

If South Korea intends to embrace the trends of globalization and seize the benefits offered by greater integration into world markets, corporations must extend Korean products into other countries. They must also permit foreign firms, in turn, to compete within the Korean market, either as rivals or partners. Closer interaction between businesses will lead to further corporate structural changes as mergers and acquisitions (M&A) become more common. "Korea in general has been hostile to mergers and acquisitions [...] and corporate restructuring"⁶⁴, but such an attitude will undermine efforts to build up better corporate governance. According to Kang Sung-doo, the president and CEO of Golden Bridge Investment & Securities in Seoul, restructuring corporations through M&As helps maintain the competitiveness of firms when management becomes corrupt and ineffective and undermines the shareholders' assets.⁶⁵ As such, leaving Korean firms open to M&As protects good corporate governance, though it does change some governing agents. According to Lee Won-il, serving CEO of Allianz Global Investors Korea since 2006, Korea's maturing market will be driven by M&As "over the next decade as more businesses resort to acquiring competitors and promising companies in other sectors to create synergy effects with existing units and emerge as a winner in an increasingly saturated marketplace."⁶⁶

If this is true, Korea's continued economic liberalization and good corporate governance among the *chaebol* are of imminent importance.

Conclusion

South Korea's brisk economic development through government-directed industrialization of the 1960s, 1970s, and early 1980s created an environment where firms could compete with-

out worrying about their ventures' profitability. Success in this distorted market meant expansion into unrelated markets, fueled by debt which, if left unpaid, still did not necessarily signal failure. Under this business model, the corporate structures that lead to the disastrous 1997 Korean financial crisis were allowed to perpetuate until the Korean economy could no longer support them.

The structural reforms following the 1997 crisis have benefited the Korean economy as a whole and paved the way for the development of good corporate governance. Although the current body of corporate law in Korea has helped the creation of better governance by creating mechanisms to encourage managerial objectivity, as well as both expand and protect the rights of non-controlling shareholders, still more needs to be changed in order to guarantee Korea's successful integration into the globalized market. Past reforms have not been able to completely solve issues of corporate opacity because they lack a clear method of moving from policy goals into actual policy. This has rendered ineffective the policies designed to increase shareholder influence and reduce the control of founding families to the shares they hold outright. Such failures create problems of moral hazard, such as the creation of personal slush funds with company money.

The term *chaebol* should no longer be associated with Korea's past economic crises, yet because of continued scandals and the failure to pass effective policy, lingering structural issues undermine public opinion and corporate competitiveness. The government should pursue unified policies to supplement the post-1997 reforms. On their own, loopholes in these reforms debilitate protection of minority shareholders and management objectivity necessary for good corporate governance. As the political and economic systems upon which these reforms are based evolve, the government should continually

streamline regulation to minimize compliance costs.⁶⁷

This new policy should include stricter regulations on circular shareholding. Circular shareholding lowers transparency of the corporate system and weakens non-controlling shareholder rights. This opacity creates moral hazard as indirectly powerful shareholders can manipulate companies for personal gain at the cost of other shareholders and the public. Even when individuals are caught breaking the law, like ex-Samsung chairman Lee Kun-hee, circular shareholding makes it virtually impossible to remove corrupt agents from corporate control.

Another part of future policy should be encouragement of greater cooperation between Korean *chaebol* and other international firms. Lowering some of Korea's protectionist barriers would incentivize *chaebol* to seek partnerships with foreign firms interested in entering the Korean market.⁶⁸ By creating bonds based on mutual efficiency and profitability, the *chaebol* will avoid outright rivalry with new firms, should the latter decide to enter on their own, and increased competition will only enhance the efficiency of the Korean market.

Good corporate governance guarantees the foundation for corporate success and integrity which is critical for reaping the benefits of globalization. In his inaugural speech, President Lee Myung-bak described the *chaebol* as the "source of [South Korean] national wealth and the prime creator of jobs"⁶⁹ since their first inception under the military authoritarian government of the 1960s and 1970s to the present day. By pursuing cohesive, unified policies which protect the basic principles of good corporate governance, the *chaebol* will be able to continue carrying Korea's economy into the 21st century, ushering in prosperity even under the burden of growing globalization.



ENDNOTES

- 1 Van Jackson, *Goodbye chaebol, hello small business*, The Asian Times Online, January 5, 2008, <<http://www.atimes.com/atimes/Korea/JA05Dg01.html>> (accessed 2009-11-13).
- 2 Richard R. Nelson (ed.), *National Innovation Systems: A Comparative Analysis* (Oxford University Press, 1993), p. 358.
- 3 Diane E. David, *Discipline and Development Middle Classes and Prosperity in East Asia and Latin America* (New York, NY: Cambridge University Press, 2004), p. 73.
- 4 *Ibid.*, p. 73.
- 5 Jasper Kim, *Crisis and Change: South Korea in a Post-1997 New Era* (Seoul: Ehwa Womans University Press, 2005), p. 16.
- 6 Kae H. Chung, Hak Chong Lee, and Ku Hyun Jung, *Korean Management: Global Strategy and Cultural Transformation* (Berlin: Walter de Gruyter, 1997) p. 9.
- 7 Jasper Kim, p. 17.
- 8 *Ibid.*
- 9 Ja-young Yoon, *Korea Stays 14th in GDP Table*, The Korea Times, May 14, 2009, <http://www.koreatimes.co.kr/www/news/biz/biz_view.asp?newsIdx=44911&categoryCode=123> (accessed 2009-12-14).
- 10 Chung, Lee, and Jung, p. 9.
- 11 *Ibid.*, p. 65.
- 12 Karl J. Fields, *Enterprise and the State in Korea and Taiwan* (Cornell University Press, 1995), p. 35.
- 13 Chung, Lee, and Jung, p. 59.
- 14 Fields, p. 41.
- 15 *Ibid.*, p. 108.
- 16 Organization for Economic Co-operation and Development, *Corporate Governance in Asia: a Comparative Perspective* (2004), p. 3.
- 17 *Ibid.*, p. 47.
- 18 Stephen S. Cohen and Gavin Boyd, *Corporate Governance and Globalization* (Edward Elgar Publishing, 2000), p. 65.
- 19 A. Naciri (ed.), *Corporate Governance around the World* (Abingdon, Scotland: Routledge, 2008), p. 246.
- 20 *Ibid.*, p. 345.
- 21 *Ibid.*, p. 352.
- 22 *Ibid.*, p. 350.
- 23 Paul H. Elwood and Jeremy B. Albertus (eds.), *Korea: Economic, Political and Social Issues* (New York: Nova Science, 2008), p. 37.
- 24 Irma Adelman and Song Byung Nak, *The Korean financial crisis of 1997-98*, CUDARE Working Paper Series, University of California at Berkeley, Department of Agricultural and Resource Economics and Policy, no. 874 (2009), <<http://econpapers.repec.org/RePEc:are:cudare:874>> (accessed 2009-12-05), p. 1.
- 25 *Ibid.*, p. 1.
- 26 Byung S. Min, *Changing Pattern of Corporate Governance and Financing in the Korean "Chaebols"*, Economic Papers, Economic Society of Australia, September 1, 2007, <http://goiath.ecnext.com/coms2/gi_0199-6997306/Changing-pattern-of-corporate-governance.html> (accessed 2009-12-01).
- 27 Jasper Kim, p. 103.
- 28 Jonathan Hao, William Curt Hunter, and Won Keun Yang, *Deregulation and efficiency: the case of private Korean banks*, Journal of Economics and Business, vol. 53, nos. 2-3 (2001), pp. 237-254, <<http://ideas.repec.org/a/eeel/jebusi/v53y2001i2-3p237-254.html>> (accessed 2009-12-05).
- 29 International Monetary Fund, *IMF Stand-By Arrangement Summary of the Economic Program*, December 5, 1997, <<https://www.imf.org/external/np/oth/korea.htm>>.
- 30 Keun S. Lee, *The Korean Crisis and the IMF Bailout*, (Crisis in Asia: Analysis and Perspectives Seminar, Merrill Lynch Center for the Study of International Financial Services and Markets, February 27, 1998), <http://docs.google.com/viewer?a=v&q=cache:MTqYIYTPvi0J:www.hofstra.edu/pdf/biz_MLC_Lee3.pdf+imf+bailout+korea&hl=en&gl=us&pid=bl&scrid=ADGEESgUeOOx0YUwa5rwN95RWFYEbwFhqMU7ORpu1NYj_RkBFi5Ou5BSSkZ9oH81rOpa3NMxL_9KSIPk_O8dX-5DE4gwg9y9se1EtoanLGLdqJAcNyG92Bgvlp5gRr3pKDJe5P8HYh&sig=AHIEtbT26Rdqa8bL-5v9I7hRQzRDEt13Zw> (accessed 2009-12-02).
- 31 Adelman and Nak, p. 1.
- 32 Jasper Kim, p. 103.
- 33 Elwood and Albertus, p. 178.
- 34 *Ibid.*, p. 31.
- 35 Isao Yanagimachi, *Chaebol Reform and Corporate Governance in Korea*, Policy and Governance Working Paper Series, Keio University of Japan, Graduate School of Media and Governance, no. 18 (2004), <<http://74.125.93.132/search?q=cache:QvZMEP9kIhMJ:coe21-policy.sfc.keio.ac.jp/ja/wp/WP18.pdf+chaebol+1997+reform&cd=1&hl=en&ct=clnk&gl=us>> (accessed 2009-12-12).
- 36 Elwood and Albertus, p. 65.
- 37 *Ibid.*, p. 31.
- 38 Jasper Kim, p. 60.
- 39 *Ibid.*, p. 60.
- 40 M. Chung, personal interview, December 3, 2009.
- 41 Jasper Kim, p. 65.
- 42 Evelyn Iritani, *Korean Conglomerates to Detail Reforms; Asia: Samsung may drop plans to build an office tower; it and other firms are expected to refocus their businesses. Reports to the government are due this week*. Los Angeles Times, January 19, 1998, Business Section: 1-2, <<http://pqasb.pqarchiver.com/latimes/access/25504371.html?dids=25504371:25504371&FMT=ABS&FMTS=ABS:FT&type=current&date=Jan+19%2C+1998&author=EVELYN+IRITANI&pub=Los+Angeles+Times&desc=MONDAY+BUSINESS%3B+S.+Korean+Conglomerates+to+Detail+Reforms%3B+Asia%3A+Samsung+may+drop+plans+to+build+an+office+tower%3B+it+and+other+firms+are+expected+to+refocus+their+businesses.+Reports+to+the+government+are+due+this+week.&pqal=google>> (accessed 2009-12-12).
- 43 Peter Beck, telephone interview, November 24, 2009.
- 44 Organization for Economic Cooperation and Development, *Country statistical profiles, 2009: Korea*, OECD Stat Extracts. <<http://stats.oecd.org/viewhtml.aspx?queryname=18160>> (accessed 2009-12-04).
- 45 *Ibid.*
- 46 Stijn Claessens, *Structural Reform: Progress in Corporate Governance*, in: *Korea's Economy 2008: a Publication of the Korea Economic Institute and the Korea Institute for International Economic Policy*, 24 (2009), pp. 45-53.
- 47 Organization of Economic Cooperation and Development, *OECD Economic Surveys: Korea 2007* (Paris: OECD Publishing, 2007), p. 158.
- 48 *Ibid.*

- 49 *Ibid.*
- 50 *Ibid.*
- 51 Ihlwan Moon, *Scandal-Plagued Samsung Chairman Quits*, Business Week, April 22, 2008, <http://www.businessweek.com/globalbiz/content/apr2008/gb20080422_646584.htm?campaign_id=rss_topStories> (accessed 2009-11-12).
- 52 Claessens, pp. 45-53.
- 53 Angel Gurria, *Managing globalisation and the role of the OECD* (Korean University Business School, Seoul, South Korea, Sept. 20, 2006) <http://www.oecd.org/document/30/0,3343,en_33873108_33873555_37478942_1_1_1_1,00.html> (accessed 2009-12-02).
- 54 Angel Gurria, *Opening remarks by Angel Gurria, OECD Secretary-General* (ICGN annual conference, Seoul, South Korea, Jun. 19, 2008) <http://www.oecd.org/document/57/0,3343,en_33873108_33873555_40875513_1_1_1_1,00.html> (accessed 2009-12-02).
- 55 Claessens, pp. 45-53.
- 56 Jackson.
- 57 Beck, telephone interview.
- 58 Chang, personal interview.
- 59 Gurria, *Managing globalisation and the role of the OECD*.
- 60 Sandip Kumar Mishra, *Korea and the global financial crisis*, <http://www.korea.net/news/news/NewsView.asp?serial_no=20081209006&part=115&SearchIDay=>>.
- 61 Mishra.
- 62 Hyundai, *A Look Back – Hyundai Enters the US Market*, <<http://www.hmmausa.com/company.aspx?id=262>>.
- 63 South Korea carmakers seek expanded US market, Yahoo! Singapore News, December 4, 2009, <<http://sg.news.yahoo.com/afp/20091204/tbs-us-autos-skorea-company-0a37ea7.html>> (accessed 2009-12-06).
- 64 Ja-young Yoon, *Corporate Restructuring Purges Capital Market*, The Korea Times, July 15, 2009, <http://www.koreatimes.co.kr/www/news/biz/2009/11/258_48485.html> (accessed 2009-11-10).
- 65 *Ibid.*
- 66 Hyo-sik Lee, *M&A to Power Korea's Future Growth: Transparent Corporate Governance Key to Business Success*, The Korea Times, August 6, 2009, <http://www.koreatimes.co.kr/www/news/biz/2009/11/258_49745.html> (accessed 2009-11-19).
- 67 Organization for Economic Co-operation and Development, p. 49.
- 68 Thomas P. Kim, *The Second Opening of Korea: US–South Korea Free Trade Agreement*, Korea Policy Institute, June 14, 2007, <<http://www.kpolicy.org/documents/policy/070614thomaskimsecondopening.html>> (accessed 2009-12-14).
- 69 Lee Myung-bak, *President Lee Myung-bak's Inaugural Address: Together We Shall Open, A Road to Advancement*, Office of the President, February 25, 2008, <http://www.korea.net/News/News/NewsView.asp?serial_no=20080225037> (accessed 2009-11-19).

CHARLOTTE MARGUERITE POWERS

Charlotte Marguerite Powers is a senior at Georgetown University graduating in May of 2010 as a Political Economy major with an Asian Studies Certificate. A prominent academic focus of Powers' is the increasing challenge economic globalization presents to pre-existing social institutions and how policy can counter it. Her interest in this phenomenon has led her to research the influence *chaebol* conglomerates have had in the shaping of modern South Korea.