

기업정책 2001-02

# Market-Led Corporate Restructuring in a State-Led Economy: A Problem of Transition

March 2001

Wonhyuk Lim

Research Fellow

Korea Development Institute

Paper prepared for *Korea's Economy 2001*, published by the Korea Economic Institute of America ([www.keia.org/Korea'sEconomy-Lister.pdf](http://www.keia.org/Korea'sEconomy-Lister.pdf))

## 1. Introduction: Corporate Restructuring in a Transition Economy

The economic crisis of 1997 marked a watershed in the evolution of the South Korean economy, as it put into doubt the viability of the old system based on the public management of private risks. Although Korea's government-business risk partnership had contributed to rapid capital accumulation and impressive economic growth, the crisis made it clear that the old system, fraught with the risks of moral hazard and outright corruption, could not be sustained in a new economic environment characterized by liberalization and democratization.<sup>1</sup> The crisis also revealed the inadequacy of the existing institutional infrastructure that had failed to impose discipline on the corporate sector and had, in effect, impeded the orderly exit of nonviable firms. No effective market-oriented alternative had emerged to replace the state-led approach to corporate restructuring, the dominant feature of the industrial rationalization programs during the authoritarian era (1961 to 1987).

As a result, in order to facilitate corporate restructuring in the post-crisis period, the institutional infrastructure formed around the government-business risk partnership had to be restructured as well. In fact, in post-crisis South Korea, the term "corporate restructuring" is often used interchangeably with "structural reform in the corporate sector," referring to wide-ranging institutional changes in corporate governance, corporate finance, market competition, and bankruptcy procedures. Although this semantic confusion is unfortunate, it highlights a crucial fact: South Korean<sup>2</sup> firms have to take on the challenge of changing their business structure while the institutions governing corporate restructuring are themselves being changed. They do not have the luxury of a well-established institutional infrastructure that has been tested through time.

Moreover, this problem of transition is not just one of changing a few laws. The role of the government in the economy is also being changed in a fundamental yet potentially problematic way. As the crisis of 1997 is widely blamed on the old government-business risk partnership, the

---

<sup>1</sup> For a historical analysis of Korea's government-business risk partnership, see Wonhyuk Lim, *The Origin and Evolution of the Korean Economic System* (Seoul: Korea Development Institute, 2000).

<sup>2</sup> Henceforth in this article, Korea and Korean should be understood to refer to South Korea (the Republic of Korea)

government no longer has the mandate to “lead” the economy. At the same time, with the *de facto* nationalization of many banks and other financial institutions in the wake of the crisis, the government ironically has more resources under its control than before. If the government delays the privatization of these financial institutions and yet refuses to impose discipline on financially distressed firms, little progress will likely be made in corporate restructuring. Worse, if the government bails out firms based on non-economic considerations, the reform program itself will lose its credibility.

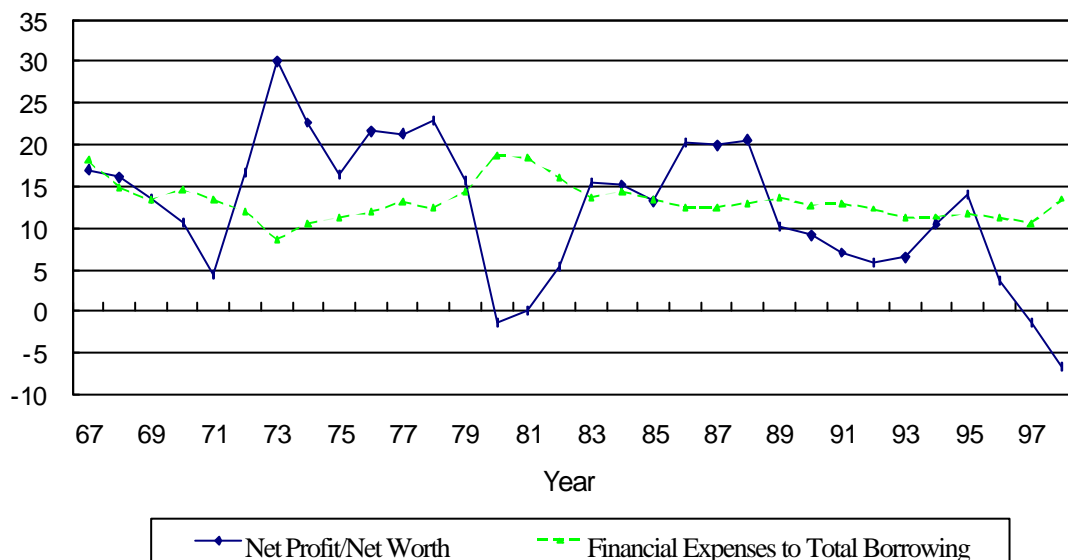
As the controlling shareholder of the nationalized financial institutions, the government should ideally abide by economic principles and take proactive steps to sort out nonviable firms and quickly implement reforms designed to improve the operation of the market. Unless pushed by the government to sort out nonviable firms according to economic principles, the managers of the nationalized financial institutions have little incentive to get tough with large distressed firms. This combination of government activism *and* adherence to economic principles should be accompanied by a well-designed exit program for the government. The market-oriented reform package should include comprehensive measures designed to facilitate mergers and acquisitions (M&As) and to effect the privatization of financial institutions. Simultaneously, it should ensure the separation of banking and commerce. Of course, any appearance of government activism in the post-crisis period might invite charges of revived interventionism, but there seems to be no better alternative in the transition period as the Korean economy moves from a state-led system to a market-oriented one. This observation seems particularly relevant as Korea pushes ahead with the second round of structural reform amid charges of “excessive government intervention.”

## **2. The 1997 Crisis in Perspective**

On the surface, the 1997 crisis may appear to have been a liquidity crisis due to Korea’s low foreign reserves, heavy reliance on short-term foreign debt, and loss of confidence by foreign investors. In fact, as of December 1997, Korea’s short-term foreign debt was more than seven times the size of its foreign reserves. When the foreign creditors suddenly decided to pull the plug, Korea

had little choice but to go to the International Monetary Fund (IMF) for relief. However, it must be recalled that a series of bankruptcies by family-controlled conglomerates (*chaebol*) in 1997 had led to the loss of investor confidence and triggered the international bank run on Korea, not the other way around. If Korea had secured a sufficient level of reserves, it might have been able to avoid a currency crisis, but it still would have had to face a serious problem with nonperforming loans.

Figure 1. Profitability and Opportunity Cost of Capital for Korean Manufacturing Firms



Source: Bank of Korea, *Financial Statements Analysis*, various issues.

What triggered the series of massive bankruptcies in 1997? Figure 1 illustrates the basic nature of the problem with the Korean corporate sector. Since the mid-1960s, Korean firms have aggressively pursued expansion through debt financing, even when carrying out massive investment projects with a long gestation period. Such debt financing might have been justified, had Korean firms recorded a sufficiently high profit to cover interest expenses, but their rate of return on net worth has been below the opportunity cost of capital for much of the past two decades. Operating on a thin margin of error, Korean firms were extremely vulnerable to adverse macroeconomic shocks, and could not help but fail in massive numbers when the government did not come to their rescue, as in 1997.<sup>3</sup>

<sup>3</sup> For a collection of perspectives on the economic crisis of 1997, see Inseok Shin (ed.), *The Korean Crisis: Before and After* (Seoul: Korea Development Institute, 2000).

Although the Korean economy supposedly moved in a more market-oriented direction in the aftermath of the Heavy and Chemical Industry Drive (1973 to 1979), the changes were notable for their partial character. Starting in the 1980s, investment and capital accumulation increasingly depended on the initiative of the private sector, but institutional reforms required to improve financial resource allocation and corporate governance were not carried out. Government control of the banks continued despite nominal privatization, while the *chaebol* expanded their influence in the financial sector through the ownership of non-bank financial institutions (NBFIs) such as merchant banks, security companies, and insurance companies. By offering a much higher rate of return than the banks, the *chaebol*-owned NBFIs were able to attract a great deal of financial resources. Investors apparently believed that their investments at NBFIs were protected by the government—just like bank deposits. As a result, the market share of NBFIs for deposits increased from 29.1 percent in 1980 to 72.2 percent in 1995. Partial financial liberalization, combined with the legacy of implicit government insurance, led to greatly increased overall risks in the financial system.

Problems in the corporate governance of private firms were no less serious than the increased risks of inefficient investment due to the control of the NBFIs by the *chaebol*. On average, the ownership share of the founder's family for the top 30 groups declined from 17.2 percent in 1983 to 8.5 percent in 1997. As is well known in corporate governance literature, this increasing separation of ownership and control aggravates the agency problem. When ownership and control are separated, it is important to devise an incentive and monitoring scheme to make sure that the managers work in the interests of the shareholders rather than their own. In pre-crisis Korea, however, the gap between ownership and control widened without concomitant changes in incentives and monitoring.

Before the economic crisis of 1997, the effectiveness of the state-led monitoring and incentive system was greatly reduced, but few financial institutions or institutional investors were allowed to step in to serve this function. This transition gap in financial resource allocation and corporate governance formed the background of the crisis. Consequently, it should have been the focus of the reform agenda in the post-crisis period.

### **3. From Initial Reform Drive to Bankruptcy Suspension**

In January 1998, five principles of corporate restructuring were announced. Designed to address what was then widely regarded as “the *chaebol* problem,” these principles included: (1) enhancing transparency in corporate management; (2) eliminating cross debt guarantees; (3) improving financial structures; (4) improving corporate governance; and (5) streamlining business activities. Principles (1) and (4) were designed to address the problem of “arbitrary imperial rule” by the *chaebol* bosses, most of whom at the time were not even legally registered as chief executives yet exercised complete control over their firms. Principles (2), (3), and (5) appeared to be intended to break up the “convoy-style” conglomerate structure of the *chaebol* groups. Their rationale, however, was not entirely clear since the structure of a firm is, by and large, determined by market conditions. In other words, the government addressed the symptoms rather than the real cause of the problem — distortions in the financial and product markets. Moreover, the operational policy measure associated with principle (3) insisted on reducing the average debt-equity ratio of each *chaebol* group to 200 percent by the end of 1999 instead of simply encouraging the practice of charging a higher risk premium for more vulnerable firms. The government’s focus on the debt-equity ratio was also misplaced, for what is more important for the viability of a firm is its profitability relative to its financial expenses—as measured by the interest coverage ratio, for instance. As most firms met the government-mandated debt-equity ratio by issuing a massive number of new stocks without substantially reducing the debt level (i.e., by raising the denominator without changing the numerator), it became clear that the government had misframed the issue.

A problem of transition has also dogged corporate restructuring in post-crisis Korea. Concerned with charges of revived interventionism as well as possible litigation a few years down the line, the bureaucrats minimized their involvement. Instead, they opted for “bank-led corporate restructuring”—an oxymoron in view of the fact that most of the banks in Korea were accustomed to following government directions. As they had done prior to the crisis, the banks looked to the government for guidance on how to deal with large distressed firms. More often than not, “bank-led corporate restructuring” turned into “bankruptcy suspension,” as the banks rescheduled just enough debt to keep the firms going, and the government, the controlling shareholder of the nationalized

banks, provided little guidance. This troubling pattern was established in the early phase of the post-crisis period. The bankruptcy of Samsung Motor in 1998 and Daewoo Group in 1999 indicated that the chaebol groups were no longer fail-proof, but a number of the so-called “workout” firms were allowed to prolong their lives in a state of limbo. Although the government did introduce some policy measures (e.g., forward-looking criteria (FLC) in asset classification) to encourage the banks to take decisive actions against financially distressed firms, the pace of reform left something to be desired. As the controlling shareholder of the nationalized banks, the government should have taken more proactive measures to facilitate corporate restructuring while quickly implementing reforms designed to improve the operation of the market.

Although institutional reforms in corporate governance and financial resource allocation were certainly less than adequate to address fundamental problems, the Korean economy did a remarkable turnaround in economic performance. Aided by favorable external conditions, particularly an information technology (IT) boom in the United States, Korea’s GDP growth rate soared from a negative 6.7 percent in 1998 to a positive 10.7 percent in 1999. Critics warning of the remaining problems in the economy were dismissed as Cassandras—as if a little more than a year of reform had managed to remove all structural problems. The government and the *chaebol* continued to control the lion’s share of financial institutions. Although President Kim Dae-jung mentioned the need for separation of banking and commerce in his 15 August 1999 speech, few concrete actions were taken. Nor was there any meaningful program to facilitate the privatization of the banks. In the area of corporate governance reform, the mandated increase in the number of outside directors did little to change established practices at the *chaebol*.

Combined with a V-shaped recovery in 1999, the advent of the National Assembly elections in April 2000 further slowed the momentum for fundamental reform. Fearing the political consequences of increased unemployment, the government became increasingly reluctant to close nonviable firms and financial institutions. The opposition party, for its part, made an election issue of national debt, as if it could have cleaned up the massive nonperforming loans problem without issuing government bonds. It also accused the government of selling distressed Korean firms at fire-sale prices to foreigners, as though it knew the appropriate price for these firms. The

politicization of the economic issues during the election campaign had an adverse effect on corporate restructuring.

#### **4. The Road to the Second Round of Corporate Restructuring**

Although the politicians on both sides in effect tried to impede corporate restructuring, market forces were unrelenting. The massive bankruptcy of the Daewoo Group in 1999 had greatly increased nonperforming loans in the financial system, but due to political considerations in an election year, the government was slow to make a request for additional public funds. Burdened with nonperforming loans, financial institutions began to reduce credit supply. Moreover, the Saehan Group's abrupt filing for workout proceedings in May 2000 revived concerns about the reliability of credit ratings, as the company had been rated investment-grade all along. It once again highlighted the need to enhance the transparency of corporate management and accounting. The Saehan case also raised uncertainty about the viability of medium-sized *chaebol* and resulted in a flight to quality in the financial market. The credit crunch was aggravated by the continued existence of nonviable workout firms, as they sucked in precious resources at the expense of their competitors. Increasingly, these competitors began to complain that "the living dead were driving out the living," and expressions like "zombie companies" or "vampire companies" began to gain currency. Both the bureaucrats and the nationalized banks, however, had incentives to stick to forbearance policy rather than adopt structural measures such as privatization to make bank-led corporate restructuring more credible.

Although the politicians and bureaucrats might have hoped that weak firms under "bankruptcy suspension" could grow out of their problems, the economic boom did not last long. In particular, rising crude oil prices and falling semiconductor prices starting in the third quarter of 2000 dramatically worsened the terms of trade.

In addition to the credit crunch and deteriorating external conditions, the continuing troubles

at the so-called MH division of the Hyundai Group raised the specter of another massive corporate bankruptcy.<sup>4</sup> In addition, the feudalistic infighting for corporate control at Hyundai illustrated that Korean firms had changed very little with regard to corporate governance. The confluence of these events eroded investor confidence and shook Korea's financial markets by the fourth quarter of 2000.

In order to calm the markets, the government had to show that it was serious about corporate restructuring. In October, the government summoned the banks to evaluate the credit risks of financially distressed firms meeting the following descriptions: (1) firms classified as "precautionary" or worse according to the FLC asset classification; (2) firms whose interest coverage ratio was less than 1.0 for the past three consecutive years; or (3) firms whose potential default risks were being closely monitored by the banks. On 3 November 2000, the banks announced the results of their credit evaluations for 287 such firms. Of these, 136 were classified as "normal"; 28 were deemed to "have temporary liquidity problems"; 69 were judged to "have structural liquidity problems but are viable" through such measures as a debt-equity swap; 52 were categorized as "nonviable"; and Ssangyong Cement Industrial and Hyundai Engineering & Construction, two of the largest firms on the list, were classified as "other." Although this announcement did mark the end of bankruptcy suspension for the "nonviable" firms, the result also raised some questions about the strictness of the evaluation criteria used. In response to criticism, the government promised to encourage the orderly exit of nonviable firms on a regular basis rather than hold an annual or biennial screening event. The government also emphasized that institutional reforms designed to facilitate the exit of nonviable firms, improve corporate governance, and enhance transparency and accountability would be the cornerstone of the second round of corporate restructuring.

## 5. Remaining Challenges

---

<sup>4</sup> The Hyundai Group is in the process of being split up into three major sub-groups controlled by three of honorary chairman Chung Ju-young's sons. The automobile division, controlled by Mong-koo (MK), met the legal requirement for disaffiliation from the rest of the Hyundai group in 2000, and the heavy industry and shipbuilding division, controlled by Mong-joon (MJ), is planning to separate by the end of 2001. The MH division of the Hyundai Group refers to the sub-group of Hyundai affiliates controlled by honorary chairman Chung's fifth son, Mong-hun (MH). The MH division includes Hyundai Corporation, Hyundai Electronics Industries, Hyundai Engineering & Construction, Hyundai Merchant Marine, Hyundai Securities, and a number of smaller affiliates. The vulnerable financial structure of Hyundai Electronics Industries and Hyundai

In the last week of December 2000, the Korea Development Bank (KDB) announced a plan to help the corporate sector by rolling over a significant portion of debt that firms would likely have trouble refinancing in 2001. Dubbed the KDB's "quick underwriting program," it is helping to roll over 80 percent of the maturing corporate bonds that the issuing firms have trouble refinancing. As of February 2001, five Hyundai affiliates and two firms in the overcrowded cement industry have been selected for the program. Taken together, the seven firms have more than 8.2 trillion *won* (about 6.56 billion dollars) of corporate bonds coming due in 2001.

The KDB's quick underwriting program is symbolic of the problem of transition that Korea faces in the post-crisis period. The bunching of maturities and the absence of a well-developed market for junk bonds may provide some justification for the program, but the government should not just stop at providing relief to the problem companies. After all, not every Korean firm has trouble having its corporate bonds rolled over. The KDB should charge a premium to reflect the risks associated the problem bonds and should demand a rigorous program of corporate restructuring, just as the IMF attaches conditionalities to its bailout loans. If the firm in question has more than a simple liquidity problem, it should not be selected for the program. The government may temporarily assume the role of underdeveloped or missing markets, but it should abide by economic principles and make serious efforts to let these markets develop.

In particular, such market-creating efforts should focus on improving the autonomy of the financial sector and introducing private remedies to address the problem of corporate governance. As long as Korea's structural problems remain in the areas of corporate governance and financial resource allocation, the investment efficiency of the economy is likely to suffer, making the economy extremely vulnerable to external shocks. Korea needs to push ahead with the second round of structural reform with sights firmly set on the fundamental problems that have plagued the economy for a long time.

---

Engineering & Construction, in particular, has been a cause for concern since the first half of 2000.

---

# OVERVIEW

## SOUTH KOREA: ACCOMPLISHMENTS AND CHALLENGES

by James M. Lister

### Introduction

South Korea's development trajectory has been truly spectacular, but for many years it relied heavily on close cooperation between government and business to help identify sectors into which resources should be channeled. This incestuous relationship was characterized by a compliant financial sector which lacked the incentive to apply standard analytical techniques to competing demands for credit. It worked well enough as long as Korea's relatively low level of development made almost any investment profitable.

By the mid-1990s, this premise no longer held true, and the degree of unprofitable, excess investment had risen to alarming levels. However, the mechanisms to identify and limit this adverse trend were weak. Financial statements lacked meaning, and audits were perfunctory. Large conglomerates (*chaebol*) were run as personal fiefdoms of founding families, with compliant boards of directors and little need to listen to minority shareholders. Banks often extended credit on the basis of personal relationships with borrowers or at government direction, accepting collateral of questionable liquidation value. They had little incentive to shut off the credit spigot and recognize losses on exposure to overextended, unprofitable firms.

The financial crisis that struck in late 1997 unmasked this unhealthy situation. While giving rise to a brief but painful recession, it also provided an opportunity and an incentive to initiate long overdue reforms. The crisis itself was largely a massive, but temporary, external liquidity problem, the resolution of which required introduction of a more flexible exchange rate regime and restoration of the confidence of foreign investors. Thanks to temporary financial support from a record IMF assistance package and the restructuring of much of the short-term external debt, the country was able to deal successfully with this problem and

recovered very quickly from the recession. However, progress on the more fundamental structural reforms has been slower going.

This article briefly reviews macroeconomic performance and policies since the crisis and the near term outlook, then outlines the status of structural reforms and offers some thoughts about challenges to policymakers in these areas. Other articles in this volume consider some of these issues in greater detail.

### Macroeconomic Performance and Policies

#### *Crisis and Recovery*

South Korea's recovery from a sharp but short recession following the 1997 external financial crisis has been dramatic. Following a 6.7 percent decline in 1998, real GDP grew 10.7 percent in 1999 and will probably register around 9 percent in 2000, although there is a greater downside than upside risk to that estimate, given the relative weakness of emerging data for the final months.

The immediate response to the financial crisis did not require significant constraint of domestic demand, as it was essentially a crisis of capital flows and reserves rather than of the current account. However, it did require policies to regain confidence of foreign investors, including a significant, though temporary, increase in interest rates. Moreover, many firms experienced a liquidity squeeze as financial institutions sought to bring their capital ratios up to the standards mandated by the authorities. (The crisis had exposed the precarious financial health of many *chaebol* and the failure of the financial institutions to reflect the true values of their loan portfolios.) Consequently, domestic demand plummeted, magnified by a drop in confidence engendered by the shock of the unexpected external financial crisis.

In 1998, net exports provided the classical cushion to a large part of the contraction of domestic demand. In volume terms, imports shrank and exports rose dramatically, helped by the depreciation of the *won*, although the impact was more striking on the import side. Nevertheless, production declined and unemployment soared.

Domestic demand recovered impressively in 1999 and during the first part of 2000. Household consumption initially led the way, as previous high levels of personal savings could be drawn on. Investment also recovered, initially via restocking and then via facilities and equipment. External demand remained strong, although diminishing, and semiconductor prices were rising early in the recovery phase. Industrial production has recovered. Unemployment remains slightly above pre-crisis levels, but that is neither surprising nor necessarily undesirable given the restructuring which is underway. Price increases have been well below the rates recorded in pre-crisis years, taking into account the impact of the *won*'s depreciation. Compared to most countries requiring IMF assistance, South Korea has done extremely well on the macroeconomic front.

The recovery of South Korea's external position has been even more spectacular. Led by the turnaround of the trade balance from a small deficit in 1997 to a huge surplus in 1998 and continuing, albeit diminishing, surpluses in 1999 and 2000, the current account has been in substantial surplus. Large inflows of equity investment, particularly portfolio investment, have permitted a substantial reduction of debt to official and private creditors, even as the authorities built up usable foreign exchange reserves which had been virtually exhausted at the time of the crisis. The lengthening of the average maturity of external liabilities, coupled with the rise of foreign currency reserves to nearly \$100 billion, indicate that the country's vulnerability to another external liquidity crisis is very low.

### ***Outlook***

Real growth decelerated during 2000, as the economy completed its recovery from the 1998 recession. Business and consumer confidence levels fell in late 2000, as the authorities encountered difficulties in implementing their restructuring agenda. Recent data have prompted some lowering of expected growth in the

fourth quarter and for the year. Most observers expect the slowdown to continue through the first half of 2001, with a recovery in the latter part of the year. However, the source of such a recovery is difficult to discern with confidence. Net exports are not seen as providing a significant boost, although they are not expected to deteriorate significantly either, so the trade and current account balances should remain marginally positive, particularly as oil prices have receded from their highs reached earlier in 2000.

### ***Fiscal and Monetary Policies***

Fiscal and monetary policies prior to the 1997 crisis were not demonstrably inappropriate. It was necessary for external purposes to raise interest rates for a period following the crisis, but there has been little need to adjust the overall stance of policies to affect the level of economic activity. The problems in that area have been largely a matter of dealing with a perceived credit crunch, which the authorities have sought to combat by various schemes designed to encourage the flow of funds to non-prime borrowers. (See the section on Structural Policies below.) This has been a difficult task, closely related to reform of the corporate sector. Although the strategy—essentially one of treating the symptoms rather than the underlying cause—is understandable, it can be questioned. Admittedly, the need to improve their balance sheets has made financial institutions more conservative, potential bond purchasers are wary in light of past problems, and there is a bunching of maturities of corporate bonds in 2001. However, administrative measures risk reducing the incentive for markets to develop longer-run solutions.

In the closing weeks of 2000 and in the beginning of the new year, signs of a sharper than expected slowing of the economic recovery have prompted a tilting of policies toward stimulus. Public spending in 2001 will be front loaded, and tax incentives for certain investments are being increased.

On the external side, South Korea properly sought to rebuild reserves while removing administrative obstacles to capital flows. The current account surplus, initially very large and continuing, albeit on a declining trend, has made this objective relatively easy. Restrictions on non-residents' acquisition of Korean assets, which had been biased against more stable inflows such as direct and portfolio investment, were

significantly liberalized, and there have been substantial inflows through these channels as the economy recovered. While the exchange rate has been notionally floating since the 1997 crisis, the policy of “leaning against the wind,” in the face of a wind which was almost constantly blowing inward, perforce resulted in a steady accumulation of reserves and enabled early repayment of much of the official borrowing undertaken in response to the crisis.

### ***Challenges***

Having dealt effectively with the acute balance of payments and reserves crisis and the ensuing recession, South Korea now faces the more complex tasks of: (1) steering a course between underemployment of resources and the possibility of overheating the economy; and (2) of ensuring that its exchange rate policy does not by default lead to undervaluation of the *won* and an excessive accumulation of reserves. Fortunately, its relatively strong fiscal position and external liquidity provide considerable flexibility to both fiscal and monetary policy.

Policies will need to take into account their impact on restructuring but not be hostage to it. Restructuring is more difficult if interest rates rise, but it is nevertheless essential to anticipate and act promptly to raise rates if needed to head off inflationary pressures. The government will need to resist any temptation to exert undue influence on the Bank of Korea’s monetary policy decisions or to promote credit flows through measures that are inconsistent with market principles.

While maintaining the external competitiveness of the economy, the authorities should not come to depend on a permanent current account surplus. At least implicitly, government policy still equates surpluses and increases of reserves with success.

### **Structural Policies**

Even before the 1997 crisis, South Korea’s leaders were generally aware of many of the problems that existed in economy, but mobilization of the political will and popular support needed to undertake reforms was greatly facilitated by the need to deal with the crisis. The incoming administration of President Kim Dae-jung had no difficulty, in conjunction with the IMF

adjustment program and emergency World Bank loans, in articulating sensible reforms to the financial and corporate sectors, the labor market, and state-owned enterprises. The authorities readily adopted principles that had become basic tenets in most of the industrialized world, even though these principles clashed in many respects with traditional ways of doing business in South Korea.

However, reflecting these principles in effective legislative and regulatory changes and making them operative have met with mixed success. The authorities benefitted from the trend in recent years toward formulation and adoption of international codes and other standards of good or best practices, although it must be conceded that substantial differences still exist among even the most economically advanced countries on various aspects of business practices for different industries. On the other hand, these concepts were unfamiliar to much of the private sector and their public sector overseers, and policies were in some cases superficial. Another problem has been the reluctance of the government to take decisive actions in the face of the lack of a clear mandate for the governing party in the National Assembly, labor opposition to closure of large firms, and criticism that nationalized assets were being sold at “fire sale” prices.

### ***The Financial Sector***

A healthy financial sector is key to an economy’s performance in several respects. From a macroeconomic perspective, it is the primary channel through which the central bank’s monetary policy is transmitted to the real economy, and weak financial institutions are less likely to perform this function effectively than strong ones. Also, weak or poorly managed institutions are more likely to be the object of sudden withdrawals of funds placed by foreign institutions, which can trigger a balance of payments/reserves crisis. From a microeconomic perspective, a weak financial sector—typically burdened by a large portfolio of non-performing loans—constrains long-run growth potential, as it is less able to channel capital efficiently to those end users which are most likely to make productive use of it and to deny it to those which cannot.

The 1997 financial crisis emphatically demonstrated these considerations and the need to rationalize weak institutions. The incoming administration moved rap-

idly to close or absorb institutions which clearly lacked the capital base needed to conduct business and to force marginal institutions to achieve minimum capital standards or lose their independent status. For this purpose it obtained appropriations of 64 trillion *won* initially (about \$53 billion) and mobilized some additional public funds. It amended laws and instituted new supervisory structures and processes aimed at achieving international standards of transparency, accounting, and management. In short, the authorities articulated clear objectives and obtained the authority needed to achieve them over time.

Three years later, however, tangible achievements have fallen well short of intentions.

- Although a number of banks have reached international capital standards, and decisions on new credits are increasingly reflecting the “forward looking criteria” introduced under the Kim Dae-jung administration, the banking system remains fragile. Many institutions are still effectively owned by the government, which is struggling to consolidate weak banks under a financial holding company or to merge them with healthier institutions. It is difficult to ascertain the extent to which new loan procedures are being given more than lip service. In any event, much of the banks’ loan portfolios are tied up in credits to large *chaebol* which are being rolled over on a basis that is not entirely voluntary. Consequently, the scope to shift credit allocation to more deserving borrowers is limited. While the reduction of deposit insurance coverage creates greater incentive for banks to improve their performance, it could in the short run create liquidity problems at individual institutions.
- Non-bank financial institutions (NBFIs) underwent massive disintermediation in favor of banks, largely because of the loss of confidence in corporate bonds, which investment trust companies and mutual savings and finance companies in particular had acquired. As noted, the lack of liquidity in the corporate bond market has prompted the government to develop various measures to support it.

Recognizing the need to reinvigorate the reform process, the government in September 2000 detailed its plan for a second round of restructuring, seeking an additional 40 trillion *won* (about \$33 billion) from the

National Assembly to finance it. Financial sector measures focused on expediting the rationalization of weaker banks, aiming at consolidating those deemed nonviable under one or more financial holding companies (FHCs) after injection of public funds, and encouraging those capable of becoming independently viable to expedite their restructuring plans. Stronger banks are being encouraged to consolidate their operations and/or form financial service conglomerates under an FHC in order to achieve the economies of scale necessary to become internationally competitive.

Non-performing loans (NPLs) have decreased (according to reports through the third quarter of 2000), as a result of sales, write-offs and recoveries, particularly in the banking sector. However, NPLs may actually be considerably larger than stated, given the uncertain status of credits to corporations likely to undergo restructuring. The authorities have stated that they will not seek to increase the amount of public funds requested, but some analysts question whether banks will be able to write off or provision adequately against the volume of bad loans which is likely to emerge once the corporate sector is restructured unless further public funds are injected.

### *Corporate Restructuring*

In the wake of the 1997 crisis, it was apparent that the corporate sector, as epitomized by the *chaebol*, had lost sight of the fundamental principle that a firm must, over time, generate profits. The complexity of *chaebol* structures and the lack of meaningful accounting and corporate governance had enabled many firms to expand recklessly. Investment is the key to increasing productivity, but only if it is rational. Irrational investment is worse than no investment.

The government has set forth a number of principles to address immediate problems and to change the business practices which had created these problems. Some of these principles are reflected in legislation or regulation—*e.g.*, requiring *chaebol* to prepare consolidated financial statements (effective for 1999 statements) and to include a minimum number of outside directors on their boards. Others, however, can be implemented only through creditor banks (largely controlled by the government), requirements for listed companies, or jawboning.

Without doubt, considerable progress has been achieved. The downfall of Daewoo has clearly signaled that no firm is “too big to fail.” Other *chaebol* have reduced their excessive leverage and moved to concentrate on core competencies. Corporate transparency has improved. Looking forward, there are grounds for confidence that the corporate sector will avoid the unwise investments of the past.

However, the legacy of the past continues to be a significant burden, and many firms’ survival remains in doubt. Consequently, as part of the second round of financial restructuring announced in September, the government required the major banks to perform a sort of triage on nearly 300 large Korean companies. Over half were found to be viable or undergoing relatively minor cash flow problems; one quarter were found to have structural problems which could be resolved with additional financial support; and the remainder are to be sold, liquidated, or placed in receivership. The second category is, as in the medical equivalent of triage, the most difficult with respect to analysis and decision making. The relatively large size of this second category is emblematic of the criticism by many observers of the slow pace of restructuring. Despite a sharp upswing in overall economic activity, these firms have not been able to regain a sound footing in more than three years after the financial crisis.

In addition to direct loans from banks, many large companies have large amounts of bond issues approaching maturity. In December 2000, the government, through the Korea Development Bank (KDB), announced that it would underwrite the rollover of 80 percent of maturing bonds of selected companies, totaling around 25 trillion *won*, of which 20 percent would be acquired by creditor banks and 70 percent would be funded by issuance of collateralized bond obligations (CBOs). (Recent reports indicate that the government is broadening this effort by increasing self-imposed limits on existing credit guarantee programs.) The interest rate paid by the companies involved is to include a risk premium reflecting their individual credit ratings, as determined by the Korea Securities Dealers Association, plus a common premium of 260 basis points.

This plan has sparked further criticism, largely with respect to the fundamental issue of whether it might reduce the incentive for these companies to undertake

meaningful restructuring efforts and in some cases do no more than delay an inevitable demise. The government insists that the plan does not violate market principles and attributes these measures to the need to normalize the financial intermediary function. In other words, the government is attempting to counter a perceived liquidity crunch, wherein borrowers other than those with top credit ratings face the possibility that they cannot obtain or roll over existing loans at an interest rate representing a rational risk premium. The government has announced its intention over time to encourage a broadening and deepening of financial markets so that they are capable of performing the intermediation function on their own.

In principle, inclusion of an appropriate risk premium should temper concerns that the scheme will provide a *de facto* subsidy and serve only to extend the life of companies that are insolvent. However, determining the appropriate risk premium—which is a market concept—is *ipso facto* difficult when the problem is one of market failure.

### **Challenges**

The authorities have a sound set of policies to encourage restructuring of the financial and corporate sectors and a good message. If there is a problem at this “strategic” level, it is in the task of making sufficiently clear to the public that restructuring is essential, and indeed unavoidable, but cannot be achieved without short-term costs. There is also a need to continue to demonstrate the consistency of measures to deal with the perceived credit crunch, on the one hand, and the stated policy to allocate resources based on a free market mechanism on the other.

The more serious challenge is to move decisively beyond this strategic level and into implementation. Companies that have not shown themselves capable of achieving a sound footing should not be maintained on “life support” and continually given extensions of deadlines. Although the government cannot ignore the economic and social cost of plant closings and downsizings, just as other countries step in when the survival of important entities is at stake, it must strike the right balance between these considerations and the risk that it is only delaying the inevitable and increasing the ultimate cost of restructuring.

A related challenge is to evaluate and accurately reflect the potential impact of this restructuring on the financial institutions to which affected companies are indebted. The authorities must take into account the need to protect the financial system, and there could be a need for additional budget funds if needed to achieve that purpose. In that regard, it remains to be seen how effective bank staff are in applying the “forward looking criteria” mandated by supervisory authorities and in ascertaining the accuracy and reliability of the newly required consolidated financial statements of large conglomerates.

## Conclusions

Compared to many if not most other countries which have faced similar problems, Korea has done remarkably well and has taken the all-important initial steps on a difficult journey. It has so far avoided major macroeconomic policy errors and does not seem to be at risk of losing the confidence of foreign investors. Despite the slowdown in the United States and Korea’s other trading partners, and declining business and consumer confidence at home, Korea is likely, after relatively slow growth in the first half of 2001, to regain a solid growth path.

However, the jury is still out on Korea’s restructuring efforts. Hard decisions lie ahead. A failure to make these decisions on a timely basis could impair Korea’s ability to make full use of its impressive human resources and thus would reduce its growth potential. In the short run, a lack of progress could also delay a rebound in domestic growth and undermine Korea’s growing international reputation as a good place to do business.

*James Lister became the Vice President of the Korea Economic Institute of America in Washington, D.C. after a 33-year career with the U.S. Treasury Department.*

# SOUTH KOREA AFTER THE IMF-SUPPORTED PROGRAM

by Ajai Chopra

## Overview

South Korea's three-year standby arrangement with the IMF expired on 3 December 2000.<sup>1</sup> Looking back, a tremendous amount was accomplished during the IMF-supported program. First, macroeconomic fundamentals have improved, and vulnerability to a balance of payments crisis has been sharply reduced. The economy has recovered very rapidly from the deep recession in the immediate aftermath of the 1997 crisis; unemployment has fallen, inflation is low, exports have boomed, foreign direct investment and portfolio inflows have increased markedly, foreign reserves have risen to record levels, and, after supporting the recovery, fiscal policy has been firmly focused on consolidation. Second, wide ranging structural reforms have made Korea's economy more open, competitive, and market driven. Significant progress has been made in stabilizing the financial system, addressing corporate distress, strengthening the institutional framework for corporate governance and financial sector supervision, liberalizing capital markets and foreign investment, enhancing transparency, and creating an environment where market discipline plays an increasingly important role.

These are impressive achievements, and they surpass those in other crisis-affected economies. The IMF-supported program has thus been very successful, and its goals—namely, to restore confidence, stabilize financial markets, lay the foundation for a sustained recovery in the real economy, and lower the chances of future crises—have been met. Moreover, the reforms initiated over the last three years will continue to yield benefits for years to come, and, in many respects, the benefits will increase as practices and ways of doing business change.

However, the reforms are incomplete, and there are still important structural weaknesses. Indeed, despite

the impressive accomplishments, market sentiment about Korea deteriorated in the latter months of 2000. The decline in confidence is largely related to perceptions that corporate and financial sector restructuring has been slow. Thus, worries about the health of the corporate sector, a large portion of which is still saddled with weak cash flow and poor profitability, have intensified. Further, financial sector risk will remain high as long as the corporate sector remains weak. The uncertainty about domestic restructuring has been exacerbated by the simultaneous weakening in the external outlook: notably, higher oil prices, slower world growth, and lower equity prices.

Recognizing that slow progress on the structural front will increasingly exert a drag on the economy, the government has recently increased its efforts to provide new impetus to reform and restructuring. Under the *Second Round Restructuring Plan* announced by the government in late 2000, weak banks are being pressed to restructure and recapitalize, and more public funds have been allocated to assist this process. Creditors, in turn, are beginning to take a tougher attitude toward weak companies, forcing some important ones into court-supervised insolvency. These are positive steps, but many challenges still remain.

## The Near-Term Outlook

There is considerable uncertainty about the projections for 2001 related both to the domestic environment and restructuring efforts and to the weakening of the external environment. In the short run, a pickup in the pace and depth of restructuring will result in higher unemployment that could dampen confidence, but the risks associated with inaction are likely to be greater.

In the IMF staff's baseline scenario, growth in 2001 is projected to fall to about half the rate in 2000 (when

---

1. Henceforth, all references in this article to "Korea" are understood to apply to the Republic of Korea (South Korea).

growth was estimated to be 9 percent), and there are downside risks to this forecast. Domestic demand is projected to be weaker, with both consumer spending and equipment investment likely to remain subdued. With slower world growth, external demand is also expected to weaken and is not likely to be an engine of growth as it was for much of 2000. The current account, nevertheless, is projected to record a surplus of about \$7.5 billion (1½ percent of GDP) in 2001, albeit narrower than the \$10 to \$11 billion (2¼ percent of GDP) surplus estimated for 2000.

Wage and demand pressures on prices are likely to remain muted, as projected output is only modestly above potential in 2000 and 2001. Headline inflation, nevertheless, is projected to increase from 2½ percent in 2000 to about 3½ percent in 2001, largely because of the carryover effect of oil price hikes in 2000.

## The Remaining Agenda

Bold policies and a commitment to reform have led to the overhaul of many domestic institutions and have increased the market orientation of the economy. As a result, many of the weaknesses that contributed to the crisis in 1997 have been addressed. But much remains to be done to ensure that the gains endure and that the Korean economy is sufficiently sound and flexible to adapt and prosper as conditions change. Specifically, further progress in restructuring—principally the exit of nonviable firms and asset sales—is imperative to ensure that the remaining problems do not jeopardize what has already been achieved and adversely affect Korea's long-term capacity to grow. Although the economic situation has weakened over the last few months of 2000 and created new problems for policymakers, there is also considerable upside potential; tangible progress with restructuring, especially in some of the high profile cases, could set in motion a virtuous circle of improved confidence, higher economic growth, and support for further restructuring.

The basic framework for restructuring the corporate and financial sectors is in place, and, looking ahead, the key issue will be implementation and ensuring a stronger role for markets—especially creditors and investors—to drive the process. Indeed, although the government clearly has a critical role to play in monitoring and enforcement of regulations, Korea is a ma-

turing economy; it will now be important for the government to step back from intervening in the operation of markets and economic decision making, and instead to rely in the future on markets to impose discipline.

## Corporate Restructuring

Important strides have been made in addressing the corporate sector's problems. The top four industrial conglomerates (*chaebol*) have made progress in meeting pledges under their capital structure improvement plans, with equity issues, spin-offs, asset sales, and strategic alliances with foreign investors contributing to the improvement in debt-equity ratios. A creditor-led, out-of-court debt workout process was put in place to drive the restructuring of highly leveraged second-tier *chaebol* and other large corporations. A large number of companies are also restructuring under court-supervised reorganizations. In addition, the government signaled that no conglomerate is "too big to fail" when affiliates of the Daewoo group were forced to enter into workout programs with their creditors. Less distressed *chaebol*, acting voluntarily outside formal workout programs, have also made efforts to restructure. Finally, financial disclosure and corporate governance are improving.

Despite these accomplishments, a large number of companies are still in deep distress, and several are close to insolvency. Much of the corporate sector remains highly leveraged by international standards and continues to suffer from low profitability. Asset sales as a way of reducing debt have been somewhat limited, perhaps because of sellers' unwillingness to accept realistic valuations, and this problem has stalled progress in a number of workout and non-workout cases. Clearly, much more needs to be done. To strengthen corporate performance and boost investor confidence, the process of lowering firms' debt levels needs to be accelerated, and improvements in corporate financial structure will need to be buttressed by deeper operational restructuring and improved disclosure.

Devoting greater attention to strengthening the bottom line will require cost cutting, the sale of non-core assets, and strategic alliances. In some respects, the difficult part of corporate restructuring still lies ahead—nonviable firms need to be closed, and viable but distressed companies should be subject to rigorous work-

outs involving debt writedowns (as opposed to rescheduling). Indeed, the closure of nonviable companies may be a prerequisite for the growth of other companies, as these “zombie” companies are eroding the profit margins and crowding out credit to viable companies. With the improved social safety net, the economy should be strong enough to absorb the temporary dislocation that accompanies restructuring in the short run.

The recently announced list of nonviable companies is a step in the right direction, but this will now need to be translated into action, and banks will need to continue to scrutinize other weak companies. The focus of attention should also now shift towards greater reliance on court-supervised insolvency. In pending cases, including new court-supervised cases among the recent list of nonviable companies, reorganizations and liquidations should be implemented as quickly as possible. Further insolvency reform will therefore be essential. The government’s proposal on “pre-packaged” reorganizations is a critical step, and should be complemented by efforts to remove other impediments to more efficient and rapid resolutions.<sup>2</sup>

There has been little concrete progress in the highly visible case of the Daewoo affiliates that are in workout programs. Creditors need to resolve the fate of these affiliates quickly before more value is destroyed and additional working capital is provided to nonviable operations. Pushing Daewoo Motors into receivership was a courageous step. Other Daewoo affiliates should either be sold quickly or put into court-supervised reorganizations or bankruptcy, depending on the affiliates’ situations.

Finally, the campaign to discourage Korea’s largest *chaebol* from ill-advised and excessive investments financed by debt will require longer-term efforts. Success will require progress on a number of fronts—strict oversight by investors and creditors, enhanced risk management practices, elimination of anticompetitive practices, stronger and more efficient insolvency procedures, and improved corporate governance. In this connection, the government’s recently announced *Corporate Governance Improvement Plan*—which cov-

ers issues such as improving the cumulative voting system, a further strengthening of minority shareholder rights, qualifications of outside directors, and transactions with related parties—is welcome and should be implemented without delay.

## Financial Sector Restructuring

Major steps have been taken to stabilize and strengthen the financial system, facilitated by a large injection of public funds. Notable progress has been made in raising banks’ capital ratios, which in a number of cases now exceed the minimum standards recommended by the Bank for International Settlements. Accompanied by extensive business restructuring, over time this should contribute to a stronger bottom line. The numbers of staff and branches have been reduced, and important steps have been taken to improve risk management (although this is still in the early stages of an ongoing process), information technology, and human resource systems. Foreign management expertise has been introduced in a number of banks that have substantial foreign ownership, and also in some without it.

In the non-bank sector, most merchant banks have been closed, leaving just a few institutions, and restructuring of the insurance industry is underway. Reforms have also been initiated to put the investment trust sector on a sound footing in the longer run. The government has also taken important steps to improve supervisory oversight and to bring prudential regulations in line with best international practice. For example, tighter “forward-looking criteria” for loan classification and provisioning came into effect at the end of 1999; together with new accounting standards, this is beginning to result in a more aggressive view of asset quality. The January 2001 switch from blanket deposit insurance to partial insurance (set at 50 million won—about \$40,000—per depositor) is also spurring restructuring of the financial sector.

Although much has been done to stabilize the financial system, more needs to be done before the system’s soundness is firmly established. Deeper corporate

---

2. “Pre-packaged” reorganization refers to an out-of-court agreement reached between a debtor and a majority of its creditors and then submitted to the court for approval under the applicable reorganization laws. Approval of the agreement by the court then makes it binding on dissenting creditors.

restructuring will likely reveal additional impaired loans that banks will have to resolve, and a subset of banks remain weak. Indeed, the problems that remain in the financial sector are now largely the result of continuing weaknesses in the corporate sector. It is now up to the banks, under the supervision of the authorities, to take an even more aggressive attitude in accounting for asset quality. Only by doing so will banks convince markets that known credit losses have been met and that they are now making operating profits sufficient to meet new credit losses in the future. For balance sheet improvements to be sustained, banks will need to strengthen business practices, especially with regard to risk analysis and lending practices. In this connection, banks are already beginning to shift their focus from asset growth to profitability. In view of the substantial cuts in branches and staff that have already taken place, future improvement in profitability will need to come from improved portfolio efficiency, including better pricing of credit risk in order to boost interest margins.

A market driven corporate restructuring process will only be truly feasible if it is led by sound and privately owned banks. The privatization of Korea First Bank was a landmark step, and priority will need to be given to privatizing the other nationalized banks and divesting government minority stakes in other banks. The privatization process cannot be done rapidly, but it is important that a start be made as soon as the market allows; the costs involved in the government's continuing to own these banks for several years outweigh the benefits that might accrue by waiting in the hope that the share price might rise.

Turning to specific issues: first, an immediate priority is the rehabilitation of the six weak banks that have recently submitted restructuring plans. Second, financial sector consolidation is likely to occur naturally over time through market-driven mergers. The creation of financial conglomerates, however, should be pursued only after an adequate governance and regulatory infrastructure is in place; this will take time to create. And third, the authorities need to be vigilant about the credibility of the supervisory framework; it will be critical to resist pressures for forbearance and to ensure operational autonomy of the financial supervisory authorities. Most of the needed improvements in the regulatory framework, or what might be called the "hardware," have now largely been completed.

However, important steps remain to be completed in the "software" of the supervisory system. In particular, it will be important to move from a process that emphasizes formal compliance with regulations—which was the tradition of the predecessor organizations of the Financial Supervisory Service—to one that concerns itself mainly with assessing risk and promoting better risk management.

## Capital Market Development

Efforts are needed to develop a vibrant capital market to reduce reliance on bank debt as the main source of financing for investment. Experience elsewhere suggests that it will take time to develop a genuine long-term corporate bond market. The recent trend toward securitization in Korea is a positive development. Reform and restructuring of insurance companies, which should offer longer-term products invested in longer-term traded securities, would also contribute to capital market development. Pension reform, which is under consideration by the government, should also be designed with a view to fostering the growth of capital markets.

There are already indications that banks and capital markets (especially the bond market) are being more selective in the companies to which they provide financing and are not providing new financing to companies that are not creditworthy. Such discriminating behavior is appropriate and encourages restructuring. Liquidity pressure in the corporate bond market, however, has prompted the government to provide support, including a plan under which the state-owned Korea Development Bank underwrites the rollover of maturing bonds for subsequent sale in government-guaranteed collateralized bond obligations. Some government intervention may have been warranted in view of the large volume of corporate bonds reaching maturity, the decline of the investment trust sector, the risk aversion of the banks, and the strong likelihood of a negative impact on many viable companies.

Nevertheless, the government's increasing role in the corporate bond market raises concerns that will need to be addressed in the coming months. First, the authorities must ensure that intervention in the bond market does not slow corporate restructuring, including the exit of nonviable companies. Second, the use of gov-

ernment guarantees should not become so widespread that the role of the market in assessing and pricing risk is effectively replaced by the credit decisions of state-owned financial institutions. Furthermore, the government should publish details of the potential liabilities that it assumes with these guarantees in order to make clear the potential costs to the taxpayers. Third, new funding for troubled companies should be at penalty rates of interest that encourage continued use of the regular bond market. Fourth, it will be critical to avoid actions that imply that some corporate groups are “too big to fail,” thereby introducing moral hazard and undoing some of the progress of the last three years. Finally, participation by banks should be voluntary. Government pressure on the banks to participate is contrary to the direction of reforms in recent years.

A durable solution to the current liquidity pressures in the bond market will require efforts aimed at reducing leverage in the corporate sector, the exit of nonviable firms that have created negative externalities for healthy firms, and reform of the investment trust industry to create a genuine fund management business.

## The Future Role of the IMF in Korea

The close cooperation between the Korean authorities and people and the IMF over the last three years has been exemplary and in many respects serves as a model for other countries. Even with the end of the IMF-supported program in December 2000, the IMF will continue to have close relations with Korea. Regular consultations under Article IV of the IMF Articles of Agreement will continue to be held on an annual basis, as they are with virtually all member countries. Staff missions will also visit Korea between the annual consultation discussions to maintain a close policy dialogue, and Korea will be subject to the IMF's new policy on post-program monitoring.<sup>3</sup>

The Korean government has also asked the IMF to prepare Reports on the Observance of Standards and Codes (ROSC) covering fiscal, data, and financial sector issues, which will provide an additional opportunity for continued dialogue on needed reforms. The

fiscal transparency module of the ROSC has been completed and is available on the IMF's worldwide web site; the ROSC data module is expected to be completed by mid-2001; and the financial sector ROSC module will be completed in 2002.

The three-year standby arrangement with the IMF, approved on 4 December 1997, was for a total of \$21 billion (or 950 percent of Korea's IMF quota). Korea made ten drawings, totaling \$19½ billion, under the arrangement. The last drawing was made in May 1999. After that, Korea was eligible to make six further drawings, totaling \$1½ billion, but decided to forego these in view of the strengthening of its foreign reserve position. Of the amount drawn, about \$13½ billion was under the Supplemental Reserve Facility (SRF), which is designed to assist countries facing exceptional balance of payments problems created by large short-term financing needs. The strong reserve position allowed the Korean government to accelerate repayments under this facility, and by September 1999 the entire amount drawn under the SRF had been repaid nine months ahead of schedule. The government has announced that the remaining \$6 billion of outstanding IMF loans (about 275 percent of quota) will also be repaid in advance.

## Conclusions

The past three years have been among the most turbulent in Korea's recent economic history. During this period, Korea has not only witnessed severe financial turmoil in domestic financial and foreign exchange markets, but also a remarkably rapid stabilization and recovery from crisis conditions. As noted at the outset, the three-year IMF-supported program has been successful, and the objectives of the program have been met. The reforms initiated over the last three years will help restore Korea to the position of one of the most dynamic and vibrant economies in the world. The credit for Korea's successful turnaround belongs to the Korean people, who sacrificed and worked hard, and to Korea's political leadership, which claimed ownership of the program from the beginning and pushed forward with tough reforms.

---

3. Post-program monitoring involves members engaging in more frequent consultations with the Fund, with a particular focus on macroeconomic and structural policies that have a bearing on external viability.

Although there is still a long way to go to complete the restructuring and reform process, this is largely a reflection of the magnitude of the necessary changes and should not detract from the major achievements of the last three years. Restructuring needs to be seen as an ongoing process, and the challenge ahead will be to press ahead with this process. At the same time, it will be important for the government to continue with its prudent macroeconomic management to keep inflation in check and to maintain a stable environment for ongoing restructuring. In sum, the policies adopted by the government are working and have been instrumental in the impressive performance of the economy; their continuation is essential for ensuring high medium-term growth and reducing vulnerability to shifts in market sentiment and other shocks.

*Dr. Chopra is Assistant Director, Asia and Pacific Department, of the International Monetary Fund (IMF) in Washington, D.C. The opinions expressed in this paper are those of the author and do not necessarily reflect the views of national authorities or IMF Executive Directors.*

# POLICY DECISION MAKING IN RESTRUCTURING SOUTH KOREA'S ECONOMY

by Ahn Choong-yong

## Introduction

In pursuit of rapid economic development in South Korea<sup>1</sup> during the past four decades, government economic policy has been critical, playing major but different roles at various stages of development. Korea's development model has mostly been government-driven and outward oriented since the early 1960s, and it has successfully transformed Korea from a poverty-stricken agrarian society to a semi-advanced industrial economy. As Korea's economy has developed, the role of government has gradually changed from direct interventionism to indirect facilitator of market mechanisms. This shift has been realized through a series of liberalization efforts<sup>2</sup> in an increasingly globalizing world economy.

However, despite accelerated globalization and the information revolution occurring in the world in the 1990s, government policies have failed to achieve the economy's timely integration into the new international environment. The era of intense and borderless competition had begun, yet "protectionism" still lingered in the mind-set of many Koreans. In many respects, Korea remained passive in transforming its institutions and practices in accordance with international standards.

In the wake of the Asian financial crisis of 1997, however, Korea's once seemingly effective development model, which was based on expansion of industrial conglomerates (*chaebol*) through debt financing, proved to contain serious flaws which stymied competitiveness in the World Trade Organization (WTO) era. With its available foreign exchange reserves nearly exhausted in early November 1997, Korea had no

choice but to seek International Monetary Fund (IMF) financial assistance and to agree to IMF conditionality to fully restructure its economy. In compliance with the IMF agreements, Korea has been undertaking far-reaching structural reforms in four major areas: financial, corporate, public sector, and labor markets. The IMF mandates provided the Korean government with an opportunity to reform the economy forcefully and far more rapidly than previously envisioned.

This article seeks to describe both economic policy decision making and the role of the government over time, with special emphasis on recent restructuring of the inefficient Korean economy and implementation of reform policies to introduce global best practices. The role of government in economic decision making during the high-growth period prior to the economic crisis will be briefly reviewed. Then the article will describe how various reform measures have been formulated under the IMF mandates and how the government has played its role in the recent restructuring. The article concludes with a few remarks on policy implications.

## Economic Decision Making under the Government-Led Growth Model

*Table 1* lists the basic characteristics and policy shifts of Korea's government-led growth model chronologically. Korea's rapid rise of per capita income was accompanied by its own series of autonomous liberalization measures. However, occasional external pressures generated from the globalization process and recent IMF conditionality also had an impact.

---

1. Hereafter referred to simply as "Korea."

2. Liberalization in this article is defined as a removal of intervention and the shifting toward reliance on market forces to achieve development objectives. Liberalization is therefore a process of removing the types of intervention detrimental to growth.

Korea's government-led development regime began under President Park Chung-hee in the early 1960s by developing export promotion schemes for labor-intensive products. This deviated drastically from a brief period under an import substitution regime in the late 1950s. An outward orientation enabled Korean exporters to expose the domestic economy to international competition. Two tasks were the substitution of price signals for administrative controls and the adjustment of relative domestic prices so that they conformed to relative prices internationally. One of the first policy actions taken in the mid-1960s was to devalue the overvalued local currency and to double the interest rate in order to mobilize domestic savings.

Key mechanisms to encourage export promotion were: (a) automatic and unrestricted access to bank loans for exporters; and (b) automatic and tariff-free access to intermediate goods and raw materials for exports. Evidence suggests that an export-promotion regime is superior to a generalized import-substitution regime because it promotes the upgrading of human resources

and access to advanced production technology and managerial practices. An export-oriented economy can also create a more competitive market environment by bringing in "unlimited" competition from abroad.

While recognizing the robustness of the export-oriented regime during the Park Chung-hee era in the 1960s, a synergistic partnership between government and business was developed to implement export targeting and market expansion abroad. Such institutions as the monthly export promotion meeting, chaired by the President and attended by cabinet ministers and business leaders, and Export Day symbolized the government-led export promotion efforts. The Economic Planning Board (EPB), a cradle of elite bureaucrats under presidential blessing, played a pivotal role in pushing the export-led development machinery through a series of five-year development plans. The government slogan of "export-based nation building" and a strong "can do" spirit was enough to encourage export-driven growth.

**Table 1: Evolution of Liberalization and Major Economic Performance Indices in Korea**

Period	Main Policy Direction	Major Performance
1950s	<ul style="list-style-type: none"> <li>• Import substitution</li> <li>• Price stabilization</li> </ul>	<ul style="list-style-type: none"> <li>• Completion of "easy import substitution" of the three white industries (textiles, flour, &amp; sugar).</li> </ul>
1960s	<ul style="list-style-type: none"> <li>• Policy shift to export promotion and export liberalization.</li> <li>• Expanding social overhead capital.</li> </ul>	<ul style="list-style-type: none"> <li>• Export Volume: \$0.1 billion (1962) \$1 billion (1971)</li> <li>• GNP per capita: \$82 (1961) \$289 (1971)</li> <li>• Manufacturing /GNP : 17.0% (1966)</li> </ul>
1970s	<ul style="list-style-type: none"> <li>• Heavy and Chemical Industrialization</li> <li>• Administered credit allocation</li> <li>• Import substitution of parts and components</li> </ul>	<ul style="list-style-type: none"> <li>• Export volume: \$10 billion (1977)</li> <li>• GNP per capita: \$1,000</li> <li>• Manufacturing/GNP: 27.6% (1976)</li> </ul>
1980s	<ul style="list-style-type: none"> <li>• Industrial rationalization</li> <li>• Initial import liberalization and market opening</li> <li>• Shift to private sector initiatives</li> </ul>	<ul style="list-style-type: none"> <li>• Total trade volume: \$150 billion (1991)</li> <li>• GNP per capita: \$5,000 (1990)</li> <li>• Import liberalization ratio for manufactured goods: 99.9% (1991)</li> </ul>
Mid 1990s	<ul style="list-style-type: none"> <li>• Deregulation</li> <li>• Initial globalization (partial liberalization of capital account and foreign exchange)</li> <li>• Fairness and transparency in industrial and trade policy</li> <li>• Technology-based industrial policy</li> </ul>	<ul style="list-style-type: none"> <li>• Export volume: \$100 billion (1995)</li> <li>• GNP per capita: \$10,000</li> <li>• Application for OECD membership</li> </ul>
Late 90s and 2000	<ul style="list-style-type: none"> <li>• Required liberalization under IMF agreement</li> <li>• Full liberalization of foreign exchange and capital account</li> <li>• International best practices in financial and business sectors</li> </ul>	<ul style="list-style-type: none"> <li>• Negative GDP growth at 6.7% in 1998</li> <li>• Speedy recovery in 1999</li> <li>• Foreign Exchange Reserve at &gt;\$90 billion</li> </ul>

Beginning in the early 1970s, the policy focus shifted from light manufacturing to heavy and chemical industries (HCI) in order to upgrade both Korea's industrial structure and national defense capability. The government set industrial objectives to promote heavy and chemical industries, not only in the domestic market but also in the global market, by intentionally creating large conglomerates known as *chaebol* to take advantage of scale economies. Various sector-specific special laws for HCI development allowed the government to allocate subsidized funds to industry-specific and even firm-specific targets, and government intervention became acute, direct, and specific.

In addition to the Economic Planning Board, a special commission was created directly under the President to draw up and implement the blueprints for heavy and chemical industrialization. The government identified the priority of HCI projects and then virtually assigned specific projects to experienced and proven entrepreneurs. The government utilized both carrot and stick approaches to encourage business firms to engage in heavy and chemical industries. Those *chaebol* which performed well in achieving the government blueprints were well rewarded with business expansion and diversification incentives. However, those which performed rather poorly and inconsistently with the government's intended business focus were punished by being cut off from financial institution lending and by having their tax records investigated.

Having channeled massive financial resources to the *chaebol* by means of "administered credit allocation" at concessional interest rates to carry out high priority investment projects, the government was also held responsible should these projects turn unprofitable. Despite a number of short-run problems, government-led heavy and chemical industrialization turned out to be effective during the 1970s and until the mid-1980s. This contributed a great deal to Korea's present status as a global producer of shipbuilding, iron and steel, electronics, and automobiles. During the HCI promotion period, the government industrial policy favoring large businesses required heavy protection and subsidies at the early stage of industrial development, but intervention was gradually phased out as the heavy and chemical industries became competitive. Sub-sectors such as shipbuilding, iron and steel, and semiconductors are cases in point.

However, as time went by, the sheer size of highly leveraged *chaebol* also created a classic moral hazard problem of "too big to fail." *Chaebol* owners and government policymakers were interlocked in creating and having access to financial support, irrespective of profitability. When a cyclical but long recession (in part resulting from uncontrollable external conditions such as oil shocks) led to a massive amount of non-performing loans being held by banks due to huge lending to unprofitable *chaebol*, the government, fearing large-scale bankruptcies and related short-run instability, decided to socialize the losses. The bureaucrats were often more willing to accommodate the short-run wishes of the entrenched interest groups, thus setting the reform-oriented policies aside.

Nevertheless, beginning in the early 1980s the government recognized that distortions due to administered credit allocation in the financial sector had to be removed if Korea was to move to a more market-oriented system. To this end, the gap between interest rates on policy loans and rates on general loans was almost completely eliminated in 1982. In addition, the government reoriented its policy away from industry targeting toward functional support, including R&D.

Furthermore, since the mid-1980s, Korean policymakers began to recognize that market opening is necessary, not only to resolve rising trade frictions but also to bring competitive forces into protected but stagnant sectors in the economy. Although Korea's export-oriented development strategy allowed for complete import liberalization of raw materials or intermediate inputs needed to manufacture products for export activities, imported consumer goods and other expenditures that would result in the outflow of foreign currency were tightly controlled. These selective import restrictions helped to protect domestic industries from foreign competition throughout the early stages of development.

In order to maximize the benefits of market opening in a still protectionist environment, the government announced in the early 1980s a five-year import liberalization schedule, designed gradually to reduce tariff rates and eliminate non-tariff barriers. As a result, the import liberalization ratio of manufactured goods (measured by the ratio of automatic approval items to total tradable items) rose from 37 percent in 1965 to 95.4 percent by 1988, and finally to 99 percent in 1994. As

the Uruguay Round of multilateral trade negotiations kept unfolding, both liberalization and deregulation have been emphasized in government policy. However, the Korean government failed to establish, in a timely manner, a market mechanism characterized by global standards and practices. This failure weakened the competitiveness of Korea's economy and eventually helped bring on the economic crisis.

## Forced Restructuring and Reforms to Introduce International Best Practices

Both administered credit allocation, which often resulted in excessive lending without prudential rules, and the *chaebol* focus on increasing market share and pursuing diversification through debt financing (with little attention to profitability) caused an interlocking chain of inefficiencies in the financial and corporate sectors. In consequence, the real and financial sectors are intertwined due to highly leveraged businesses in the corporate sector and mounting non-performing loans in the financial sector.

As corporate bankruptcies rose, financial institutions became burdened with bad debts and were no longer able to roll over their domestic or foreign liabilities. By November 1997, Korea had nearly exhausted its

foreign exchange reserves. While receiving emergency financial help from the IMF, the Kim Young-sam administration in its waning months agreed to carry out major reforms in four major areas—financial, corporate, and public sectors, and the labor market—to avoid a moratorium on Korea's foreign debts. As a consequence, the newly elected Kim Dae-jung administration—inaugurated in February 1998—carried out reforms under a program agreed upon with the IMF. The Korean government's major policy guidelines and actions to implement the IMF mandates are summarized in *Table 2*.

### *Presidential Initiatives and Reform of the Government*

The immediate economic task for the Kim Dae-jung administration was to overcome the currency crisis as quickly as possible, to regain market confidence at home and abroad, and to establish a free, fair, and democratic market economic system. Therefore, the new government policy focus was on removal of arbitrary market intervention, authoritarian orders, and unnecessary regulation. The basic principles of economic policy were: (1) guaranteeing economic freedom with personal responsibility; (2) encouraging performance-based competition; (3) guaranteeing equal opportunity; and (4) opening all markets to both nationals and foreigners.

**Table 2: Major Policy Guidelines and Actions to Implement the IMF Mandates**

Sector	Policy Guidelines and Actions
Financial Sector	<ul style="list-style-type: none"> <li>• Determine the viability of banks and non-bank financial institutions based on a BIS minimum capital adequacy ratio of 8 percent.</li> <li>• Abolish the interest limit act.</li> <li>• Streamline disclosure standards.</li> <li>• Introduce a new governance system.</li> <li>• Open up the short-term capital market.</li> </ul>
Corporate sector	<ul style="list-style-type: none"> <li>• Enhance transparency in corporate governance.</li> <li>• Prohibit cross guarantees.</li> <li>• Reduce debt levels.</li> <li>• Concentrate on core businesses and strengthen cooperative relationships with small and medium-sized enterprises..</li> <li>• Strengthen accountability of the controlling shareholders and management.</li> </ul>
Labor sector	<ul style="list-style-type: none"> <li>• Make the labor market more flexible; including legalizing layoffs and employee outsourcing.</li> <li>• Create a social safety net such as unemployment insurance.</li> <li>• Create a tripartite commission consisting of labor, business, and government to handle labor market issues.</li> </ul>
Public Sector	<ul style="list-style-type: none"> <li>• Privatize state-owned enterprises.</li> <li>• Downsize government organization and implement a merit system.</li> </ul>

Source: South Korean Ministry of Finance and Economy

Any reform in Korea needs to begin with the government. The Kim Dae-jung administration recognized that frequent government intervention, authoritative dictates, and unnecessary regulations in the past had been detrimental to the development of a free market economy. In redesigning government's role as service-oriented, transparent, competitive, and accountable, the government has been downsized, an entrepreneurial spirit introduced, and a merit-based personnel management system implemented.

However, establishing a market economic system does not mean that the government should assume a passive role. There are some areas where government involvement should be reduced through deregulation, but in other areas the government's role should be enlarged to promote a genuine market economy. This amounts to redefining the government's role.

During the previous administration, the Economic Planning Board and the Ministry of Finance, which often had opposed each other in policy formulation, were consolidated as the Ministry of Finance and Economy (MOFE). MOFE exercised budget power in formulating macroeconomic policies as well as virtual regulatory and supervisory power in the financial sector. The Minister was also empowered as Deputy Prime Minister, so that he could effectively coordinate the various ministries in charge of economic matters. However, the absence of a check and balance system within MOFE on macroeconomic and financial policies and MOFE's *de facto* influence over the Bank of Korea on monetary policy formulation are believed to have caused misalignments of the exchange rate and a maturities mismatch affecting a large amount of short-term borrowing to finance long-term investment projects. This eventually contributed to the depletion of foreign exchange reserves.

In order to bring checks and balances into national economic management, the Kim Dae-jung administration demoted MOFE to be simply one of the sixteen ministries. The budget function and public enterprise administration were separated from MOFE and shifted to the newly created Ministry of Budget and Planning.

The resulting virtual absence of any coordinating power over the national economic policies proposed by the various ministries required that the President himself coordinate the restructuring efforts and the IMF reform programs. Given the policy guidelines agreed upon with the IMF, the President chaired temporary emergency Economic Policy Coordination Meetings which the Prime Minister, key members of economic ministries, and two private representatives attended. During the first six months, the Economic Policy Coordinating Meetings were held almost every other week to ensure that the reform programs were on the right track.

Once the first round of key restructurings was completed by mid-2000 under the President's direct supervision, and foreign exchange reserves were rapidly rising, routine implementation of the reform agenda was transferred to the cabinet. The government then realized that an effective mechanism was required to ensure smooth policy coordination of reforms being carried out under the supervision of various ministries. Therefore, in January 2001, the Minister of Finance and Economy was once more designated Deputy Prime Minister to carry out this coordination function.

The administration's philosophy of the proper role of government in establishing a market economic order has been influenced by the school of "ordo-liberalism,"<sup>3</sup> which argues that the failure of the *laissez-faire* economy in Germany in the 1930s arose from the growth of private, monopolistic, economic power and the resulting lack of competition. Due to the lack of institutional provisions to safeguard the market economic order, enterprises faced few restrictions in forming monopolies, cartels, or other interest groups. Their power base was sufficiently large to extend their influence into the political sphere. In the end, the government no longer served as a guardian of the public interest, but was reduced to an instrument of the interest groups that enjoyed special privileges by limiting competition.

In order to safeguard political and economic freedom and to promote social stability and development, the ordo-liberalists advocate that the government should

---

3. Ordo-liberalism, developed primarily by the Freiburg school of thought in Germany, asserts that the collusive ties between the government and businesses, which were further strengthened during the periods of Imperial Germany and the Weimar Republic, led to the complete concentration of essentially all economic and political power under the Nazi government.

establish an economic order capable of checking the monopoly power of private firms. A laissez-faire economic system limits the role of the government to protecting individual property rights and securing public order, whereas ordo-liberalism demands a more active role for the government by emphasizing the importance of economic policy to create a fair and competitive market. The Kim Dae-jung administration's policy on *chaebol* reform reflects these tenets of ordo-liberalism. The school also recognizes the utility of certain progressive taxation measures and a social security system to maintain the competitive system, but considers direct government intervention in resource allocation detrimental to a market economy.

In many respects, economic reform within a market economy is virtually synonymous with liberalization. Indeed, liberalization has been a key word in Korea during the pre-crisis as well as the post-crisis period. As a means of promoting a more competitive market environment against *chaebol* monopolies, liberalization has been pursued steadily but gradually. The decision to liberalize is likely to be more effective and more likely to occur in the midst of a crisis. However, a crisis requires immediate action, while the benefits of liberalization occur only in the medium and long run. In this context, the East Asian financial crisis provided Korea with a rare opportunity to liberalize its economy against opposition from entrenched interest groups. This view is widely shared by the general public as well as by reform-minded policymakers.

Although liberalization is designed to let the market do more of the allocating, certain allocative decisions will still be required of the government, because they involve things in which the state has a comparative advantage in supply (such as education). For example, if a country is soon to enter a phase of development beyond producing and exporting labor-intensive manufactured products, human capital must be developed in time to be available when needed. This is where policymakers can turn to the experiences of other countries for guidance.

A new round of negotiations under the WTO is needed to address the proper sequencing of liberalization. Traditional literature on sequencing has emphasized that capital account liberalization must be preceded by the creation of stable macroeconomic conditions, current

account liberalization, and domestic market liberalization. To prepare for financial and capital account liberalization, domestic financial institutions must have the capabilities and expertise to manage assets, liabilities, and inherent risks efficiently. The authorities should maintain a solid framework of adequate supervision, full disclosure of financial statements, and international accounting standards.

In order to ensure smooth liberalization without serious adverse impact, the government must carry on restructuring as well as reforms so that the market can function effectively. In line with foreign exchange market liberalization, the government should not exercise direct intervention, but instead utilize appropriate macroeconomic policy tools. Korea needs to monitor the flow of foreign exchange and foreign capital, especially in the form of offshore financial operations, hedge funds, and derivatives. The government must strengthen prudential supervision of the financial system, ensure public release of informative corporate financial statements, and design effective safety measures.

In formulating restructuring policies by various ministries, a total of 14 government think tanks—such as Korea Development Institute (KDI), the Korea Institute for International Economic Policy (KIEP), the Korea Institute of Economics and Technology (KIET), and 11 other national institutes—play key roles in assisting respective ministries to design guidelines and policy prescriptions. Private or semi-private research institutes, such as the Korea Economic Research Institute and the Korea Finance Institute, which are attached to the Federation of Korean Industries and the Korea Bankers' Association, respectively, also regularly express their views on restructuring agendas and policies.

Legislation of reform measures is critical to restructure the Korean economy. Quite frequently, the scope, speed, and sequencing of reform bills have been subject to hot debate between government and opposition parties. Depending on the political implications of the reform bill, the passage of legislation in the National Assembly does not occur in a timely manner and can cause undue delays in implementing reforms. Sometimes, the substance of the bill is changed substantially to please political interest groups.

## ***Financial and Corporate Sector Reforms***

In pushing the IMF reform programs, the restructuring of Korea's economy must focus on breaking the vicious chain of inefficiency between the financial and corporate sectors. Major restructuring initially focused on the financial sector and then moved to the corporate sector. In order to carry out financial sector restructuring effectively, the government consolidated the three separate supervisory bodies in charge of banking, securities, and insurance companies to create a single Financial Supervisory Commission, which includes a great deal of outside expertise.

While removing structurally unviable firms from the market, the government has relied primarily on bank-led voluntary corporate debt workouts for the temporarily troubled *chaebol* and other medium and large-sized firms. Hence, recapitalization and restructuring of banks are a central element in the strategy for corporate and financial sector reform. During the first round of restructuring, eight major creditor banks, identified as leading banks, were responsible for negotiating workouts with the 64 major corporate groups.

As specified under the IMF agreements, the establishment of a new governance system is required for the financial and corporate sectors. The banking sector immediately introduced a new requirement that 60 percent of bank board members come from outside the bank. This acts as a check against management. Korea's corporate sector is also required to introduce a new governance system. Evidence suggests that introduction of an equity-holders dominant governance system may not be effective, because owners' family members are themselves the largest shareholders, and they have already attempted to retain management control through cross-shareholding. If the outside equity holders are too small to balance internal ownership, the rights of minority shareholders should be strengthened. Institutional investors, including foreigner investors, can play an important role in improving transparency. The new governance proposal mandates that half of a corporate board be represented by outside directors. Who selects them, and how many board members from where, remain important issues as well as their exact role in enhancing transparency and effectiveness in routine corporate management.

Korea needs to undertake further trade liberalization to expedite the restructuring of the *chaebol*. A more efficient mechanism of ensuring *chaebol* restructuring might require a complete opening up of the domestic markets, the introduction of a careful monitoring system for insider trading among *chaebol* subsidiaries, and a more transparent system for preparing consolidated balance sheets. Then the market could handle business swaps and dispose of unprofitable subsidiaries as necessary. These actions would far exceed WTO requirements. In sum, the remaining structural reforms in the years to come must address the following key issues:

- Return of the "nationalized banks" to the private sector;
- Restructuring of the non-banking sectors and separation of ownership links between industrial conglomerates and financial entities;
- Further improvement in accounting, auditing, and financial disclosure;
- Gradual reduction of the budget deficit by tax reform and issuance of fewer bonds (to keep the budget deficit below 2.5 percent of GDP in 2001); and
- Modernization of the corporate insolvency system.

## ***Reforms of the Labor Market and the Public Sector***

Increasing flexibility in the labor market is necessary to solve Korea's economic inefficiency. Observing Korea's militant labor movement since the late 1980s, labor market flexibility must be regarded as a critical prerequisite to attract foreign capital and hence capital market liberalization. In order to expedite labor sector reform, a tripartite commission including labor, business, and government was established in January 1998. The Labor Standards Act, revised in February 1998 through the Tripartite Commission, now provides legal grounds for employment adjustment. The revised law permits layoffs if a company has duly considered the interests of its workers. In return, the government aims to strengthen its support programs by providing vocational training and information on reemployment. To adjust labor supply in accordance with changing market environments, new employment options, such as temporary work, part-time employment, and work

at home, have also been developed, and a flexible and performance-based pay system has been introduced.

Public sector reform basically involves two tasks. One is related to small but efficient government organization. The other involves privatization of government-owned enterprises. Any reform undertaken in Korea must begin with the government. Korea's government reform has involved downsizing of its organization as well as the number of government employees to achieve the objectives of customer priority, entrepreneurial management, flexible and transparent administration, and maximum individual creativity and initiative.

Government-owned enterprises in Korea have been characterized by their large size and inefficient management practices. In 1997, 108 public corporations, excluding financial institutions, employed over 210,000 people. The monopolistic market environment of many government-owned corporations created inefficient management. In order to address these problems, the government plans to privatize inefficient public corporations, based on market principles of transparency and fairness. Foreign firms have also been allowed to participate in the privatization process.

### ***Foreign Exchange Market Liberalization***

For the past thirty years, Korea has strictly controlled foreign exchange transactions. During the era of government-led growth, this policy was necessary to manage the limited amount of foreign currency efficiently. However, it is impossible to adapt to the globalization era with heavy restrictions on foreign exchange and capital accounts. The government consequently announced plans to liberalize foreign exchange transactions to the level of advanced countries and to increase transparency to international standards. Previously, overseas commercial borrowing had to exceed one million dollars and have a maturity of more than three years. However, on 1 July 1998, this restriction was eliminated, and maturity limits for commercial borrowing and the issuance of securities were reduced to one year.

In April 1999, Korea abolished the regulatory Foreign Exchange Management Act and introduced instead the Foreign Exchange Transaction Act. The new act eliminates most restrictions on foreign exchange transactions and on domestic transactions in foreign currencies for businesses and financial institutions. Remaining restrictions are classified under a negative rather than a positive list system. Eligibility to engage in foreign exchange transactions is now determined by preset conditions rather than by a government permit. Businesses have more financing options, such as credit transactions for exports and imports or medium and long-term foreign borrowing. Korean exporters are now able to establish their own trade-finance corporations. Also, payments for goods and services within Korea can be made with foreign currency. Beginning in 2001, all remaining foreign exchange transactions have been liberalized. This will allow individuals to deposit their money into foreign-based banks and to buy foreign securities or foreign real estate.

### ***Capital Market Liberalization***

Since the outbreak of the financial crisis, Korea has aggressively sought to invite in foreign capital in the form of foreign direct investment as well as in the form of portfolio investment. One of the motivations for capital market opening was that the parent firms or subsidiaries of multinational firms in crisis-ridden countries do not suffer lowered credit ratings or difficulties in importing raw materials or obtaining trade financing as do domestic firms. However, as a late-comer in an increasingly globalizing world economy, it will take time and considerable effort for Korea to overcome its negative international image as a destination for foreign capital.<sup>4</sup>

Regulations governing foreign ownership in listed stocks have therefore been changed to allow 100 percent foreign ownership; the merger and acquisitions (M&A) regime has been liberalized to allow hostile takeovers by foreigners; tax incentives (*e.g.*, on asset sales) have been introduced; the real estate market has been opened to foreigners; financial disclosure and

---

4. In the past, Korea relied little on foreign investment due to its indigenous growth strategy and high saving rate. This resulted in a weak foreign presence and made Korea one of Asia's most difficult markets.

reporting have been strengthened; and insolvency procedures have been improved.

In sum, effective liberalization of the capital market should be preceded or at least accompanied by foreign exchange market liberalization. Korea's second phase of capital market liberalization is outlined in **Table 3**. Because of delayed reforms, "full" liberalization of both capital and foreign exchange markets has taken place virtually simultaneously under the IMF programs.

**Table 3: Capital Transactions to be Allowed from 2001**

- Won-based domestic deposits (including trust deposits) held by non-residents with maturities of less than one year;
- Businesses borrowing directly through foreign banks;
- Capital transactions by individuals (foreign deposits and borrowing, real estate investments, etc.);
- Direct overseas securities investments (ending required use of a domestic intermediary); and
- Direct derivatives transactions with foreign financial institutions.

## Conclusions

Korea's economy bounced back surprisingly in 1999, with GDP growth at 10.9 percent and a record trade surplus of \$40 billion following 1998's worst year record of a negative 6.7 percent GDP growth. As of the end of 2000, Korea's foreign exchange reserves had swelled to a historic record of more than \$90 billion. The Korean government plans to pay back the remainder of its emergency loan from the IMF by mid-2001, far sooner than expected. However, Korea's policymakers should not regard graduation from IMF-guided management as inviting a return to the old system. Rather, it should be seen as offering a new basis upon which a genuine foundation can be established to build a global-standard market economy, applying all of the lessons learned during the IMF mandate years.

For Korea to overcome the financial crisis and become an advanced country, the government should end its direct intervention in the economy, and economic policymaking should be autonomous, based on genuine market principles of free competition and accountability. Over the past three years, the Korean government has had to carry out a reform agenda agreed upon

with the IMF. In this process, the role of the government has again been heavy-handed and very specific in order to ensure fast track reform. For example, in the absence of appropriate legal systems, both injections of public funds to recapitalize banks suffering from mounting non-performing loans and the exit of unviable corporations had to be hastily determined by discretionary decisions of government officials.

The government now needs to lead the way in building up a market system, parts of which have not had the opportunity to develop fully. Under these circumstances, it would be irresponsible of the government to let market forces prevail over everything and not limit the market excesses that could aggravate the economic crisis. Therefore, the government still needs to be active in areas where market development is still inadequate. This should be regarded as expediting and protecting the formation of a free market.

Since an orderly competitive system will not be realized automatically, the government must improve the rules of the game to allow free and fair competition to regulate the market, and it must supervise the overall structure to ensure that the rules are followed. The Kim Dae-jung administration has focused on shaping the framework through which the market economy will work properly. This has been done by establishing the underlying laws and institutions so as to transform the Korean economy from the state-led and regulation-oriented economic system of the past.

The government will also continue its efforts to correct market failures for investment in research and development, for technological advancement, and educational investment for human development. The government should also play an active role in promoting investment in public goods such as defense, safety, or social overhead capital facilities that cannot be provided solely by the market. Additionally, environmental problems cannot be resolved by the market itself, and imperfect competition or information can lead to inefficient allocation of resources.

It is the government which should take the initiative in overcoming obstacles to reform such as prevalent moral hazard, the resistance of interest groups, or the paucity of financial resources. While the Korean government should improve institutions for the establishment of market discipline, it should also enhance its own effi-

ciency through radical reform of public institutions and practices.

The government should strengthen its role in taking care of those economically disadvantaged due to poor market competitiveness and those not given an equal opportunity in competition from the beginning. However, the social safety net, introduced to promote the stable development of a market economy, should not be allowed to generate “welfare state disease.” Consequently, in addition to efforts at job creation, the government has introduced a “productive welfare system” to provide the unemployed with on-the-job retraining and new skills.

In many cases, the government’s efforts to establish the framework of a market economy have been prone to degenerate into either patriarchal intervention or authoritarian rules as was prevalent in the past. We should ensure that government and markets act as complements rather than substitutes. In addition, the Korean government needs to establish administrative transparency and responsibility by clearly designating the administrative body responsible for implementation of laws and regulations. The government should also enact clear and concrete laws for administrative procedures and information release.

As the Kim Dae-jung administration pursues parallel development of democracy and a market economy, neither unfair competition nor coercion by the government is supposed to exist. Therefore, individuals should be held responsible for their actions and learn how to accept the outcome of fair and transparent competition. Above all, each economic agent in Korea should accept that structural reform is an on-going and never-ending process that will continue until Korea establishes a new economic paradigm similar to that of today’s advanced countries.

*Dr. Ahn is a Professor of Economics at Chung-ang University in Seoul.*

---

## SECOND ROUND OF STRUCTURAL REFORM IN SOUTH KOREA

### SOUTH KOREA'S FINANCIAL SECTOR: DEVELOPMENTS, OUTLOOK AND SOME MACROECONOMIC IMPLICATIONS

by Thomas Byrne

#### Overview

In 2000, the third year after the onset of South Korea's financial crisis, government support and restructuring measures have advanced system-wide consolidation and stability. Earlier measures have stabilized the banking sector; current measures are seeking to stabilize non-bank financial institutions. However, despite the sharp rebound in macroeconomic performance in 1999 and 2000, liquidity problems still affect some segments of the financial system, in particular the non-bank financial sector and the bond market. The system as a whole remains undercapitalized, more so in an economic than in a regulatory sense, because of underlying credit losses embedded in loan and investment portfolios. The source of these losses remains the highly leveraged industrial conglomerates (*chaebol*). The government's recourse to a second round of support funds may not be sufficient to ensure self-sustaining stability until the *chaebol* system is fundamentally restructured.

Although reforms already taken can improve the health of the financial system over time, the system remains fragile and vulnerable to volatility in the economic environment. Future stability will likely depend on continued government support. (This is factored into Moody's relatively high credit ratings for the banks compared with their low "intrinsic financial strength" ratings.) Efforts by financial institutions and supervisory authorities to strengthen risk control are underway, but results will take time. The fiscal costs of stabilizing the financial system have had a greater ef-

fect than government budget deficit financing or external crisis funding in ratcheting up public sector debt to historically high levels. The fiscal costs of financial restructuring should be manageable if the political consensus remains supportive of meaningful progress in corporate sector restructuring, and if Korea's macroeconomic environment remains stable.

#### Bank and Financial System Fundamentals

Adequate capital, whether as defined by regulators or indicated by underlying economic solvency, has remained problematic for the system as a whole. This is despite government injections, which have totalled almost 50 trillion *won* for the rated banks, or roughly twice the level of aggregate capital in the entire pre-crisis banking system. Korean banks have depended on substantial government support for post-crisis recapitalization, as their ability to raise equity on their own remains severely constricted by the lack of investor appetite. Many Korean banks have tapped the subordinated debt market, especially upper Tier-II notes,<sup>1</sup> which provide some financial flexibility (at high cost) but do not contribute to core equity capital.

Asset quality is still suspect because of the huge credit losses that are embedded in the banks' loan and investment portfolios. These arise from the necessary deleveraging of the Korean corporations and devaluation of their loans. The table below shows that the total debt and debt equity ratios of companies listed on the Korea Stock Exchange actually increased in the first half of 2000, despite the increase in profits. This

---

1. Tier II capital has features similar to debt, and it is distinct from equity or capital reserves that comprise Tier I capital. Because payments on upper Tier II capital can be suspended if a bank becomes insolvent or its ratio of non-performing loans falls below the regulatory threshold, it provides the bank with some flexibility. However, such capital is generally more costly and can therefore adversely impact a bank's profits.

can be interpreted as a sign of complacency in the corporate sector and of financial system vulnerability to an inability of the *chaebol* to service debt in an economic downturn.

**Table 1: Debt of Companies Listed on the Korea Stock Exchange**

	Dec. 98	Dec. 99	Jun. 00
Total debt ( <i>won</i> trillion)	352	326	340
Debt/equity (percent)	279	148	167
Total profits ( <i>won</i> trillion)	-13.4	14.6	16.3

Source: South Korean Financial Supervisory Commission.

The closure of nonviable financial institutions, self-rescue efforts, and loan buyouts by the Korean Asset Management Corporation (KAMCO) had reduced non-performing loans (NPLs) by the end of 1999 from their peak in early 1999. However, the demise of the Daewoo Group and adoption of more stringent, forward-looking loan classification standards at the end of 1999 arrested the decline in NPLs, or redefined more realistically the asset qualities of the banks. Loan classification by banks and most other financial institutions must now take into account a borrower's capacity to repay. Based on the new criteria, the Financial Supervisory Commission reported that loans classified as "substandard" and below amounted to about 14 percent of total loans in June 2000, down just slightly from the end of 1999. The average, however, masks widely diverging performance within the financial sector. Loans classified as substandard and below by commercial banks stood at about 12 percent, while such loans in all non-bank financial institutions were 25 percent of the total. Banks are also increasingly utilizing asset-backed securities to dispose of problem assets, though it is unlikely that all the risks are removed.

Both loans classified as substandard or below and non-performing loans are indicators of the health of a bank and a banking system, but there are caveats when interpreting such numbers that are a function of the experience and effectiveness of bank supervision. The fact that the occurrence of new corporate failures boosts the level of published non-performing loan figures (and related provisioning) suggests that application of loan assessment standards needs improvement.

Korean banks can be broadly grouped into the "better off" and the "worse off." Examples of the banks in

better shape include former specialized banks, such as the Housing and Commercial Bank and Citizens Bank, which are not heavily exposed to the corporate sector, and such banks as Koram and Shinhan, which are newer and had a lesser role in Korea's government-directed industrialization drive. In effect, these banks do not have the original sin of the older established banks and therefore have not had the need for government-led redemption. These banks have higher intrinsic financial strength ratings. On a scale of "A" to "E," they are rated "D" on average, which signifies adequate intrinsic strength not dependent on the government or other outside agent. Such banks are also characterized by significant foreign participation in their share holdings. The Ministry of Finance and Economy (MOFE) reported that foreign ownership of the Housing and Commercial Bank, Citizens Bank, and Shinhan Bank in 2000 ranged from 51 percent to 64 percent. This may be surprising, in view of a perception fostered by the failure to sell Seoul Bank that foreign participation in the financial sector is more limited than it actually is.

The "worse off" banks include those which have been government-intervened and which will be consolidated into financial holding companies (FHCs). These banks have the weakest intrinsic financial strength rating given by Moody's, an "E." Korea's banking system as a whole has a financial strength rating of "E+," which places it among the lowest rated systems. (The average financial strength ratings for countries having banks which Moody's rates is close to "C," which indicates good intrinsic financial strength, valuable and defensible franchises having acceptable fundamentals in a stable operating environment, or better than average fundamentals in an unstable operating environment.)

From a macroeconomic perspective, the weakness of a banking system in crisis is reflected in the ultimate public cost incurred in paying off depositors of failed banks, purchasing NPLs, and recapitalizing the system. According to MOFE, the fiscalization cost to the South Korean central government and its agencies currently stands somewhere in the neighborhood of 130 trillion *won* as of the end of 2000 (more than 20 percent of GDP), after taking into account recovered funds (about 25 trillion *won*) and funds re-injected from recoveries. This consists of 64 trillion *won* originally guaranteed by the National Assembly in May 1998 and an additional 40 trillion *won* approved in late 2000

for the second round of restructuring. Apart from government-guaranteed Korea Asset Management Corporation and Korea Deposit Insurance Company (KDIC) securities used to fund the 1<sup>st</sup> and 2<sup>nd</sup> rounds of restructuring, MOFE reported that 25.8 trillion *won* in extra funds were raised, mostly from state-run bank investments and borrowings from banks for financial sector restructuring. This sum excludes the state-owned Korea Development Bank (KDB) purchases of *chaebol* bonds maturing in 2001, purchases that are being made to stabilize the bond market.

**Table 2: Financial Sector Restructuring Costs, 1998-2000 (*won* trillion)**

	Banks	Non-banks	Total
1 <sup>st</sup> Round (1998)	45.2	18.8	64.0
2 <sup>nd</sup> Round (2000)	6.0	34.0	40.0
Extra funds	---	---	25.8

Source: South Korean Ministry of Finance & Economy

The ratio of total public sector debt to GDP has risen sharply, from around 20 percent pre-crisis to around 50 percent in the subsequent crisis management years. Although Korea has reduced external debt incurred in the early stage of its crisis (IMF loans and government guarantees on the restructuring of foreign bank short-term credits), the internal costs of budget deficits and financial sector support funds have largely offset the external debt reduction. Korea's crisis has progressed from an acute external debt phase to a more chronic internalized phase. This is probably manageable, based on the large reservoir of domestic savings, if fiscal consolidation achievements are sustained (the government's budget was in surplus in 2000, four years ahead of the original target), and if additional financial restructuring costs are contained.

### The Non-Bank Financial Sector

Fragility in the non-bank financial sector remains a difficult policy problem more than three years after the onset of the crisis. The worst asset quality among non-bank financial institutions is seen in investment trust companies and securities firms. Exposure in this sector was highly concentrated in the large *chaebol*. Second round funds will mostly be used to close a merchant bank, recapitalize Seoul Guarantee Insurance Company, and support Korea and Daehan investment

and trust companies, the need for which stems from the demise of Daewoo. A portion of the second round funds will also be available to help capitalize the proposed financial holding companies (FHCs).

Government policy has achieved substantial consolidation. Well over 400 non-bank financial institutions have been removed from the scene since 1997. The non-bank financial sector has been neutralized as a source of funding for the economy. Between January and February of 2000, the reduction of credit from non-bank financial institutions was great enough to offset the expansion of credit to the private sector by commercial and other banks. The investment trust companies (ITCs) had been a major investor in corporate bonds and, in both absolute and relative terms, were much more heavily exposed to Daewoo's losses than the banks. Therefore, it is not surprising that the demise of Daewoo triggered a liquidity crisis for the ITCs. The resulting flight to quality in 2000 led to a shift of more than 100 trillion *won* in deposits from the ITCs to commercial banks, where deposits were fully insured. (New regulations effective in 2001 place a cap on insurance for individual depositors.) The tightening of regulations to require mark-to-market accounting of ITC assets in 2000 also contributed to depositor fears about the soundness of those institutions.

The lack of a diversity of bond issuers, coupled with previous regulator forbearance, added to the risks for non-bank financial institutions. Moreover, risk was not priced into lending, although this is now changing with more transparent accounting and the sharp reduction in third-party guarantees. Historically, institutional investors tolerated the lack of transparency and low standards of corporate governance. This was attributable to related lending conflicts and the pervasive use of guarantees insulating investors from credit risk, or so they believed; more than 90 percent of all outstanding corporate bonds were guaranteed by financial institutions back in 1996. The drop in guarantees since then, however, has been accompanied by decreased diversity in bond issuers. Hyundai, Samsung, LG, and Daewoo accounted for 68 percent of total bonds outstanding in 1997 and 78 percent in early 1998. In fact, refinancing risks increased after the onset of the crisis, with typical maturities shortening from three years to one or two years. These conditions explain why state-owned Korea Development Bank announced in January 2001 that it would help the corporate sector

roll over an estimated 25 trillion *won* (about \$20 billion) out of 65 trillion *won* (about \$52 billion) in corporate bonds due this year. This plan prevents market discipline from enforcing adjustment in the Hyundai Group this time, two affiliates of which are struggling. Ultimately, moral hazard from government intervention will only add to the ultimate cost in terms of public debt.

**Table 3: Financial Sector Consolidation, First Round: 1998-2000**

	Licenses revoked	Closures/mergers	Total
Banks	5	6	11
Non-bank financial inst.	86	384	470

Source: South Korean Ministry of Finance & Economy.

### *Financial Holding Companies*

Further consolidation is another key feature of the second round of financial restructuring announced in late 2000. In the first round of financial restructuring, 11 out of 33 banks were removed from the industry. More banks will disappear, reducing the number of banking institutions to half of the pre-crisis level. This will be accomplished through the forced integration of government-intervened banks into financial holding companies (FHCs) or by additional mergers of sound banks. Based on an assessment by the independent Management and Evaluation Committee established by the Financial Supervisory Commission, Hanvit Bank, Peace Bank, Kwangju Bank, and Cheju Bank were judged to be not sustainable, as these banks' liabilities exceeded their assets. KDIC will inject additional capital to raise their Bank of International Settlements (BIS) ratios to more than 10 percent, and shareholders' capital will be completely reduced. Consequently, these banks and Kyongnam Bank will be subject to inclusion as subsidiaries of a government-led financial holding company (FHC). Another government-intervened bank, Seoul Bank, will also be included in an FHC if an international buyer is not found by the end of the first half of 2001. The first FHC is to be launched in the first quarter of 2001.

The FHCs are envisaged to improve efficiency, reduce costs, and enhance international competitiveness. It is

also anticipated that other non-bank financial institutions may be acquired and incorporated into the holding companies, thereby creating universal financial services groups. The complex holding company structure will present an enormous challenge for bank managers and also pose challenges on the ability of management to raise capital, as the FHCs will have legal limits on financial leverage (though the restriction on debt raising may be a credit positive).

### **Outlook**

Signs of an improved future are seen in system wide consolidation and recapitalization as well as in internal restructuring among banks and wider foreign participation. This may, over time, strengthen governance, credit structures, and business focus. However, residual strong government involvement perpetuates moral hazard. This is seen in the use of the Korea Development Bank to circumvent discipline in the bond market.

The Korean banks in 2000 concluded their due diligence of their corporate borrowers in an effort to weed out non-viable companies that may pose a systemic risk. This exercise has yielded 52 companies (mostly ones already in the banks' workout programs) that will be put through court receivership or liquidation processes. The modest number suggests that this is just a start in advancing corporate restructuring, although a Korean proverb does tell us that "by starting, a task is half completed." Yet political interests are threatened by radical restructuring, and institutional inertia remains formidable in this early stage of reform.

Ultimately, the health of the financial sector will be a function of the capability of financial institution managements to assess credit risk and weed out nonviable firms. Progress is most evident in the dismantling of two of the largest *chaebol*, Daewoo and Hyundai, and in mid-tier *chaebol*, which have been more successful in reorganizing and selling their non-core businesses. *Chaebol* are acceding to government policies that mandate the elimination of cross guarantees, and they are scaling back cross shareholdings. These remove incentives for increasing leverage and supporting the weaker affiliates to the detriment of the group as a whole. Another crucial element of restructuring would be the disintegration of family controls, but that has proved difficult so far.

In summary, there are key strengths and risks associated with the future of the financial sector:

***Key Strengths:***

- The government is willing and able to provide financial support.
- Domestic resources are still ample for support of the system.
- An independent regulatory agency and improved supervision have been established (although they remain untested by adverse economic conditions).
- Internal restructuring and consolidation will set the stage for improved profitability.
- Increased foreign participation will enhance management practices and stimulate competition.

***Key Risks:***

- Credit strength remains impaired owing to embedded *chaebol* losses.
- The lack of diversification in sources of capital for borrowers, owing to weakness in the non-bank financial institutions, could increase credit vulnerabilities to the banking sector.
- Political opposition and social concerns need to be effectively managed, as demonstrated by recent labor unrest in the Housing and Commercial Bank and the Kookmin Bank.
- Profitability will remain constrained by high credit costs, lack of income diversification, and close government involvement.
- Risk management and corporate governance remain inhibited by structural weaknesses, inexperience, and government involvement.
- Regulators need more time to develop experience and credibility.

*Thomas Byrne is Vice President of Moody's Investors Service in New York City.*

# MARKET-LED CORPORATE RESTRUCTURING IN A STATE-LED ECONOMY: A PROBLEM OF TRANSITION

by Lim Won-hyuk

## Introduction: Corporate Restructuring in a Transition Economy

The economic crisis of 1997 marked a watershed in the evolution of the South Korean economy, as it put into doubt the viability of the old system based on the public management of private risks. Although Korea's government-business risk partnership had contributed to rapid capital accumulation and impressive economic growth, the crisis made it clear that the old system, fraught with the risks of moral hazard and outright corruption, could not be sustained in a new economic environment characterized by liberalization and democratization.<sup>1</sup> The crisis also revealed the inadequacy of the existing institutional infrastructure that had failed to impose discipline on the corporate sector and had, in effect, impeded the orderly exit of nonviable firms. No effective market-oriented alternative had emerged to replace the state-led approach to corporate restructuring, which was the dominant feature of the industrial rationalization programs during the authoritarian era (1961 to 1987).

As a result, in order to facilitate corporate restructuring in the post-crisis period, the institutional infrastructure formed around the government-business risk partnership had to be restructured as well. In fact, in post-crisis South Korea, the term "corporate restructuring" is often used interchangeably with "structural reform in the corporate sector," referring to wide-ranging institutional changes in corporate governance, corporate finance, market competition, and bankruptcy procedures. Although this semantic confusion is unfortunate, it highlights a crucial fact: South Korean<sup>2</sup> firms have to take on the challenge of changing their business structure while the institutions governing corporate restructuring are themselves being changed.

They do not have the luxury of a well-established institutional infrastructure that has been tested through time.

Moreover, this problem of transition is not just one of changing a few laws. The role of the government in the economy is also being changed in a fundamental yet potentially problematic way. As the crisis of 1997 is widely blamed on the old government-business risk partnership, the government no longer has the mandate to "lead" the economy. At the same time, with the *de facto* nationalization of many banks and other financial institutions in the wake of the crisis, the government ironically has more resources under its control than before. If the government delays the privatization of these financial institutions and yet refuses to impose discipline on financially distressed firms, little progress will be made in corporate restructuring. Worse, if the government bails out firms based on non-economic considerations, the reform program itself will lose its credibility.

As the controlling shareholder of the nationalized financial institutions, the government should ideally abide by economic principles and take proactive steps to sort out nonviable firms and quickly implement reforms designed to improve the operation of the market. Unless pushed by the government to sort out nonviable firms according to economic principles, the managers of the nationalized financial institutions have little incentive to get tough with large distressed firms. This combination of government activism *and* adherence to economic principles should be accompanied by a well-designed exit program for the government. The market-oriented reform package should include comprehensive measures designed to facilitate mergers and acquisitions (M&As) and to effect the

---

1. For a historical analysis of Korea's government-business risk partnership, see Lim Won-hyuk (2000). *The Origin and Evolution of the Korean Economic System*. Seoul: Korea Development Institute.

2. Henceforth in this article, Korea and Korean should be understood to refer to South Korea (the Republic of Korea).

privatization of financial institutions. Simultaneously, it should insure the separation of banking and commerce. Of course, any appearance of government activism in the post-crisis period may invite charges of revived interventionism, but there seems to be no better alternative in the transition period as the Korean economy moves from a state-led system to a market-oriented one. This observation seems particularly relevant as Korea pushes ahead with the second round of structural reform amid charges of “excessive government intervention.”

## The 1997 Crisis in Perspective

On the surface, the 1997 crisis may appear to have been a liquidity crisis due to Korea’s low foreign reserves, heavy reliance on short-term foreign debt, and loss of confidence by foreign investors. As of December 1997, Korea’s short-term foreign debt was more than seven times the size of its foreign reserves. When the foreign creditors suddenly decided to pull the plug, Korea had little choice but to go to the International Monetary Fund (IMF) for relief. However, a series of bankruptcies by family-controlled conglomerates (*chaebol*) in 1997 had led to the loss of investor confidence and had triggered the international bank run on Korea, not the other way around. If Korea had secured a sufficient level of reserves, it might have been able to avoid a currency crisis, but it still would have had to face a serious problem with nonperforming loans.

What triggered the series of massive bankruptcies in 1997? *Figure 1* illustrates the basic nature of the problem with the Korean corporate sector. Since the mid-1960s, Korean firms have aggressively pursued expansion through debt financing, even when carrying out massive investment projects with a long gestation period. Such debt financing might have been justified, had Korean firms recorded a sufficiently high profit to cover interest expenses, but their rate of return on net worth has been below the opportunity cost of capital for much of the past two decades. Operating on a thin margin of error, Korean firms were extremely vulnerable to adverse macroeconomic shocks, and they could not help but fail in massive numbers when the government did not come to their rescue, as in 1997.<sup>3</sup>

Although the Korean economy supposedly moved in a more market-oriented direction in the aftermath of the drive to develop heavy and chemical industry (1973 to 1979), the changes were notable for their partial character. Starting in the 1980s, investment and capital accumulation increasingly depended on the initiative of the private sector, but the institutional reforms that were required to improve financial resource allocation and corporate governance were not carried out. Government control of the banks continued despite nominal privatization, while the *chaebol* expanded their influence in the financial sector through the ownership of non-bank financial institutions (NBFIs) such as merchant banks, security companies, and insurance companies. By offering a much higher rate of return than the banks, the *chaebol*-owned NBFIs were able to attract a great deal of financial resources. Investors apparently believed that their investments at NBFIs were protected by the government—just like bank deposits. As a result, the market share of NBFIs for deposits increased from 29.1 percent in 1980 to 72.2 percent in 1995. Partial financial liberalization, combined with the legacy of implicit government insurance, led to greatly increased overall risks in the financial system.

Problems in the corporate governance of private firms were no less serious than the increased risks of inefficient investment due to the control of the NBFIs by the *chaebol*. On average, the ownership share of the founder’s family for the top 30 groups declined from 17.2 percent in 1983 to 8.5 percent in 1997. As is well known in corporate governance literature, this increasing separation of ownership and control aggravates the agency problem. When ownership and control are separated, it is important to devise an incentive and monitoring scheme to make sure that the managers work in the interests of the shareholders rather than in their own interests. In pre-crisis Korea, however, the gap between ownership and control widened without concomitant changes in incentives and monitoring.

Before the economic crisis of 1997, the effectiveness of the state-led monitoring and incentive system was greatly reduced, but few financial institutions or institutional investors were allowed to step in to serve this

---

3. For a collection of perspectives on the economic crisis of 1997, see Shin In-seok (ed.) 2000. *The Korean Crisis: Before and After*. Seoul: Korea Development Institute.

**Figure 1: Profitability and Opportunity Cost of Capital for Korean Manufacturing Firms**



Source: Bank of Korea, *Financial Statements Analysis*, various issues.

function. This transition gap in financial resource allocation and corporate governance formed the background of the crisis. Consequently, it should have been the focus of the reform agenda in the post-crisis period.

### From Initial Reform Drive to Bankruptcy Suspension

In January 1998, five principles of corporate restructuring were announced. Designed to address what was then widely regarded as “the *chaebol* problem,” these principles included: (1) enhancing transparency in corporate management; (2) eliminating cross debt guarantees; (3) improving financial structures; (4) improving corporate governance; and (5) streamlining business activities. Principles (1) and (4) were designed to address the problem of “arbitrary imperial rule” by the *chaebol* bosses, most of whom at the time were not even legally registered as chief executives yet exercised complete control over their firms. Principles (2), (3), and (5) appeared to be intended to break up the “convoy-style” conglomerate structure of the *chaebol* groups. However, their rationale was not entirely clear, since the structure of a firm is, by and large, deter-

mined by market conditions. In other words, the government addressed the symptoms rather than the real cause of the problem—distortions in the financial and product markets. Moreover, the operational policy measure associated with principle (3) insisted on reducing the average debt-equity ratio of each *chaebol* group to 200 percent by the end of 1999 instead of simply encouraging the practice of charging a higher risk premium for more vulnerable firms. The government’s focus on the debt-equity ratio was also misplaced, for what is more important for the viability of a firm is its profitability relative to its financial expenses—as measured by the interest coverage ratio, for instance. As most firms met the government-mandated debt-equity ratio by issuing a massive amount of new stock without substantially reducing their debt level (*i.e.*, by raising the denominator without changing the numerator), it became clear that the government had misframed the issue.

A problem of transition has also dogged corporate restructuring in post-crisis Korea. Concerned with charges of revived interventionism as well as possible litigation a few years down the line, the bureaucrats minimized their involvement. Instead, they opted for

“bank-led corporate restructuring”—an oxymoron in view of the fact that most of the banks in Korea were accustomed to following government directions. As they had done prior to the crisis, the banks looked to the government for guidance on how to deal with large distressed firms. More often than not, “bank-led corporate restructuring” turned into “bankruptcy suspension,” as the banks rescheduled just enough debt to keep the firms going, and the government, the controlling shareholder of the nationalized banks, provided little guidance. This troubling pattern was established in the early phase of the post-crisis period. The bankruptcy of Samsung Motors in 1998 and the Daewoo Group in 1999 indicated that the *chaebol* were no longer fail-proof, but a number of the so-called “workout” firms were allowed to prolong their lives in a state of limbo. Although the government did introduce some policy measures (e.g., forward-looking criteria in asset classification) to encourage the banks to take decisive actions against financially distressed firms, the pace of reform left something to be desired. As the controlling shareholder of the nationalized banks, the government should have taken more proactive measures to facilitate corporate restructuring while quickly implementing reforms designed to improve the operation of the market.

Although institutional reforms in corporate governance and financial resource allocation were certainly less than adequate to address fundamental problems, the Korean economy did a remarkable turnaround in economic performance. Aided by favorable external conditions, particularly an information technology boom in the United States, Korea’s GDP growth rate soared from a negative 6.7 percent in 1998 to a positive 10.9 percent in 1999. Critics who warned of the remaining problems in the economy were dismissed as Cassandras—as if a little more than a year of reform had managed to remove all structural problems. The government and the *chaebol* continued to control the lion’s share of financial institutions. Although President Kim Dae-jung mentioned the need for separation of banking and commerce in his 15 August 1999 speech, few concrete actions were taken. Nor was there any meaningful program to facilitate the privatization of the banks. In the area of corporate governance reform, the mandated increase in the number of outside directors did little to change established practices at the *chaebol*.

Combined with a V-shaped recovery in 1999, the advent of the National Assembly elections in April 2000 further slowed the momentum for fundamental reform. Fearing the political consequences of increased unemployment, the government became increasingly reluctant to close nonviable firms and financial institutions. The opposition party, for its part, made an election issue of national debt, as if it could have cleaned up the massive nonperforming loans problem without issuing government bonds. It also accused the government of selling distressed Korean firms at fire-sale prices to foreigners, as though it knew the appropriate price for these firms. The politicization of the economic issues during the election campaign had an adverse effect on corporate restructuring.

### **The Road to the Second Round of Corporate Restructuring**

Although the politicians on both sides in effect tried to impede corporate restructuring, market forces were unrelenting. The massive bankruptcy of the Daewoo Group in 1999 had greatly increased nonperforming loans in the financial system, but, due to political considerations in an election year, the government was slow to make a request for additional public funds. Burdened with nonperforming loans, financial institutions began to reduce credit supply. Moreover, the Saehan Group’s abrupt filing for workout proceedings in May 2000 revived concerns about the reliability of credit ratings, as the company had been rated investment-grade all along. This once again highlighted the need to enhance the transparency of corporate management and accounting. The Saehan case also raised uncertainty about the viability of medium-sized *chaebol* and resulted in a flight to quality in the financial market. The credit crunch was aggravated by the continued existence of nonviable workout firms, as they sucked in precious resources at the expense of their competitors. Increasingly, these competitors began to complain that “the living dead were driving out the living,” and expressions like “zombie companies” or “vampire companies” began to gain currency. Both the bureaucrats and the nationalized banks, however, had incentives to stick to a forbearance policy rather than adopt structural measures such as privatization to make bank-led corporate restructuring more credible.

Although the politicians and bureaucrats might have hoped that weak firms under “bankruptcy suspension” could grow out of their problems, the economic boom did not last long. Rising crude oil prices and falling semiconductor prices starting in the third quarter of 2000 dramatically worsened the terms of trade.

In addition to the credit crunch and deteriorating external conditions, the continuing troubles at the so-called MH division of the Hyundai Group<sup>4</sup> raised the specter of another massive corporate bankruptcy. In addition, the feudalistic infighting for corporate control at Hyundai illustrated that Korean firms had changed very little with regard to corporate governance. The confluence of these events eroded investor confidence and shook Korea’s financial markets by the fourth quarter of 2000.

In order to calm the markets, the government had to show that it was serious about corporate restructuring. In October 2000, the government summoned the banks to evaluate the credit risks of financially distressed firms meeting the following descriptions: (1) firms classified as “precautionary” or worse according to the “forward looking criteria” asset classification; (2) firms whose interest coverage ratio was less than 1.0 for the past three consecutive years; or (3) firms whose potential default risks were being closely monitored by the banks. On 3 November 2000, the banks announced the results of their credit evaluations for 287 such firms. Of these, 136 were classified as “normal”; 28 were deemed to “have temporary liquidity problems”; 69 were judged to “have structural liquidity problems but are viable” through such measures as a debt-equity swap; 52 were categorized as “nonviable”; and Ssangyong Cement Industrial and Hyundai Engineering & Construction, two of the largest firms on the list, were classified as “other.” Although this announcement did mark the end of bankruptcy suspension for the “nonviable” firms, the result also raised some questions about the strictness of the evaluation criteria used.

In response to criticism, the government promised to encourage the orderly exit of nonviable firms on a regular basis rather than hold an annual or biennial screening event. The government also emphasized that institutional reforms designed to facilitate the exit of nonviable firms, improve corporate governance, and enhance transparency and accountability would be the cornerstone of the second round of corporate restructuring.

## Remaining Challenges

In the last week of December 2000, the Korea Development Bank (KDB) announced a plan to help the corporate sector by rolling over a significant portion of debt that firms would likely have trouble refinancing in 2001. Dubbed the KDB’s “quick underwriting program,” it is helping to roll over 80 percent of the maturing corporate bonds that the issuing firms have trouble refinancing. As of February 2001, five Hyundai affiliates and two firms in the overcrowded cement industry have been selected for the program. Taken together, the seven firms have more than 8.2 trillion *won* (about 6.56 billion dollars) of corporate bonds coming due in 2001.

The KDB’s quick underwriting program is symbolic of the problem of transition that Korea faces in the post-crisis period. The bunching of maturities and the absence of a well-developed market for junk bonds may provide some justification for the program, but the government should not just stop at providing relief to the problem companies. After all, not every Korean firm has trouble having its corporate bonds rolled over. The KDB should charge a premium to reflect the risks associated with the problem bonds and should demand a rigorous program of corporate restructuring, just as the IMF attaches conditionalities to its bailout loans. If the firm in question has more than a simple liquidity problem, it should not be selected for the program. The

---

4. The Hyundai group is in the process of being split into three major sub-groups controlled by three sons of honorary chairman Chung Ju-young. The automobile division, controlled by Chung Mong-koo (MK), met the legal requirement for separation from the rest of the Hyundai group in 2000, and the heavy industry and shipbuilding division, controlled by Chung Mong-joon (MJ), is planning to separate by the end of 2001. The MH division refers to the sub-group of Hyundai affiliates controlled by the fifth son, Chung Mong-hun (MH). This division includes the Hyundai Corporation, Hyundai Electronics Industries, Hyundai Engineering and Construction, Hyundai Merchant Marine, Hyundai Securities, and a number of smaller affiliates. The vulnerable financial structures of Hyundai Electronics Industries and Hyundai Engineering and Construction, in particular, have been a cause for concern since the first half of 2000.

government may temporarily assume the role of underdeveloped or missing markets, but it should abide by economic principles and make a serious effort to let these markets develop.

In particular, such market-creating efforts should focus on improving the autonomy of the financial sector and introducing private remedies to address the problems of corporate governance. As long as Korea's structural problems remain in the areas of corporate governance and financial resource allocation, the investment efficiency of the economy is likely to suffer, making the economy extremely vulnerable to external shocks. Korea needs to push ahead with the second round of structural reform with sights firmly set on the fundamental problems that have plagued the economy for a long time.

*Dr. Lim is a Research Fellow at the Korea Development Institute in Seoul.*

# CORPORATE GOVERNANCE REFORM IN KOREA: A WORK-IN-PROCESS

by Park Yoon-shik

## Corporate Governance Defined

The three main forms of business organization are the sole proprietorship, the partnership, and the corporation. Both a sole proprietorship and a partnership contain inherent organizational weaknesses, such as unlimited liability of the business owner(s) and limited life of the business organization, and hence they find it difficult to raise large amounts of capital at competitive costs. In a modern economy, therefore, the corporate form of business organization has been the preferred method by which to conduct business. By dollar value of sales, about 80 percent of business in the United States is conducted by corporations. A corporation is a legal entity created by a state, and it is separate and distinct from its owners and managers. This separateness gives the corporation three major advantages: unlimited life, easy transferability of ownership interest, and limited owner liability.

Corporations raise their investment funds in two different ways—debt financing and equity financing. Creditors who lend to a corporation are reasonably well protected by loan covenants backed by various laws and court decisions. On the other hand, shareholders, who provide the equity capital of a firm, are the bearers of the residual risk of the firm, their claims coming last after the interests of various classes of creditors are fully met. While fiduciary rules require managers to act in the best interests of shareholders, corporate governance further ensures managerial competence through the exercise of voting power by shareholders to encourage the managers to respect shareholder interests rather than their own self-interests. Thus, corporate governance is a means to reduce the costs imposed by managers (agents) acting in their own interests to the detriment of shareholders. It is a framework of the rules, standards, and management practices that govern the behavior of the managers by defining their duties and accountability to the shareholders. Sound corporate governance is essential to making efficient resource allocation decisions and lowering the overall cost of capital to a firm.

The term “corporate governance” was not very well understood, and the subject was not a topic of much interest in South Korea, until the outbreak of a major financial crisis in 1997. From the early 1960s until the crisis, Korean business practices were heavily influenced by dirigiste government intervention within a framework of the national economic development program. The government was extensively involved in the allocation of financial resources to the favored sectors of the economy, monitoring business performance in those preferred sectors, bailing out troubled big businesses, and intervening in stock market operations to protect investors from undue downside risks. In such an environment, most Korean stockholders did not understand the concept of corporate governance very well and may also have felt little need to exercise their rights. The concentration of corporate ownership among large industrial conglomerate (*chaebol*) families was also promoted by heavy reliance on debt financing rather than on equity capital.

In the aftermath of the 1997 crisis, however, there was widespread recognition that poor corporate governance in Korea was a major cause of the crisis by allowing business firms to rely on debt financing too heavily, resulting in misallocation of resources through over-investments and mis-investments without proper regard for their financial returns. In this circumstance, major international financial institutions, such as the International Monetary Fund (IMF) and the World Bank, encouraged the South Korean government to adopt a variety of new measures to modernize and strengthen corporate governance structure.

## Governance Practices Until the 1997 Crisis

For several decades until the crisis, the South Korean economy was heavily influenced by the government’s export-oriented growth strategy. The government tightly controlled the banking system to channel scarce financial resources into the export sector and other key

industries strategically selected and favored by the government. Business firms in these strategic industries, which mostly belonged to *chaebol*, were able to benefit handsomely from this symbiotic relationship with the government and were able to grow rapidly by investing heavily into those sectors favored by the government. In such a business environment, market share, asset size, and revenue growth were the main focus of large Korean *chaebol*, while cash flow, profitability and the mounting debt burden were systemically ignored. *Chaebol* were controlled by their founding family members, who exercised their control through the centralized office of planning and coordination, which, although without any legal base for its authority, still directed and coordinated such key operations as finance, personnel, and investments of a *chaebol* group's entire affiliated firms. This centralized office was directly answerable only to the office of the *chaebol* chairman.

Even though the founding families directly owned far less than 50 percent of the outstanding shares of their companies listed on the stock exchange, they were able to exercise effective management control over the entire group of companies through cross-shareholdings among the many affiliated firms, both listed and unlisted, within the *chaebol* group. For the top 30 *chaebol*, Korea Fair Trade Commission data showed that the percentage shareholdings of the founding families in 1997 amounted to only 8.5 percent, while cross-shareholdings were 34.5 percent, providing a total shareholding of 43 percent under the direct control of the chairman's office. The comparable numbers were 57.2 percent in 1983 and 43.4 percent in 1993. In addition to cross-shareholdings, *chaebol* firms benefited from inter-company loan guarantees in order to ensure their preferred credit access to both Korean and international financial institutions.

Meanwhile, the rights of minority shareholders were severely limited. They had difficulty in accessing corporate financial information, and their voice was not effectively represented to the management due to the lack of credible legal protection. The degree of transparency of financial statements published by companies was rather low due to inadequate disclosure requirements under traditional Korean accounting stan-

dards. This was confirmed by comparing Korean accounting practices and disclosure rules for a sample of eleven *chaebol* firms and large banks with relevant international accounting standards.<sup>1</sup> The study indicated that there was no disclosure of such key financial information as the amount of related party lending and borrowing, the amount of foreign debt in the currency of repayment, foreign currency translation gains or losses, commitments for off-balance-sheet financing activities and others, as recommended by international accounting standards.

Until 1997, hostile mergers in Korea were almost unheard of, due to the unduly cumbersome tender offer process, while the concentrated *chaebol* ownership structure also made it difficult for outsiders to take over a firm. For example, the law prohibited outsiders from accumulating more than 5 percent of the outstanding shares of a company without an advance filing with the Korea Securities Commission. If anyone wanted to purchase more than 20 percent of the outstanding shares, more than 50 percent of them had to be purchased through a public tender offer. Furthermore, hostile takeovers by foreigners required prior approval by the target company's board of directors, discouraging the emergence of mergers and acquisitions (M&As) as incentives for managers to maximize shareholders' interests in order to prevent a takeover.

Institutional investors such as banks, insurance companies, investment trust companies, and pension funds were allowed only to exercise neutral "shadow voting," except in the case of mergers and business transfers, for the ostensible reason of avoiding an undue exercise of voting powers by outside financial institutions. A system of shadow voting requires institutional investors to cast their votes proportionate to other votes cast. Under this system, institutional investors could not effectively raise their own voices to maximize their share value. Moreover, in many cases institutional investors themselves were affiliated with *chaebol*, reducing their incentives to monitor the management of the company in which they invested. The result was a lack of vigilant oversight and supervision by institutional investors like that which occurs in the United States and other advanced countries.

---

1. Rahman, Matur. 1998. *The Role of Accounting Disclosure in the East Asian Financial Crisis: Lessons Learned?* UNCTAD, 1998.

Internal monitoring and supervision of management by an independent board of directors was also not possible due to the fact that all the board members were the senior executives of the company itself. Their managerial careers were wholly dependent upon the chairman and CEO in a system of lifetime employment. In most advanced industrialized countries such as the United States, boards of directors are a critical element in corporate governance, as they are the link between the outside stockholders and the internal corporate management. On the other hand, the Korean boards of directors did not function as an important internal monitoring mechanism. Due to the widespread practice of lifetime employment, the managerial labor market remained underdeveloped, and this reality further weakened managers' incentives to increase shareholder value at the expense of the interests of the owner/managers.

## Recent Changes in the Korean Business Environment

During the three years since the outbreak of the financial crisis in 1997, the South Korean business environment has changed drastically, forcing companies to change their management practices. Before we discuss some of the major reforms in corporate governance, it may be useful to analyze first some of the important structural changes during the past three years in the business environment. First, as the government has aggressively pursued a policy of economic globalization and liberalization following the advice of such international institutions as the IMF and the World Bank, Korean companies have been constantly forced to meet global standards in terms of business decision-making, financial practices, and accounting standards. Second, operational risk for firms has increased significantly due to the progressive opening of the domestic market and the consequent sharpening of foreign competition, resulting in heightened volatility of both revenues and earnings. Third, restructuring of the banking and financial system pursuant to the Bank of International Settlements (BIS) guidelines has meant that bank loans are no longer automatically available, even to some of the largest *chaebol* component companies, unless the latter can demonstrate credible cash flow projections to potential creditors. Fourth, the government-mandated corporate restructuring has forced *chaebol* affiliates to reduce their debt-to-equity

ratios below 200 percent and to cease cross-guarantee of credits to their affiliated companies and other internal self-dealing. Fifth, the voices of shareholders, including foreign equity investors, have become louder, forcing domestic companies to improve their management performance.

With this drastic change in the business environment, there has been great turmoil in the Korean corporate scene. During the past three years, 17 out of 41 *chaebol*—which have been in and out of the list of the nation's top 30 *chaebol* since 1997—have been placed under a “workout program,” court receivership, court mediation, or “life support” loans from creditors. The second largest *chaebol*, the Daewoo Group, was put into bankruptcy proceedings in early 1999, along with many other *chaebol*. As a result of the government's “big deals” (business swaps), the total number of affiliates of the nation's top 30 *chaebol* decreased from 821 in 1997 to 584 by September 2000. The debt-to-equity ratio of Korean companies decreased from 396 percent at the end of 1997 to 193 percent as of June 2000.

Even though the debt-to-equity ratio has declined significantly, the liquidity of Korean companies has not improved, and the relative interest expense burden for companies has not been reduced much either. This is because they have reduced their debt-to-equity ratios through the issuance of new stock and sale of assets rather than actually reducing the outstanding amount of their debt. As a result, manufacturing companies' average ratio of interest expenses to sales revenues declined only modestly, from 6.4 percent in 1997 to 5.1 percent at the end of June 2000, despite a deliberate low-interest policy pursued by the government. This is far higher than the 2.0 percent ratio of interest expenses to sales in the United States or the 0.9 percent in Japan. Another significant change has been in the area of corporate finance, in that the preferred method of raising capital has now shifted from bank loans to direct financing, such as the issuance of new stocks, corporate bonds, or commercial paper.

## Reforms in Corporate Governance

In the aftermath of the financial crisis, the government initiated a series of reforms to modernize corporate governance practices in South Korea. First, as a means to strengthen the internal monitoring of companies, the

role of boards of directors has been strengthened and their membership diversified by including outside board members for the first time in addition to the traditional inside members from the senior executive ranks. As a first step, all exchange-listed firms were required from 1998 to elect at least one outside director to promote effective monitoring of management. From 1999, this requirement was further strengthened by increasing the proportion of outside directors to at least 25 percent of the board in order to monitor effectively any conflicts of interest between management and shareholders. For large companies with total assets of at least 2 trillion *won* (about \$1.7 billion) as of June 2000, more than half of the board members must be outside directors from 2001. As of 2000, 82 out of 704 companies listed on the Korea Stock Exchange and 8 out of 604 companies listed on KOSDAQ qualified for this category.

In order to ensure their independence, outside directors are also not to be closely related to the major controlling shareholders or to anyone affiliated with them, and the role and power of the board has been broadened significantly to establish the board as the supreme authority for key management decisions impacting the interests of shareholders. Large listed companies are also required to establish an independent audit committee comprised of at least three board members, two-thirds of whom must be outside directors. The chairman of the audit committee must be an outside director. For the purpose of enhancing the independence of auditors, from 1998 external auditors must be chosen by an independent selection committee consisting of internal auditors, outside directors, large creditors, and the two largest non-controlling shareholders.

**Table 1: Outside Directorship for Firms Listed on the Korea Stock Exchange**

	1998	1999	2000
Number of firms	736	701	704
Percent of Outside Directors	11.4%	24.8%	32.3%
Average No. of Outside Directors	0.91	1.72	2.12

*Source: Korea Stock Exchange.*

Since 1998, various steps have been taken to strengthen the rights of shareholders, including especially the minority shareholders. Specifically, minimum shareholding requirements have been drastically

reduced for exercising key shareholders' rights, such as the right to file derivative lawsuits against the company management for any losses caused by mismanagement, to request dismissal of directors and internal auditors, to review accounting books, or to call for a general shareholders' meeting. Laws have been changed to allow institutional investors to exercise their voting rights effectively by abolishing the shadow voting system, and banks have been permitted since 1998 to cast votes for the shares in their trust accounts. Shareholder activism has also been increasing, with the voices of minority shareholders and foreign investment funds now being loudly heard. For example, minority shareholders have filed lawsuits demanding compensation for losses allegedly caused by mismanagement, such as one against Korea First Bank.

Annual shareholders' meetings of Korean companies formerly were convention-like events at which the management agendas were routinely approved. Following the 1998 reforms to strengthen minority shareholders' rights, however, various civic groups representing minority shareholders, such as the People's Solidarity for Participatory Democracy (PSPD), have been vocal in their demand for greater managerial transparency and improved corporate governance structure. Civic groups have also called for minority shareholders' right to recommend and elect their own outside directors as a means to protect their interests. In fact, the PSPD, in cooperation with the Tiger Fund, a major U.S. investment fund and an active institutional investor in Korea, succeeded in the appointment of three outside directors at SK Telecom in 1998. In March 1999, Dacom (a major Korean telecommunication company) reached an agreement with its employee stock ownership association and the PSPD that each of them would appoint one outside director to the board.

Several steps have also been taken to improve external corporate governance mechanisms. In an effort to promote the M&A market, the government has removed the pre-reporting requirements for the purchase of more than 5 percent of the outstanding shares of a company. Laws requiring mandatory tender offers have been abolished, and merger procedures have been simplified. The government has also lifted most regulations restricting share purchases by foreigners. In December 1997, the ceiling on foreign equity ownership was raised from 26 percent to 55 percent of the total outstanding shares of a company, and then the ceiling was

completely eliminated in May 1998. In addition, the earlier requirement that foreigners obtain prior board approval for ownership of more than one-third of the shares outstanding was dropped. Consequently, foreign investors, especially institutional investors such as hedge funds, have entered the Korean stock market enthusiastically, and, as of late 2000, about 30 percent of total Korean shares were owned by foreign investors. In addition to active foreign portfolio investments in Korea, foreign direct investments have been equally robust, with foreign interests taking over leading domestic companies in petrochemicals, paper manufacturing, medicine, food, and automobile components. As a result, the proportion of sales revenues of South Korean manufacturing companies whose controlling shareholders are foreigners increased from 5.5 percent in 1996 to 18.5 percent in 1999.

## Strengthening Financial Disclosure Standards

Right after the financial crisis, there were strong demands for the reform of accounting and auditing practices in South Korea in order to enhance financial transparency. Among others, both the IMF and the World Bank required the government to upgrade accounting standards and disclosure rules to meet international standards. In response, the government embarked on the reform process in two specific areas: (1) revision of Korean financial accounting standards consistent with international best practices patterned after the International Accounting Standards and the U.S. Generally Accepted Accounting Principles (GAAP); and (2) establishment of accounting standards for combined financial statements.

Like most countries, the Korean accounting standards have traditionally required firms that have subsidiaries to prepare consolidated financial statements to cover a parent-subsidiary relationship if a company owns more than 30 percent of the other company's voting interest. Because of the unique *chaebol* ownership structure in Korea, however, several consolidated financial statements were issued within the same *chaebol*, while many affiliated companies of a *chaebol* with less than 30 percent voting interest were not included, even though they were under the effective management control of the *chaebol*. In order to address this reporting gap unique to the Korean *chaebol*

structure, the Korean Parliament passed a bill that requires combined financial statements (CFSs) for large *chaebol* in fiscal years beginning after 1 January 1999. The objective of CFSs is to present each *chaebol* group's balance sheet, income statement, and cash flow statement as a whole under the assumption that *chaebol*-affiliated companies, regardless of their respective voting interests, constitute a single economic entity. According to the new law, the 30 largest *chaebol* designated by the Fair Trade Commission are required to issue audited CFSs covering all domestic and foreign affiliates that are under the effective control of an individual owner and his or her relatives. In this way, all intragroup balances and intragroup transactions are eliminated in the preparation of CFSs.

On 1 August 2000, South Korea's Financial Supervisory Service (FSS) released for the first time a report on the CFSs of sixteen Korean *chaebol* for the fiscal year 1999. Significant variations from traditional *chaebol* financial statements are revealed in such key financial variables as total assets, total liabilities, equity capital, revenues, and profits. For example, the top four *chaebol* in Korea have their sales and total assets reduced significantly in the new CFSs from those reported in their traditional financial statements, while their debt-to-equity ratios (excluding affiliated financial institutions) are much worse than previously reported. Furthermore, like other *chaebol*, their operating income to total revenue ratios for non-financial affiliates were found to be very low, despite the fact that the Korean GDP recorded an impressive real growth rate of 10.9 percent in 1999.

The CFSs show that in 1999 the top four *chaebol* accounted for 75 percent of assets, 76 percent of debt, 72 percent of equity capital, and 77 percent of the total revenues of the sixteen largest *chaebol* in Korea. The CFSs also revealed that many Korean *chaebol* registered very poor operating performance. For nine out of the sixteen *chaebol*, the interest coverage ratio (operating income divided by interest expenses) was less than one, meaning that their operating income in 1999 was not sufficient to cover even the interest expenses of that year, not to speak of total debt service obligations. Among the top four, Hyundai's financial performance was the worst, with an interest coverage ratio of only 0.91. Adoption of international accounting standards and introduction of the combined financial statements have appreciably increased both the trans-

parency and credibility of published financial statements of Korean firms, contributing to a more modern corporate governance structure.

## Agenda for Further Reforms

In 2000, the government proceeded to make further progress in improving corporate governance. Using part of the World Bank's technical assistance loan, the government retained an international consulting group to recommend further steps to improve the governance structure in Korea. Based on the proposal submitted by the consulting group, the government has developed a set of new measures and has submitted the draft to the Korean Parliament for enactment into laws. The goal is to implement the new measures in 2001. These measures make it even easier for minority shareholders to request examination of their company's accounting books and to stop illegal actions taken by company directors. Also, the process of electing new outside board members has been tightened, making the board candidates' experience and qualifications more transparent to shareholders before their voting. Stronger measures are also included to prevent self-dealing between a company and its controlling shareholders and other affiliated parties.

In an attempt to promote the M&A market, the requirement for prior notice to the Financial Supervisory Board (FSB) of a public tender offer has been replaced by post-offer notification to the FSB. The required waiting period between the public tender offer and the actual purchase deadline has been shortened from 7 days to 3 days, and the waiting period for the first tender offer and another subsequent offer is reduced from 12 months to 6 months. The new measures also make it easier for companies to buy back their own shares on the open market and to write off those repurchased shares for the purpose of supporting the market price of shares. The proposal allows the establishment of an after-hours stock market in 2001 in order to create a 24-hour trading market. This is expected to improve stock market liquidity and attract more foreign portfolio investments.

However, the new measures do not include a mandatory cumulative voting system or an immediate implementation of class action suits due to fierce opposition from the business community. A cumulative voting system in the election of board members allows all the shareholders to cast their assigned votes in any manner, including concentration of all their assigned votes for the election slate only of their favored candidates rather than casting one vote for each candidate individually. Such a system enables minority shareholders to elect a few of their own candidates by concentrating all their votes simultaneously only for their own candidates.<sup>2</sup> Even in the United States and Japan, the cumulative voting system is left as an optional choice of companies, and few companies there have adopted it. Countries like the United Kingdom and Germany do not even recognize such a system. Only three countries, Russia, Mexico, and Chile, have adopted a mandatory cumulative voting system. As in the United States, Korea established a voluntary cumulative voting system in 1998, but few companies have actually adopted it. Certain activist civic groups argued for a mandatory cumulative voting system in 2000; however, the government decided not to make it mandatory but leave it to the discretion of each company.

After much debate, shareholders' class action suits have been included in the new government proposal sent to the parliament, despite vigorous opposition from the business community. Class action suits allow one or a group of shareholders to sue their company for compensation of their losses caused by gross negligence or mismanagement, and, if victorious, all other shareholders are equally eligible for the same compensation. In the United States and other countries where class action suits are allowed, there has been bitter criticism by the business community that such a system only enriches aggressive and unscrupulous trial lawyers who are willing to bear the litigation costs on behalf of nominal shareholder plaintiffs in order to collect an astronomical fee if successful. If approved by the Korean Parliament, class action suits are scheduled to become effective from 2002.

---

2. Suppose that ten candidates are proposed, but the total number of board members to be elected is only four. Under a cumulative voting system, a minority shareholder with 1,000 shares will be assigned a total of 4,000 votes, all of which can then be cast for only one candidate rather than spreading 4,000 votes among four of the ten candidates.

## Conclusions

Since the 1997 financial crisis, corporate governance in South Korea has been materially strengthened and improved as a way to modernize business practices and to enhance the international competitiveness of Korean firms. Hopefully, a modernized corporate governance structure can attract more foreign investors and increase the depth and liquidity of the Korean capital market as well. International financial observers have considered weak corporate governance as one of the primary reasons for the poor stock market performance of emerging capital markets in 2000, as it has discouraged foreign portfolio investments. Many studies have also shown that good governance practice leads to better stock market performance. For example, according to a study conducted in 1997 by *Business Week*, the top 25 U.S. companies with the highest governance scores on their boards of directors achieved annual total shareholder returns of 27.6 percent over the previous five years, far outpacing the average annual gains of 19.8 percent during the same period for the Standard & Poor's 500 stock index, while the worst 25 companies (measured by corporate governance) registered average annual returns of only 5.9 percent.<sup>3</sup>

The series of governance measures adopted in Korea since 1998 are likely to increase the transparency of business practices. Adoption of international accounting standards and introduction of combined financial statements for *chaebol* will further improve the credibility of Korean companies for international investors, who have become increasingly important in this era of economic and financial market globalization. On the other hand, it is also possible that the Korean government, prompted by some aggressive civic groups, may have been persuaded to introduce certain governance practices that may not yet be suitable to the Korean business environment. Adoption of class action suits, which are known to be abused even in the United States, could be one such example. It is important that a balanced and measured approach be taken in modernizing and strengthening corporate governance in Korea.

*Dr. Park is Professor of International Banking and Finance at George Washington University in Washington, D.C.*

---

3. "The Best and Worst Boards," *Business Week*, 8 December 1997.

---

# BUSINESS OPPORTUNITIES IN SOUTH KOREA

## ENSURING VITALITY: FOUR ISSUES TO ADDRESS IF KOREA IS TO MAINTAIN ITS COMPETITIVENESS

by Andrew Salmon

*This article sets out four major themes promoted by the American Chamber of Commerce in Korea and makes recommendations which the American business community believes are important for the continued prosperity of the Republic of Korea. These recommendations are based on close observation of Korea's business and social environment. We hope that the points raised will generate discussion, and that all readers will accept this article in the spirit in which it is intended.*

### Introduction

The American Chamber of Commerce in Korea (henceforth AMCHAM) believes that there are four main areas in which the Republic of Korea (South Korea) should consider implementing *institutional, systemic, and behavioral* reforms in order to meet global standards of best practice, while continuing to excel as a modern, democratic, and prosperous nation. In the past, certain parties have suggested that Korea's business, political, and social cultures are intrinsically different from those pertaining elsewhere; therefore, international standards do not apply or should not be applied to Korea. However, with Korea now a major global player in international political and trade institutions—the United Nations, the World Trade Organization (WTO), the Organization for Economic Cooperation and Development (OECD), etc.—as well as being the world's 12<sup>th</sup> largest trading nation and the United States' 8<sup>th</sup> largest trading partner, AMCHAM believes that these allegedly “unique” factors should not be allowed to restrain necessary restructuring.

These four key areas are: Transparency; The Rule of Law; Democratization of Business; and Education.

This article sets out the views of the American Chamber of Commerce in Korea on the problems these issues have created or perpetuated and some recommen-

dations for possible remedies. As a responsible business organization with a very strong vested interest in the continuing competitiveness of the South Korean economy, AMCHAM is willing to put its advice, resources, and contacts at the disposal of the appropriate authorities in order to aid the Republic in addressing these issues.

### Transparency

#### *Why is Transparency Important?*

A transparent political and business environment is essential for sovereign risk ratings, ease of operations, accurate analyses, investment promotion, and fairness in political, legal, and business disputes. Transparency ensures the visibility of incompetence or wrongdoing, and permits appropriate legal proceedings to be carried out fully and fairly, in the public eye and the public interest.

#### *What are the Elements of Transparency?*

Transparency can largely be divided into two areas: political and commercial.

- Politically, a transparent environment includes free, fair and regular elections, a system of checks and balances, and open decision-making processes. Even-handed oversight, and a mechanism for public voices to be heard, should extend from the policy-making arms of government to front desk bureaucrats.
- Commercially, a transparent environment includes clear ownership and management structures and the disclosure of honest and accurate company information to all shareholders. Responsible corporate governance—the oversight of managerial decision making and shareholder inclusion—is a further major element.

## *The Korean Situation*

Korea, having moved from military government to full democracy in under a decade, has made strides in governmental transparency. However, areas of concern remain. The prosecution is not yet fully independent of political influence; there have been delays in pushing reformist legislation through the bureaucratic layers; and the political decision-making process is frequently cloudy. Opacity promotes an environment in which corruption flourishes: South Korea was ranked in 18<sup>th</sup> place (out of 19 leading exporters surveyed) in the Transparency International (TI) 1999 Bribe-paying Index (ahead of China, but behind Malaysia and Thailand); South Korea's position in TI's 2000 Corruption Perception Index was 48 (out of 90 countries surveyed).<sup>1</sup> The latter figure is a minor improvement, but these surveys nevertheless indicate that South Korea's corruption risks are significantly higher than its level of development would suggest. However, we are pleased to note decreased tolerance for corruption among citizens, outspoken internet users bypassing the (conservative) traditional media, and the emplacement of certain mechanisms that permit citizens to air grievances against bureaucratic inflexibility, corruption, poor service, *etc.* Seoul City Hall's publicly viewable electronic oversight of public purchases is an example of the successful implementation of a program which enables citizens to see where their taxes are being spent.

On the business front, progress has been slower. Historically, the industrial conglomerates (*chaebol*) were shielded from competitive pressures in a closed market system. In the early years of economic growth, *chaebol* were channeled into defined sectors. As government control relaxed, cross guarantees permitted them to expand into sectors in which they held no competitive advantage, but which satisfied managerial ambition. Convoluting financial webs were woven between the various affiliates, and the *chaebol* rose to near-total economic dominance.

This "piggy-banking"<sup>2</sup> makes the application and enforcement of improved accounting standards especially difficult. For the investor, it results in an environment

in which money is channeled away from the enterprise in which the investor had originally invested and sunk instead into troubled affiliates. This results in situations such as the November 2000 bankruptcy of Dongah Construction, which dragged down its historically profitable affiliate, Korea Express, on the back of a 700 billion *won* guarantee. Stock Exchange disclosure regulations have not been as strict as those in the United States; only from 2001 will there be a requirement for consolidated, rather than combined, financial statements.

*Chaebol* decisions were—and still are—made behind closed doors, and have often borne little relationship to sound business strategies or shareholder value. They continue to include cross-guarantees and cross-subsidization. Management structures are unclear: *chaebol* heads can control companies through affiliate holdings. Minority shareholders have been unable to enforce their rights, transactions between related parties are rife, hidden affiliates exist, and illegal wealth transfer has taken place in the form of secret stock transfers. There are strong grounds for suspecting collusion in some instances between business heads and auditors. Cumulative voting rights have been voted out of existence by the managements of 75% of listed companies. Market manipulation has been indulged in by *chaebol* financial affiliates, as has the system of "barter" buying (in which, by mutual agreement, two *chaebol* boost their share prices by purchasing each others' stock).

## *Recommendations*

- Beef up the powers, professionalism, and resources of regulatory and supervisory bodies across the board to ensure improved implementation of regulations and more stringent oversight of business than has been the case heretofore.
- Ensure clear, detailed, and accurate enterprise financial statements, which are at the heart of business transparency. In Korea a wealth of raw data is available, but there is insufficient analysis thereof. In the tangled *chaebol* financial webs, an abundance of data can lead to opacity as much as a shortage can.

---

1. For details, see Transparency International's Worldwide Web site: [www.transparency.org](http://www.transparency.org).

2. "Piggy-banking" has come to mean in Korea that a *chaebol* is riding on the back of its affiliated financial institutions.

- Hold auditing and accounting firms accountable for the veracity of their work; audit accuracy remains questionable. After the failure of auditors to correctly assess Daewoo, a number of accountants lost their licenses, while the firm retained was ordered to suspend business for a year. AMCHAM supports this action and recommends continued accountability for the profession. Now that the ceiling on audit fees has been lifted, the profession has no excuse for lax standards. Ensure that, in line with internationally accepted accounting principles, businesses under audit are legally required to disclose all necessary information to accounting firms.
- Require publication of quarterly financial reports. AMCHAM supports legislation in this regard. The combined financial statements produced in 2000 were an improvement over the past, but, due to different financial-year reporting requirements, they did not include *chaebol* financial affiliates. The required publication of consolidated financial statements from 2001 (which will, crucially, list affiliates) is an excellent step. AMCHAM recommends strict oversight of this vital regulation.
- Current supervisory bodies should have their powers reinforced to improve the trustworthiness of disclosed financial information.
- Initiate a program of education in sound business ethics to ensure that officials and businessmen understand exactly what constitutes breach of fiduciary responsibility. This can be implemented through the adoption, dissemination, and oversight of practical codes of behavior for financial professionals (e.g., the Association for Investment Management and Research's "Standard of Practices Handbook" provides a globally accepted code of ethics). Introduce professional licensing standards to the financial industry, together with mechanisms to oversee application of these guidelines.
- Appoint truly independent outside directors rather than corporate "yes men" in order to provide objective, professional input into corporate decision-making—or, at the very least, to oversee management. This will be possible only if minority shareholders' voting rights are promoted.
- Protect the rights of small shareholders. Revise the law so that cumulative voting is enshrined, and class action lawsuits are permitted. These laws would make managers accountable. A Milken Institute report<sup>3</sup> notes that valuations of firms controlled by inside shareholders lag behind those of comparable firms—suggesting large-scale expropriation by the principals.

### **Benefits**

Greater transparency will lead to company fundamentals becoming clear to investors, ensuring that capital flow into the market is provided on a rational basis—channeling capital to viable enterprises, while nonviable companies, shortcomings exposed, will be unable to access funds. This will rationalize and stabilize the corporate landscape.

Greater capital flows will lead to growth in capital markets. This will permit Korean companies to expand based on *equity*, rather than on *debt*. It will also provide beneficial competitive pressure on banks.

Accessibility of trustworthy analysis should allow investors to take informed, reasoned decisions, rather than current practices which are short-term in nature, based on rumor or inside information and likened to gambling. Such investments are thus viable only for those with disposable income. The removal of uncertainty, together with heightened awareness of the risk levels of investments, should lead to greater participation in the market by ordinary Koreans. With the market being seen as a viable long-term destination for investment (on the back of improved corporate governance), democratization will filter from the political sphere to the economic.

In a transparent business climate, managerial shortcomings will be exposed, leading to informed calls for resignations of inept or fraudulent managers. The fact that there has been little managerial change—even in companies under court receivership or workout—suggests substantial resistance capacity at Korea, Inc.'s top levels. If restructuring is to succeed, managerial heads need to roll. This may contribute to mollifying

---

3. See Root, Hilton L. 2000. "Korea's Recovery: Don't Count on the Government." Policy Brief (May). Santa Monica, California: The Milken Institute.

labor, which has thus far borne most of the pain of restructuring.

Conversely, the heightened visibility of professional managers with successful track records should lead to managerial mobility and the creation of a CEO market in Korea. With shareholders recognizing the benefits of professional and successful management, *chaebol* owner-families will be pressured to improve managerial practices.

The disclosure of transparent financial data will apply pressure to the unproductive money (“entertainment” expenses, *etc.*) which forms such a major segment of Korean corporate expenses.

## The Rule of Law

### *Why is it Important?*

A clear set of laws establishes rules for and regulates the behavior of citizenry, government, and markets. If necessary, it imposes penalties for transgressions. Equally important is oversight and implementation of laws, and citizens’ attitudes towards the law: Is the law impartial, adhered to, respected, and enforced? Particularly for foreigners coming into a new market, a clear, comprehensible, and utilizable legal system is a bedrock of business, as it establishes operational ground rules.

### *The Korean Situation*

Although Korea has a highly qualified legal profession and laws covering most areas, implementation is problematic. The legal profession is, while professional, elitist, extremely small, very costly, and lacking in career specialization. These factors are probable contributory causes in underuse of the system. Another factor in underutilization of legal/contractual resources is the preponderance of relationship-based business deals.

Korea uses a civil law system modeled on the German system of the 1870s. This in effect means that judges, prosecutors, and lawyers all enter the system with the same education. This is not problematic in itself—but mandatory geographic reassignment of prosecutors and judges every two years means the removal of acquired expertise. This has a particularly serious effect on com-

mercial and bankruptcy courts (predominantly based in Seoul). For example, an IMF-sponsored project reworking Korean bankruptcy law was hindered when reassignment removed the most experienced Korean team member.

The guidelines under which law is interpreted are at the discretion of bureaucrats charged with implementation. In effect, this means that, although laws are available for perusal, there is no transparency in their implementation; the crucial guidelines are not required to be made public. An example of the difficulties this causes is the case of a foreign securities company which was unable to access the regulations it required to establish in Korea.

Bureaucracy has also exhibited a strong tendency to resist implementing new legislation. In the insurance sector in 1999, life insurance pricing was deregulated, but officials continued to insist upon the previous system. There is also the problem of consistent compliance throughout the bureaucracy. Chemical importers have noted that national customs regulations are applied differently at different ports of entry.

Many existing laws are enforced unevenly or not at all. This makes things difficult for foreign investors who, lacking experience in-country, will be unable to distinguish between those laws that need to be adhered to and those that are routinely ignored. In the auto field, for example, foreign manufacturers suspect that emission standards are ignored by local manufacturers. There is also minimal compliance with water pollution laws.

Many laws are overly idealistic, making them impossible or extremely onerous to follow in practice. This is the case with labor law; even now, with layoffs being permitted by law, the actual practice of reducing staff remains extremely vexatious. Labor laws date from the period when the Korean economy was dominated by smokestack industries, and thus they lack the flexibility required by hi-tech small and medium-sized enterprises (SMEs). For a tech company wishing to reassign staff or work under pressure (frequently the case in fast-moving sectors, when a flurry of activity requires heavy overtime), “one-size-fits-all” labor laws are a hindrance.

The number of cases in which individuals at high levels of government or business have been perceived to

have flouted or broken the law without incurring relevant penalties is substantial. This lessens respect for the law in the minds of citizens and contributes to “them-and-us” and “smart-guys-break-the-law” mentalities.

There is occasional unnecessary intrusion of criminal law into commercial disputes. For example, in civil misrepresentation cases, the charge of fraud can be leveled, making a relatively simple commercial case a criminal case, resulting in unjustifiable jail terms. Conversely, in some commercial cases, penalties incurred for serious transgressions have been mere slaps on the wrist. A company which has made an illegal deal will hardly be deterred from repeating its actions if financial penalties incurred are less than the profit made.

The authorities have also often used the law—particularly tax law—as a blunt weapon against disfavored companies.

### ***Recommendations***

- Improve dissemination of legislation and oversight of its application throughout the bureaucracy. Civil servants charged with implementation of law need to be fully informed of, and trained on, legal revisions; their performance needs to be overseen on local and national levels to ensure compliance with government directives. Bureaucratic guidelines on implementation should be made public.
  - Place greater emphasis on the law as Korea moves towards international business standards. As Korea continues to globalize, the importance of law, domestic and international, will only increase. Emphasize the contract, in particular.
  - Increase the number of graduating lawyers, prosecutors, and judges (now approximately 800 per year) in order to cope with the increasing demands being placed on the legal profession. This can be done by putting in place an objective examination system in which all who meet a certain standard pass, rather than the current quota system based upon the number of entrants the field feels it requires.
  - Introduce greater professional specialization into the court system.
- Adhere to and apply the rule of law evenly in order that it may be respected. If law is to be rigorously adhered to, it must be realistic; a number of overly altruistic laws (such as those relating to layoffs, severance pay, and environmental protection) may require modification. Lawmaking must be practical and practically enforceable. If unrealistic standards are legislated and then are ignored or under-enforced, respect for the rule of law falls across the entire social spectrum.
  - Establish clear legal precedents for the punishment of corporate wrongdoing and apply these penalties impartially. This would send a message to the market, dispel rumors of favoritism towards certain conglomerates, and restore confidence in legal/regulatory authorities. More stringent sanctions, in which penalties incurred for an illegal deal outweigh profits accrued from that deal, would provide appropriate deterrence.
  - Allow entry of foreign law firms so as to increase the options open to companies seeking legal resources, and introduce foreign competition—heretofore lacking—into the legal system. This would also provide a significant “comfort factor” for multinationals seeking to establish in Korea. With even Vietnam now permitting the establishment of foreign law firms, Korea looks increasingly out of touch with global norms. This step could also aid Korean firms wishing to expand overseas.

### **Democratization of Business**

Korea’s business landscape has long been dominated by the *chaebol*. In the past, this situation made sense: under prevailing political winds, the *chaebol*, working within the framework of a command economy, were the engines of national economic growth. In today’s environment, this system is no longer viable. What is required is a landscape in which agile small and medium-sized enterprises can access funds and flourish, and where their participation and survival are not linked to a *chaebol*. Similarly, government has played a key role in deciding in which industries companies are permitted to invest. While this has reined in the *chaebol* to an extent, it has also distorted market mechanisms. Since the financial crisis, the government has—perhaps necessarily—taken a strong role in the financial

sector. However, re-privatization plans for this crucial sector remain unclear.

Daewoo has been hailed as the death of the “too big to fail” mentality. However, although the Daewoo Group has been broken up, Daewoo affiliates have failed to exit the market and instead have been kept afloat with public money. Daewoo Motors, for example, is believed to be costing the taxpayer \$80 to 100 million a month. Of the 41 conglomerates which have been in and out of the top-30 list since 1997, 17 have been placed under court receivership, mediation, or debt workout, or have received life support from creditors. Failure to liquidate “zombie” companies is a massive drain on the economy. As more good money is thrown at bad companies, credit dries up. This adversely impacts smaller companies which have neither the high-level relationships with banks or officials, nor the economy of scale, to warrant preferential treatment. The credit situation for SMEs is unfavorable. With the exception of the unprecedented venture boom in late 1999 and early 2000, SMEs in Korea have historically been unable to access capital. In 1999, more than 50% of new funds raised in Korea went to the top-5 *chaebol*—largely in the form of corporate bonds. As of May 2000, only 1.8 trillion *won* (about \$1.5 billion) had been invested in venture start-ups. Given the scale of the economy, this is small change. Lack of managerial change in failing companies is also a serious concern.

Another aspect of economic democratization—empowerment of minority shareholders—is dealt with in the section on transparency above.

### **Recommendations**

- Continue cutting the ties between *chaebol* affiliates. Extensive and comprehensive oversight is needed to ensure that the process is carried out consistently, transparently, and rigorously. This will force companies to succeed or fail on their own merit, rather than continue the current situation, in which failing affiliates receive cash infusions from otherwise unrelated arms of the parent group—resulting in unfair competition for companies which have to succeed using only their own resources. This process will level the playing field, permitting SMEs and start-ups to compete on an equal footing with larger, longer-established companies.

- Improve Korea’s exit mechanisms—*i.e.* insolvency and bankruptcy laws—and increase their utilization. Awareness needs to be raised nationwide that short-term pain is a lesser evil than continuing misallocation of capital resources. The government, which controls much of the financial sector, needs to take the lead in cutting credit to “zombie” companies.
- Educate investors in the concept that investment is a risk which can lead to loss. This will result in investors and creditors sharing the burden of corporate failure, rather than government’s shouldering it exclusively.
- Institute better analytical systems for banks so that capital can be most effectively allocated. Banks need to train staff in assessing start-up business plans, making credit and risk assessments, and providing ongoing business advice and financial products to small businesses.
- Promote privatization. State-owned enterprises, such as the Korea Electric Power Corporation (KEPCO) and Korea Tobacco and Ginseng, have had their privatization schedules delayed due to inhospitable market conditions. While KEPCO privatization looks like it will go ahead as planned, the timetable for Korea Tobacco and Ginseng privatization is still uncertain, as is the situation of Korea Gas (KOGAS). By breaking up and privatizing these companies, a more efficient, fairer, and freer market system will develop. Also, introduce a structured timetable for bank re-privatization.

### **Benefits**

The promotion of meritocracy in business will lead to opportunities for all companies, rather than for just a favored few, and will more firmly entrench Korea’s promising, but fragile, hi-tech venture sector into the economic landscape. This does not mean the death of large businesses, simply the death of *inefficient* large businesses—leading financial and human resources to move towards more productive fields. Ideally, competitive *chaebol* cores will remain to maintain economies of scale, while SMEs will flourish concurrently. This would introduce the benefits of a Taiwanese-style economy running in tandem with Korea’s heavy industrial structure. Furthermore, it will diversify the economy away from its current over-reliance on a limited number of manufactured products.

## Education

While education is not an area with which a business organization such as AMCHAM would usually concern itself, it is our belief that educational reform is vital to the success of the economy.

### *Strengths and Weaknesses*

Korea's greatest strength is its well-educated and diligent workforce. Culturally, Koreans hold immense respect for education. The public education system produces a highly literate, numerate, and disciplined population. Diligence is a virtue for employers, and this characteristic is strongly imbued during the rigorous school years, as is respect for seniority. Parents spend prodigiously on extra-curricular education, a factor behind spending on education, which is high even by OECD standards.

The exam system is entirely objective and scrupulously fair, making education a true path to upward mobility.

However, the reasoning behind the examination system—in which knowledge is acquired solely for the purpose of passing tests—is outdated and uneconomical in terms of time and return on resources. The system also supports a huge private tutoring industry, which suggests that schools alone cannot satisfy demand.

A system in which students are expected to be “sponges”—absorbing knowledge without questioning the teacher—ingrains a habit of not questioning superiors which is detrimental in adult life. It also leads students away from thinking for themselves and problem solving, instead referring them to the “textbook” answer and stifling creativity. Even in higher education, this attitude is visible: the Dean of Academic Affairs of one of Seoul's top five universities was quoted as saying that copying from other scholars' work was a matter for praise not rebuke, as it proved that the students concerned had at least read the relevant research. (Compare this to the attitude in western universities, where plagiarism is grounds for disciplinary action and even expulsion.) This attitude is a probable contributory cause to the problems Korea has faced, and continues to face, in protecting intellectual property rights.

AMCHAM members have noted that, while Korean employees are hard working, literate, fast adopters of new technologies and are in possession of improving English skills, they are unprepared to take basic initiatives which a western company would expect. Furthermore, they are unwilling to raise their voices in front of their superiors. In corporate situations, where personal initiative and free and open discussion is desirable, and where a manager will use his staff as a sounding board for new ideas, these characteristics are detrimental. Open—even contrary—discussion is especially essential at Board of Director levels.

Due to the harshness of the local educational environment, increasing numbers of Korean parents are sending their children abroad for education. This is a positive, as it improves English skills and provides international experience, but it is also a rebuke to the Korean system. As foreign education is costly, however, it may also prove socially divisive.

In the years in which Korea was a top-down industrial society, the education system produced a workforce well attuned to industry's demands: diligent, disciplined, responsive to authority, and willing to work hard in the national interest. As Korea's economy matures and moves away from the heavy industrial model toward a system which can harness creative thinkers capable of producing high-level R&D and innovative business models, while productively utilizing human resources, educational reforms will need to be instituted. In a world in which creativity and originality are more important than massed ranks of laborers, an education system which fosters these qualities is essential.

### *Recommendations*

- Encourage the virtue of seeing—and offering—differing viewpoints and opinions. Teachers need to promote problem-solving skills and to generate questions and independent thinking, rather than simply providing answers. A more flexible system, capable of adjusting to and nurturing the differing talents of the student body is required, rather than a “one size fits all” educational/exam model.
- Reduce class sizes to enable students to work in problem-solving groups and to permit teachers to give individual attention. At the undergraduate level, fully utilize the benefits of the seminar, so that in-

structors can directly challenge students and promote discussion.

- Allow some leeway in university entrance criteria rather than concentrating exclusively on exam scores and academic records. Permit universities to choose applicants on the basis of students' personal interests, extra-curricular activities, interview results, *etc.*, in addition to entrance exam scores. The danger will be in losing the fairness and objectivity of the current system, but a certain amount of subjectivity is permissible, as professors involved in selecting students will intimately understand the requirements of the courses they teach.
- Disseminate and enforce a code of ethics throughout the teaching field. This code should include clear definitions of favoritism and corruption and should lay out the penalties. Students also need to be educated in what constitutes plagiarism—and why it is bad.
- Implement objective grading systems in university departments, rather than mandating artificial quotas of “As,” “Bs,” and Fails.
- Increase cooperation between local and foreign universities (*e.g.*, professorial exchanges and jointly taught or administered courses) as a method of raising standards.
- Continue to promote use of English. It should be taught as a *language*, not as an *academic subject*. It would also be desirable to remove restrictions on broadcasting in English.
- Increase the current use of information technology (IT) in (and outside) classrooms. Use of IT by students allows them to bypass problematic teaching methods, learn by doing, and acquire skills which will be useful in working life.

## Conclusions

It is no coincidence that the above issues overlap and are interlinked. Improved transparency, mandated and enforced by the rule of law, will contribute to a leveling of the business playing field. Educational reform will further strengthen Korea's formidable human capital in all areas and promote the desirable social changes which are implicit in the points raised above. AMCHAM believes that, by addressing these issues,

Korea can continue to thrive, as Korean skills in manufacturing and knowledge-based industries, in connection with its increasingly important geopolitical position at the crossroads of Northeast Asia, open up substantial opportunities in this millennium.

*Mr. Salmon is Research and Publications Manager at the American Chamber of Commerce in Seoul.*

# THE INFORMATION TECHNOLOGY SECTOR IN KOREA

by Choi Gae-iyong

## Introduction

Economic development relies largely on the effective use of information and knowledge, knowledge of how to organize society to allow productive activities to flourish and how to create an economic environment facilitating coordination among economic agents. The information technology (IT) sector connects individuals and firms via networks, thereby facilitating the production, distribution, and consumption of information by the whole economy and promoting development of the intangible economy. In particular, the advance of the Internet in the business world largely depends on the development of the IT industry. The development of information technology enables the explosive growth of electronic commerce and business re-engineering.

In recent years, the world IT industry has undergone radical changes. The evolution of information networks is occurring through the explosive growth of telecommunications service users, expansion of the communication bandwidth, and the advent of various new services and technologies. Since the World Trade Organization (WTO) agreement on basic telecommunications services,<sup>1</sup> the liberalization of the telecommunications service market has been accelerated. Inevitably, telecommunications service providers are racing to make global alliances with other providers in different regions to meet users' needs. Most of the trade barriers in the IT equipment market have also been lifted by tariff removals under the Information Technology Products Agreement (ITA) of 1996.

Given these environmental changes, the IT industry in Korea has grown impressively. In the 1990s the average IT production growth rate was about three times the GDP growth rate, and information technology's

share of the total trade volume was also great. This has resulted in diverse spillover effects, such as electronic commerce, new distribution channels, and the digitalizing of traditional content. The main objective of this article is to review the current situation of the IT industry in Korea and its meaning for the whole economy.

## The IT Industry as a Driver of Growth

Information technology industry classifications differ among countries. This article will follow the industry categorization of the National Statistical Office<sup>2</sup> of Korea. Three sectors—telecommunications services, equipment, and software—are included in the IT industry category. Telecommunications services include wired, wireless, value-added, and other specific services. Equipment covers computers and peripherals, insulators and cable, electronic tubes, wired and wireless communication devices, and broadcasting equipment. Software means packaged software and computing-related services such as systems integration.

Since the middle 1990s, IT production in Korea, including the sales of telecommunications services, has enjoyed an average annual growth rate of 21 percent, more than three times the GDP growth rate in the same period. IT industry production has contributed significantly to the recovery of the domestic economy, recording a growth rate of 13.9 percent in 1998 and 16.8 percent in 1999. As a result, the IT industry accounted for 10.7 percent of total GDP in 1999 on a value added basis, much increased from 8.1 percent in 1996. In 1999, total IT production was valued at 107.5 trillion *won* and is expected to reach 128.5 trillion *won* (about \$107 billion) in 2000.

---

1. The 1997 Basic Telecommunications Agreement (4<sup>th</sup> Protocol) under the General Agreement on Trade in Services (GATS).

<sup>2</sup> See *Report on the Information and Telecommunications Survey*. 1999. National Statistical Office of the Republic of Korea.

The increasing weight of the IT industry in South Korea's GDP is significant, for it has contributed more to economic growth than any other industry. In 1999, the IT industry accounted for 38.3 percent of the growth in GDP,<sup>3</sup> greatly exceeding its 10.7 percent overall share in GDP.

The information technology industry has also played a great role in price stabilization and in the current account surplus. In 1999, the producer price index of the IT industry was lower than that of the total of all industries, recording a 6.4 percent and 2.0 percent rate of decrease, respectively, and continuing to decline. As for trade, exports of IT products in 1999 reached \$39.95 billion and a sectoral trade surplus of \$13.5 billion. Information technology accounted for 28.5 percent of total exports and 56.1 percent of the gross trade surplus. Exports of IT products are expected to reach \$47.7 billion (with a \$16 billion sectoral surplus) in 2000. Mobile terminals, liquid crystal diodes (LCDs), liquid crystal monitors, and personal computers (PCs), together with traditional export items such as microchips and cathode ray tubes, are the main components of IT exports which have led to the IT industry trade surplus.

On the other hand, the principal IT imports are wafers, micro-components, transmission devices, wireless communication parts, and transistors.

### The Present Condition of the IT Industry by Sectors<sup>4</sup>

The three sub-sectors—telecommunications services, equipment, and software—accounted for 20.2 percent, 75.0 percent, and 4.8 percent, respectively, of the IT industry in 1999, compared to 25.6, 69.9, and 4.5 per-

**Table 1: Production, Domestic Sales, and Trade Balance in the IT Industry**

		1998	1999	2000
Production	won trillions	88.3	107.5	128.5
Valued-added		42.4	51.6	61.6
Domestic sales		71.2	91.6	110.6
Exports	\$ billions	30.5	40.0	47.7
Imports		18.2	26.5	31.7
IT Industry Trade Balance		12.3	13.5	16.0

Source: Korea Association of Information & Telecommunications. 2000. *Statistical Yearbook of Information & Communications Industry in Korea*, (June).

cent in 1996. The relatively high proportion of telecommunications equipment is due to large exports in this category, which implies that the growth of the IT industry depends significantly on foreign markets. According to market forecasts by the Korea Information Society Development Institute, the relative proportions are expected to change to 18.6, 66.5, and 14.8 percent, respectively, by the year 2004, as the software sector is growing rapidly.

### Telecommunications Services

The telecommunication services sector<sup>5</sup> grew at the rate of 20.1 percent in 1999, rebounding from the sales stagnation caused by the economic slump in 1998. It is expected to grow at an average of 12 percent per year by 2004. The facilities-based services sector has grown 15.4 percent on average every year from 1997 to 1999. Wired telecommunications services and broadcasting services, which suffered from sales decline in 1998, enjoyed an upturn in 1999, showing 9.1 percent and

3. The IT industry contribution rate to GDP growth is the share of real value-added increase from the IT industry to the real increase of value-added from the whole economy. See *The Effect of IT Industry Development on Productivity*, Bank of Korea, 2000 (in Korean).

4. The market forecasts in this section are from Korea Information Society Development Institute. 2000. *Mid-term Market Forecast of Information and Communications Industry (2000-2004)* (in Korean).

5. In Korea, telecommunications services are classified into three categories: facilities-based telecommunications services, value-added services, and specific services. Facilities-based telecommunications services (including telephone services, integrated services digital networks {ISDN}, cellular phone services, personal communication services {PCS}, trunked radio service {TRS}, pagers, and satellite communication services) involve networks owned by the service provider. When the network is leased, the service is called a value-added service (including enhanced fax services, data network services, value-added network services, and on-line information processing services). New services, such as voice resale, Internet phone, international callback and private line services are classified as specific services.

6.8 percent growth, respectively. Wireless services grew surprisingly in 1999, at the rate of 73.2 percent, and they are expected to grow further as IMT-2000 and Internet usage spread. The number of wireless service subscribers reached 26.6 million in October 1999, surpassing the number of wired subscribers. The introduction of a third-generation wireless network (known as IMT-2000) in 2002 is expected to promote the wireless services sector as well as the content sector.

Value-added communication services grew 23.2 percent annually from 1997 to 1999. Steady high growth is expected due to the expansion of new services like virtual private networks (VPN) and traditional services such as personal computer communications and Internet access. Specific communication services grew explosively at 221 percent in 1999. This growth rate, however, is expected to decline because of intensified competition from basic communication services operators and due to the saturated international voice market.

Sales of broadcasting services declined by 17 percent because of shrinkage of the advertising market in 1998, but sales grew again by 6.8 percent in 1999 due to economic recovery. Owing to the start of digital broadcasting, cable TV and satellite broadcasting are expected to grow over 20 percent annually for the next 5 years.

### ***Equipment***

In 1999, total Korean production of IT equipment (telecommunications equipment, information equipment, broadcasting equipment, and electronic components) reached 80.6 trillion *won*, 15 percent growth from 1998. This was aided both by increases in domestic sales as the economy recovered and increases in exports. The domestic sale of IT equipment reached 64.3 trillion *won*, and the IT equipment trade surplus was \$13.77 billion.

The production of IT equipment is expected to grow 11.6 percent annually from 2000 to 2004, mainly due to increased investment by telecommunications services providers and the diffusion of Internet usage. Moreover, the increase in domestic sales and exports of satellite and digital broadcasting equipment will contribute to greater IT equipment production.

The recession in 1998 resulted in less growth in the production of telecommunications equipment, except

for mobile terminals. In 1999, however, new business investment and purchases by the public sector contributed to an 18.1 percent growth. The increasing demand produced by the construction of a third generation wireless network (IMT-2000) and high-speed, mobile data communications should lead to sustained growth of almost 9 percent annually by 2004.

The production of information equipment, including PCs and peripherals, increased by 37.8 percent in 1999, based on expanded exports of low-cost PCs, hard disk drives, and optical disk drives. After 2000, sustained annual growth of 7 percent is anticipated as a result of increasing demand from individual households and companies.

Production of broadcasting equipment in 1999 increased by 56.1 percent owing to expanded exports of satellite broadcasting receivers. It is expected that a high growth rate of 36 percent will continue till 2004 due to the expansion of digital satellite broadcasting services.

The production of electronic components, including semiconductors, LCDs, and printed circuit boards, grew 48.3 percent in 1999, backed by an increase in exports and growing domestic demand. In particular, the production of semiconductors reached 26.4 trillion *won* (about \$21 billion) in value in 1999, accounting for over 61% of the total Korean production of electronic components. After 2000, increased demand for PCs, expanded distribution of mobile phones, and the distribution of digital TVs will lead expansion of the electronic components sector, with over 13 percent annual growth expected by 2004.

### ***Software***

Despite the economic crisis, software production increased by 22.5 percent from 1997 to 1999, but software is still a negative in the trade balance. However, software production is expected to grow at a rate of almost 33 percent annually by 2004 due to increases in public investment, expanded outsourcing of computing services, and the IT consulting market.

The production of packaged software from 1997 to 1999 grew by 6.8 percent annually. In particular, the demand for business application software such as ERP (Enterprise Resource Planning), SCM (Supply Chain

Management), CRM (Customer Relationship Management) and KMS (Knowledge Management System) is increasing. The sales of computer related services, including system integration services, increased by 30.8 percent during the period from 1997 to 1999, and there will be market expansion due to increasing IT investment by small and medium-sized companies and the boom in electronic commerce.

## The Rapid Growth of New Business

The expansion of the Internet now influences individual customers as well as entrepreneurs. The increase in the number of Internet users and more sophisticated information and communication networks enable customers to overcome time and space limitations when they choose products. The number of Internet protocol (IP) addresses in South Korea increased from 7,255,552 in 1999 to 13,810,176 by September 2000, while Worldwide Web domains registered with the “kr” (Republic of Korea) suffix increased from 207,023 to 511,003. As of August 2000, the number of Internet users had reached 16.4 million, including 2.67 million subscribers to high-speed Internet access such as digital subscriber lines (DSL) or cable modem services.<sup>6</sup> In Korea, cable modem service gained ground earlier than DSL, but the growth of DSL is outpacing that of the cable modem. There are 1.73 million users subscribing to DSL-based Internet access and 0.94 million to cable modem-based Internet access. Accordingly, electronic commerce is now emerging as a promising new field in Korea.

### *Electronic Commerce*

The advantage of electronic commerce from businesses to consumers (B2C) is that it can enhance distribution efficiency at low cost through activating information transactions among the interested parties. This means that fields with less efficient distribution channels will be given more impact by electronic commerce. According to a report by the Ministry of Commerce, Industry,

and Energy,<sup>7</sup> the number of Internet shopping malls in Korea in January 2000 was about 1,500, much larger than the 60 in 1997. Currently, B2C is active in the fields of personal computers, automobiles, books, clothing, and gifts. The average value of online shopping by each Korean Internet shopper for six months (June 1999 to November 1999) was 220 thousand *won*, increasing to 340 thousand *won* (about \$280) during the six month period December 1999 to May 2000. The total value of online purchases was 202.7 billion *won* from June 1999 to November 1999, increasing to 736.0 billion *won* (about \$605 million) during the period December 1999 to May 2000.<sup>8</sup>

B2B (Business to Business) electronic commerce is the biggest segment of electronic commerce. It is also regarded as the most important for its spillover effect to the whole economy. Through electronic commerce it is possible to purchase from the cheapest suppliers and to reduce transaction costs. In addition, total costs can be reduced by improved supply chain management and inventory control. In 2000, a number of e-markets in manufacturing sectors like electronics, automobiles, steel, clothing, and chemistry were established. Internet banking, cyber-stock trading, and electronic commerce in logistics, distribution, and international trade became prevalent. Of 842.9 trillion *won* of total value of B2B transactions during 1999, the value of goods and services traded between companies over the Internet was estimated at 9.86 trillion *won*, and this amount is expected to increase to 17.52 trillion *won* in 2000. Moreover, various auction sites are initiating C2B (Consumer to Business) and C2C (Consumer to Consumer) transactions.

### *Digital Content Business*

On the other hand, the explosive increase of Internet users and highly advanced Internet networks greatly contributes to digitalization of traditional content such as books, music, and movies and promotes service businesses which provide digitalized content. Internet movie

---

6. Data from the Korea Network Information Center.

7. See “Electronic Commerce White Paper,” Ministry of Commerce, Industry, and Energy. 2000.

8. See “Statistical Investigation on Electronic Commerce in Korea,” Korea Information Society Development Institute. 2000, (June) (in Korean).

services are expected to grow as subscribers to broadband Internet access services like DSL and cable modems increase. About 30 Internet movie service companies in Korea provided service in May 2000, and most of them buy copyrights of ready-made films rather than produce new films. Internet music refers to digitalized music files distributed via the Internet. As the transmission speed of information through the Internet is improved, and zipped audio files like MP3 appear, users can easily store music files on their PCs. Accordingly, the Internet music market is growing rapidly. Currently about 10 Internet music service providers have alliances with traditional disc producers. Text information like encyclopedias, professional and academic publications, newspapers, magazines, and general books are digitalized earlier than music and movies. The so-called e-book service is a new business where users can download digitalized books to their PCs for exclusive usage. As of August 2000, about 20 companies are providing e-book services, and about 100 texts are sold per company each day. Games are a promising business area, also. The Korean game market reached 12.39 billion *won* in 1999. As the number of Internet users steadily increases, online games have become the most representative entertainment in the digital era. A number of Internet service providers (ISPs) have begun online game services. Webcasting, the fastest growing area, is a service which supplies all kinds of digital content—music, movies, and text information. There were only 5 webcasting companies in 1997, but about 700 as of August 2000.

This increased demand for digitalized content signals the possibility of big changes in the distribution channels of traditional content industries. Distribution channel changes can appear first in audio and text areas which are easier to digitalize and to distribute with current technology. When broadband Internet becomes prevalent, services for full movies will gradually spread. For the digital content industry to experience high growth, however, a stable business model is urgently needed. The current business model, mainly relying on advertising revenue, must change into a model based on services for a fee. The mere digitalization of existing content cannot induce consumers to use a fee-based service. Consequently, the future of digital content depends on production of brand new material and supply of customized services which can meet the diversified demand of consumers in the information age.

## Conclusions

This review of the IT sector in Korea has identified the areas of high growth potential. For the telecommunications services sector, the introduction of a third-generation wireless network and the expansion of Internet use will boost multimedia data communication services. Domestic sales of IT equipment are closely related to the increasing role of data communication services. Major export items such as semiconductors, mobile terminals, PCs, and LCDs will support the growth of the IT equipment sector. Among the three sub-sectors of the IT industry, the software sector is expected to experience the highest growth rate by 2004. As information technology spreads in the business world, the demand for business application software and computer related services will increase. In sum, the overall growth rate of the IT industry is expected to continue to be higher than that of the overall GDP. This implies that the IT industry proportion of GDP and its contribution to GDP growth will both increase. Moreover, the development of the IT industry is promoting the emergence of new businesses in Korea, including electronic commerce and digital content enterprises. The spread of electronic commerce is expected to reduce transaction costs and enhance the efficiency of distribution channels. Digital content is expected to be the single most promising area of electronic commerce. As we enter into the information age, the IT sector, both traditional IT industry and new businesses, will remain one of the most dynamic business areas in Korea.

*Dr. Choi is a research fellow at the Korea Information Society Development Institute (KISDI) in Seoul.*



---

# U.S.-KOREA ECONOMIC RELATIONS IN 2000

## U.S.-KOREA ECONOMIC RELATIONS IN 2000—A VIEW FROM SEOUL

by *Cho Tae-yul*

Trade and economic relations between the United States and South Korea in 2000 confirm the ever-stronger bilateral ties between the two nations, especially in the aftermath of South Korea's late 1997 financial crisis. Two-way trade and investment have continued to rise. Through close and constructive engagement, we have successfully kept our bilateral trade issues at arms length, so that overall partnership between our two countries is not held hostage to occasional trade frictions.

### Overall Trade and Economic Relations

Strong economic performances in both the United States and South Korea (hereafter, Korea) combined to leave a monumental mark during 2000 in the history of bilateral trade relations between the two countries. For the first time, the volume of bilateral trade between the United States and Korea in 2000 surpassed the \$60 billion mark, making Korea the United States' 6<sup>th</sup> largest export market and 7<sup>th</sup> largest trading partner. In 2000, U.S.-Korean trade stood at \$67 billion. This is truly remarkable, given that U.S.-Korean trade amounted only to a negligible several hundred million dollars in the early 1960s.

It is noteworthy that this trade upsurge took place both ways and is not attributable to an increase in one-way traffic. Both Korea's exports to and imports from the United States increased considerably compared with the same period in 1999, mainly thanks to continued pick-up in demand in both countries. Based on Korea's customs clearance data, Korea's exports to the United States for 2000 amounted to \$37.6 billion, an increase of 28 percent over the year 1999. During the same period, Korea's imports from the United States increased 17 percent, to \$29.2 billion.

This trend continued in the investment sector as well. Despite some difficulties faced by Korean industries,

Korean investments into the United States amounted to nearly \$1.1 billion in 2000, whereas the flow in the other direction was an even more impressive \$2.9 billion. This continued increase in U.S. investment is unmistakable testimony to the greatly improved investment environment in Korea, a result of Korea's firm commitment to make the country one of the best places in the world to do business.

A few of the outstanding cases of U.S. investment into Korea in 2000 are: S&K Development invested \$500 million in Korea's tourism complex in the suburb of Seoul; Fairchild Semiconductor invested \$149 million in the semiconductor industry; and Philips Investment Company invested \$24 million in the chemical sector. Korea's investment into the United States includes Saerom Technology's \$60 million investment in the communications sector; Samsung Electronics' investment of \$18 million in the semiconductor sector; and Taekwang Company's \$15 million investment in the footwear industry.

The two governments played their parts in further improving the business environment. A case in point is the Korea-U.S. Social Security Agreement, signed in March 2000 between Foreign Minister Lee Joungeun and Secretary of State Madeleine Albright in Washington, DC. The agreement will take effect on 1 April 2001. Under this agreement, American businessmen who reside in Korea for less than five years are exempt from paying social security taxes, and the same benefit is accorded to Korean businessmen doing business in the United States.

Korea and the United States have also maintained close cooperation in international economic fora, such as the World Trade Organization (WTO) and the Asia Pacific Economic Cooperation (APEC). The two countries have worked together to restore momentum for the early launch of a new multilateral round of trade

negotiations under the WTO. In APEC, Korea and the United States made joint efforts to revitalize trade liberalization and facilitation processes and to introduce new proposals in various APEC activities.

## **Bilateral Trade Issues**

It seems unavoidable that some trade issues arise between two countries which enjoy an annual bilateral trade volume of more than \$60 billion. What is important is to manage the occasional trade disputes through dialogue, so that the close overall relations are not damaged.

This is exactly what both governments have in mind. The United States and Korea have been extensively engaged in a series of bilateral consultations to address market access-related issues, including, in particular, issues relating to steel, intellectual property rights (IPR), automobiles, and pharmaceutical products. Thanks to these consultations, considerable progress has been made in resolving bilateral trade disputes. Multilateral fora have also been mobilized for the purpose of exploring ways to resolve trade disputes.

### ***Bilateral Investment Treaty***

Both Korea and the United States believe that a Bilateral Investment Treaty (BIT) between the two countries will provide greater opportunities for Korean and American businessmen to strengthen their presence in each country through creating legal frameworks to protect and promote every aspect of investment, even during the pre-establishment phase.

Unfortunately, some issues, including the politically charged issue of movie quotas, still hamper the conclusion of a BIT between our two countries, despite significant progress achieved over the years. It has reached a point that strong political will is required to move the stalled process to conclusion.

### ***The Automotive Trade Imbalance***

Over the past two years, the Korean government has faithfully implemented the 1998 Korea-U.S. Automotive Memorandum of Understanding (MOU), taking, *inter alia*, various proactive measures to improve Ko-

rean consumers' perception of imported vehicles. President Kim Dae-jung personally delivered a congratulatory message welcoming the Import Motor Show held in Seoul in May 2000.

Unfortunately, however, the share of imported vehicles in the Korean automobile market has not grown satisfactorily. With a view to finding ways to address this lingering problem, we will continue to work closely with the U.S. government and the automobile industry. On the other hand, we hope that foreign automakers, in their marketing efforts, will be sensitive to the cultural aspects of Korean consumption patterns and the market structure dominated by small and medium-sized vehicles in Korea.

In this regard, we find it regrettable that Ford at the last minute withdrew from its bid to purchase Daewoo Motor Company. We hope that General Motors' renewed efforts to take over the company will bear fruit. This would help dissipate any lingering negative perception of foreign vehicles by Korean consumers, thus contributing significantly to redressing the imbalance in our bilateral automotive trade.

### ***IPR Protection***

Thanks to close and constructive engagement between our two governments, there has been considerable progress in recent years in Korea's IPR protection in general, and protection of computer software programs in particular. A revised Computer Program Protection Act was enacted in December 2000, thus creating a strengthened legal framework for the protection of software programs.

We hope that any remaining issues, particularly in regard to enforcement activities against piracy of protected works, will be resolved through continued dialogue between our two governments. Korea's commitment to strengthening enforcement efforts remains unchanged.

### ***Steel***

Faced with a surge in overall steel imports, the United States continues to express concerns about some aspects of its steel trade with Korea, such as the increase in Korean exports of steel products to the United States and the delay in the privatization of the Pohang Iron &

Steel Corporation (POSCO), one of the biggest steel companies in the world.

Thanks to the hike in demand for steel products in both Korea and Southeast Asia, Korea's steel exports to the United States in 1999 decreased by 26 percent over 1998. This trend continued well into 2000, with steel exports from Korea to the United States projected to decline by 14 percent compared with 1999.

The disposal of the remaining 6.84 percent share of POSCO that the Korea Development Bank holds was made through issuance of depository receipts, which were sold to POSCO, thus paving the way for the completion of the privatization process. POSCO was officially declared a private company in September 2000 by being removed from the list of public corporations.

Immediately following the withdrawal of Ford's bid for Daewoo Motor Company, Nabors Consortium in October 2000 abruptly withdrew from its planned purchase of Hanbo Steel Company. This was another shock for the Korean economy. Despite the resulting difficulties, however, the Korean government will make every effort to dispose of the bankrupt Hanbo Steel.

### ***WTO Resolution of Bilateral Trade Issues***

Since its establishment in 1995, the WTO has proved itself an effective forum for resolving trade disputes among more than 140 member countries. The United States and Korea have been among the most active and frequent users of WTO dispute settlement mechanisms.

In 2000, Korea initiated WTO panel proceedings against the United States in regard to two cases: (1) U.S. safeguard measures on pipeline imports; and (2) U.S. anti-dumping duties on stainless steel imports from Korea.

In December 2000, Korea, together with the European Community, Japan, India, and four other countries, requested formal consultations with regard to the so-called Byrd clause that was inserted into the Agriculture Appropriations Bill for 2001. This clause would allow for distribution to the affected U.S. companies of anti-dumping and countervailing duties collected from imported products. It is the view of many countries, including Korea, that this clause is not consistent

with the relevant WTO rules. We hope that the U.S. government will take appropriate corrective measures in cooperation with the Congress in 2001.

There were two WTO panel decisions rendered in 2000 on disputes involving Korea and the United States: Korea's procurement procedures for the Incheon International Airport, and its beef import system, both of which were initiated by the United States. The WTO panel ruled in favor of the United States regarding the beef case, but it ruled in favor of Korea with respect to the airport procurement case. Korea plans faithfully to implement the WTO panel ruling on beef.

## **Commitment to Economic Restructuring**

### ***Persistent Pursuit of Reforms***

We are fully aware that reform is not a matter of choice, but a matter of national survival, as President Kim Dae-jung succinctly remarked in his address for National Day 2000. Despite remarkable achievement in our economic reforms, we have no illusions about the acute need to complete the economic restructuring process, especially in the financial and corporate sectors. We know that there are many challenges that still need to be tackled, and we are determined to deal with any tasks required to reshape and transform our economy into one responsive to market forces, with minimal government intervention.

In the financial sector, further cleanup of weak commercial banks and restructuring of the merchant banking sector will be completed; disclosure rules will be strengthened and rigorously enforced; financial holding companies will be established in an effort to develop large financial institutions and universal banking services; and financial supervision will be further strengthened through the application of forward-looking criteria to the non-banking sector.

On the corporate side, bankruptcy laws will be revised to help exit failed companies from the market. Continued monitoring will take place; tighter accounting standards will be enforced; and a new Code of Best Practice for Corporate Governance will be developed with a view to further promoting transparency and accountability. In addition, the Fair Trade Commission will have extended access to financial transaction

information so as to ensure that unfair business practices will be matters of the past.

Further reforms in the labor and public sectors, as well as market opening and investment liberalization, will continue to receive attention from the government and will be pursued with the same vigor and determination as before.

### ***Implications for the Korea-U.S. Economic Relationship***

With these restructuring efforts completed in 2001, Korea will emerge as a country with transparent and accountable economic systems in place, and it will be able to build its future on a firm economic foundation.

There has been and will continue to be tremendous change in Korea's business environment. Gone is the brash young upstart, muscling its way into foreign markets and keeping its doors tightly shut. Gone is the historic antagonism toward foreign companies, and finally gone are the days of state intervention in the market.

These changes that the Korean economy has been undergoing and will continue to undergo are creating tremendous opportunities for foreign businesses and investors. In recent years, especially following Korea's financial crisis, we have witnessed a much stronger presence of American business in Korea, represented by the consistent hike in trade and investment figures.

A growing number of American businessmen and investors have begun to benefit from their undertakings with Korea. This trend is most welcome in Korea. President Kim Dae-jung has often emphasized that any companies doing business in Korea, whether foreign or domestic, are Korean companies and should be treated as such. We will make every effort to ensure that trailblazers and their followers from foreign countries will reap immense rewards for actively engaging with their Korean counterparts.

### **Future Prospects**

There is an old Korean saying that the ground hardens after rainfall. This proverb most aptly describes the huge benefit that the financial crisis brought to Korea.

That unprecedented crisis did indeed bring about massive unemployment and other hard-to-bear pains for the Korean people. This hardship, however, was a "blessing in disguise," as it offered Korea a rare opportunity to cure very fundamental weaknesses of the Korean economy.

The crisis had another very important result. The already close relations between our two countries have been further strengthened as Korea worked to overcome the financial crisis. Following the outbreak of the crisis in late 1997, the United States spared no effort in rendering financial as well as policy support. The United States has also kept its market wide open for foreign products, including those from Korea, thus helping crisis-ridden countries weather the unprecedented storm.

Our close relationship will continue to develop into an even more mature partnership as the Korean economy becomes stronger through across-the-board restructuring and trade and investment liberalization. In order for this prospect to materialize, we will continue to work closely with the new U.S. administration. We would welcome any friendly suggestions or thoughts from the government and business communities of the United States on ways best to deal with the huge national challenges facing Korea in the years to come.

*Mr. Cho is Counselor for Economic Affairs at the Embassy of the Republic of Korea in Washington, D.C.*

# U.S.-KOREA ECONOMIC RELATIONS IN 2000—A VIEW FROM WASHINGTON

by Anne M. Galer

## It Was a Very Good Year...

The turn of the millennium was a year of historic proportions for the United States and South Korea. The historic summit between President Kim Dae-jung and Chairman Kim Jong-il, and the visit by U.S. Secretary of State Albright to Pyongyang, were evidence of a degree of change on the Korean Peninsula unmatched in generations. Conclusion of a new U.S.-Republic of Korea military Status of Forces Agreement and extensive consultations on issues ranging from nonproliferation to the environment illustrated the continuing closeness of our bilateral relations, which has been facilitated by open communication at all levels.

Underpinning the headline events was a year of relatively smooth economic relations, as well. South Korea's economy continued its strong recovery from the financial crisis, and the U.S. economy continued to expand and take in a substantial increase in Korean imports.

The year 2001 promises to hold more historic occasions, and it will be one in which we continue close political cooperation with the Republic of Korea. However, as growth in both countries slows, 2001 also promises to be a more problematic year on the trade front. Analysts and markets will be closely watching the measures which Korea takes to consolidate economic reform and to move into the future with internationally competitive companies and sustainable growth of its economy.

## Trade to Figure More Prominently in 2001

In 2000, Korea moved up to become the United States' seventh largest trading partner, and the United States continued as Korea's largest. Two-way trade exceeded \$68 billion. Korean exports grew 28 percent, to total \$40.28 billion, while U.S. exports grew 23 percent, to total \$28.15 billion. The bilateral trade deficit for the United States grew a significant 46.3 percent over 1999—from \$8.3 billion to \$12.14 billion. Korea's

exports of semiconductors, computers, and autos topped the list of increases.

Despite the growth in exports on both sides, concerns by U.S. producers about impediments to trade have increased in a number of areas. Action will be required to meet these concerns and to dissipate mounting frustration so that we avoid slipping back into another era of considerable trade friction.

### *Access for U.S. Automobiles*

Foreign automobile sales still comprise a minuscule 0.5 percent of the Korean market, less than before the 1997–98 crisis, despite much effort on the part of U.S. auto manufacturers and continuing discussion under a 1998 U.S.-Korea Memorandum of Understanding which was intended to increase market access. In 2000, Korean automakers sold 470,357 cars in the United States alone, compared to only 4,414 cars sold in Korea by all foreign manufacturers.

Given the success of U.S. autos in markets across the world, the low export numbers to Korea do not seem justified in a truly open market. Moreover, the perception that the Korean government was acting to slow foreign imports was fueled in 2000 by the Finance Ministry's preliminary announcement of regulations requiring reporting of certain auto purchases for purposes of tax enforcement. There was a direct correlation with the drop of foreign car sales, as consumers, fearing tax audits, steered away from purchasing foreign-made cars. The U.S. auto industry is concerned, and statements from Congress have escalated in 2001, giving urgency to securing increased access for American automobiles in Korea.

### *Agriculture*

Korea is a major market for United States agricultural products, with U.S. exports over \$1.6 billion and access for U.S. products a high-priority. In 2000 there was an uptick in our industry's perception of problems,

particularly in access for U.S. beef, a \$645 million market.

New rules of origin proposed by Korea's Ministry of Agriculture—slated to come into effect at the beginning of 2001—threatened to cut off all U.S. beef exports to Korea. After extensive consultations, Korea agreed to postpone implementation of these rules until January 2002. The rules would have required cattle from third countries to reside in the United States for six months for their meat to be considered of U.S. origin. We have serious questions about these proposed requirements and will be working with the Korean government on whether and how these measures may be applied.

In addition, the United States will be watching carefully as Korea implements corrective changes after the World Trade Organization (WTO) finding that Korea discriminated against beef imports from the United States. Korea had confined sales of imported beef to specialized stores, limited the manner of its display, and otherwise constrained opportunities for the sale of imported beef.

### ***Intellectual Property Protection***

Improved intellectual property rights (IPR) protection would allow Korea to benefit more fully from the new knowledge-based economy. Improved protection and enforcement efforts are essential if Korea is to be removed from the U.S. "Special 301" Priority Watch List to which it was elevated in April 2000. Longstanding intellectual property protection issues include concerns for adequate pharmaceutical patent protection, computer software protection, and vigorous enforcement of protective laws. Korea has taken major steps to correct deficiencies in its Computer Program Protection Act (CPPA), and we hope there will be more positive actions to bring about a lessening of IPR trade problems in 2001.

### **A Strong Korean Economy for a Strong Future**

A strong South Korean economy is needed to meet the challenges of global competition and as an asset in the South's engagement with North Korea. A vibrant, competitive economy can only be achieved with a credible

restructuring of Korea's ailing corporate sector and continued efforts to strengthen the financial sector by instilling transparency and risk-based lending practices.

International markets recently reacted negatively when the Korean government resorted to directing Korea Development Bank to underwrite the redemption of unmarketable bonds in six companies which are affiliates of industrial conglomerates (*chaebol*). This action was viewed as a weakening of government resolve to proceed with corporate reforms. Korea quickly sought to quell such speculation, asserting an agenda of continued *chaebol* reform and underlining the temporary nature of the bond action.

U.S. concerns are twofold. The first, as one ally to another, is that Korea not undermine the health of its future economy and the true progress it has made in reforming Korea's financial system by resorting to government assistance to corporations. Our second concern is that U.S. industries not be disadvantaged by possible subsidies that could weaken their overall competitive position.

### **Close Ties to Continue**

Because we exchange views with Korea in so many economic fora—the International Monetary Fund (IMF), the World Trade Organization (WTO), the Organization for Economic Cooperation and Development (OECD), and the Asia Pacific Economic Cooperation (APEC), to name just a few—there will be ample opportunity for each government to convey its concerns and reasoning in this economic and trade dialogue. As always, we look forward to working closely with South Korea in the year ahead to solve problems and to share ideas that will help both of our economies to grow and prosper.

*Ms. Galer is Economic Section Chief in the Office of Korean Affairs of the U.S. Department of State in Washington, D.C.*

# ECONOMIC RELATIONS BETWEEN KOREA AND CHINA IN 2000 AND 2001

by Huh Seung-jae

## Reviewing the Year 2000

South Korean-Chinese economic relations, which have developed rapidly since the establishment of diplomatic relations between the two countries in August 1992, also made considerable progress in 2000. Although some trade disputes between South Korea and China have occurred, they have been resolved through negotiation. Furthermore, Korea and China have reached important agreements in aviation and fisheries. Korea has expressed great interest in the “Great Western Development Strategy,”<sup>1</sup> which the Chinese government enthusiastically launched in March, and dispatched three delegations of Korean bureaucrats and entrepreneurs to western China to initiate feasibility studies. When Prime Minister Zhu Rongji visited South Korea in October, Korea and China also agreed on a “comprehensive cooperative partnership” in economic relations, in both name and reality.

## Bilateral Trade

### *The Rapid Rise in Trade Volume and Status*

South Korean-Chinese trade has increased rapidly at 20 to 40 percent annually. According to Korean statistics, bilateral trade was just \$5 billion in 1991 before the establishment of diplomatic relations, but the volume quickly expanded to \$23.6 billion in 1997. In 1998, the Asian financial crisis affected bilateral trade, which decreased sharply to \$18.4 billion. However, since 1999 the situation has changed noticeably. Based on Korean statistics, bilateral trade reached \$22.6 billion in 1999, approximately the same volume as before the crisis, and exceeded \$30 billion by the end of 2000, which would be more than a 40 percent increase over 1999. As a result, China and South Korea have become each other’s third largest trading partners.

### *Increase in Bilateral Trade Disputes*

With the increase in bilateral trade, trade disputes have also grown. Two disputes, of which one was raised by each side, are particularly noteworthy. One in mid-2000 related to the Korean government safeguards against Chinese garlic. The other was about imports of Chinese marine products, in which Korean importers found many unexpected objects like lead ingots and netting. In addressing these problems, Korea discovered that there still exist big differences of opinion on economic relations between South Korea and China. Korea also realized that it should dispense with the notion that China will always be friendly to South Korea. Efforts to develop economic relations should be undertaken from a longer-term and more comprehensive viewpoint.

### *China’s Trade Deficit*

While South Korea and China reached agreements on some disputes, the problem of China’s trade deficit with South Korea has become more pronounced. According to Korean statistics, Korea had a cumulative bilateral trade surplus of \$20.3 billion from 1993 to 1999, but China insisted that the deficit reached \$9.4 billion in 1999 and surpassed \$10 billion in 2000. Chinese estimates may be a bit exaggerated, however, considering Chinese exports in 2000. Based on Chinese statistics, China’s exports to Korea from January to October were worth \$9.3 billion, a 54.2 percent increase year-on-year, the most rapid growth among China’s ten biggest trading partners. Comparing the growth rate among China’s ten largest trading partners, the growth of Korean exports to China was the second largest at the end of 2000. Chinese export growth figures for 2000 were: United States \$52.1 billion (+24.2 percent), Japan \$41.7 billion (+28.5 percent), European Union \$38.5 billion (+26.4 percent), ASEAN \$17.3 billion (+41.3 percent), Russia \$2.2 billion (+49.2 percent),

---

1. This refers to China’s long-term strategy, launched in March 2000, to boost the development of the twelve provinces of the western region.

Australia \$3.4 billion (+26.8 percent), and Canada \$3.2 billion (+29.8 percent). Despite this fact, the Chinese government has repeatedly complained about the trade deficit problem, so Korea should take more active and comprehensive measures to tackle this problem.

## Investment Cooperation

### *Rapid Growth in Direct Investment from South Korea*

Korean companies began to invest in China late compared with other countries that had begun to invest as early as the 1970s. Korean investment in China started in the late 1980s, but initially was only small and exploratory in nature. However, Korean investment in China increased rapidly after the establishment of diplomatic relations, especially after 1994. According to Korean statistics, growth was quite rapid, reaching \$4.6

billion as of December 2000. This represented 17.5 percent of total Korean investment in foreign countries. China ranks next to the United States as Korea's favorite investment destination. According to Chinese statistics, however, cumulative Korean investment, as of May 2000, had already reached \$9.7 billion, making Korea the 6<sup>th</sup> largest investor in China.<sup>3</sup>

### *Characteristics of South Korean Investment in China*

South Korea's investment projects have ranged from small to large. In the past, Korean capital enterprises were mainly small and medium in size, not large. But in recent years, giant enterprise groups such as LG, SK, Kumho, Hyundai, and Samsung have increased their investments in China. Investments by SK and LG in 2000 were particularly impressive, because those groups tried to diversify the regional distribution of their investments from the Bohai Sea rim and China's three northeastern provinces to China's middle and

**Table 1: Korean-Chinese Trade (1996-2000)<sup>2</sup>**

*Korean Statistics* (US\$ billions, % increase)

	1996	1997	1998	1999	2000
Total Trade	19.9 (20.4)	23.6 (18.2)	18.4 (-22.3)	22.6 (22.6)	31.4 (43.2)
Exports to China	11.4 (24.4)	13.6 (19.3)	11.9 (-12.0)	13.7 (14.6)	18.6 (37.6)
Imports from China	8.5 (15.4)	10.0 (16.8)	6.5 (-35.9)	8.9 (36.7)	12.8 (62.4)
Trade Balance	2.9 (62.8)	3.6 (26.4)	5.4 (52.1)	4.8 (-11.0)	5.8 (21.0)

Source: South Korean Customs Service.

*Chinese Statistics* (US\$ billions, %)

	1996	1997	1998	1999	2000
Total Trade	20.0 (17.7)	24.0 (20.3)	21.3 (-11.6)	25.0 (17.7)	34.5 (37.8)
Exports to S. Korea	7.5 (12.3)	9.1 (21.5)	6.3 (-31.3)	7.8 (24.9)	11.3 (44.6)
Imports from S. Korea	12.5 (21.2)	14.9 (19.6)	15.0 (0.4)	17.2 (14.7)	23.2 (34.7)
Trade Balance	-5.0 (38.1)	-5.8 (16.9)	-8.7 (50.1)	-9.4 (8.0)	-11.9 (20.1)

Source: China Customs Administration.

2. The South Korean government assumes that the differences in Chinese and Korean bilateral trade figures are partly accounted for by different handling of trade to Hong Kong. The two nations hold a bilateral trade data reconciliation meeting annually to attempt to cope with the discrepancies in trade data.

3. The South Korean government has not found a satisfactory answer to the differences in Chinese and Korean data on bilateral investments.

western provinces. The Korean government has also paid much attention to the Great Western Development policy, launched by the Chinese government in 2000, and has conducted various feasibility studies.

### ***Increased Chinese Investment in South Korea***

Investment by Chinese enterprises in Korea was just \$140 million as of September 2000, which is relatively small compared with Korean investment in China. Interestingly, about half of this cumulative investment into Korea (\$60 million) was contracted between January and September 2000, suggesting a significant acceleration.

### **Expansion of Korean Banking in China**

In November 1998, South Korea and China agreed that, as one of five main projects, the Chinese government would permit Korean banks to conduct transactions in Chinese *renminbi* (RMB) and would also give approval for the Korean Insurance Company to operate in China. Based on this agreement, Korea worked hard to accomplish those goals. On 2 March 2000, the Shanghai branch offices of Korea's Industrial Bank and Hanvit Bank received permission from the Chinese government to transact in RMB. On 18 August, Hana Bank also obtained approval to operate and opened a branch office in November. When Prime Minister Zhu Rongji visited Korea in October, the Chinese government also approved the operation of the Samsung Insurance Company in China. Samsung is now preparing to open an office in Pudong, Shanghai. As Korean banks receive approval to operate in China, this will be very helpful to Korean companies in finding a larger market there. It will also secure a bridgehead for more Korean banks to enter the Chinese market.

### **Official Development Assistance**

Official Development Assistance to China can be divided into two parts: Economic Development and Cooperation Fund (EDCF) loans, and grant aid by the Korea International Cooperation Agency (KOICA). Following the establishment of diplomatic relations, South Korea agreed to provide an EDCF loan amounting to \$230 million for 26 projects between 1992 and 1999. Eleven projects were canceled, however, due to

some problems in China, so Korea is now searching for new projects within the same dollar amount. As for grant aid, from 1992 to 1999 the Republic of Korea provided a total sum of \$28 million, \$10 million of which was used to construct the Korea-China Career Training Center, which opened 19 December 2000.

### **Fishery Agreement and Aviation**

#### ***The Fishery Agreement***

On 3 August 2000, Korea and China signed a fishery agreement which had been under discussion since the establishment of diplomatic relations in 1992. This agreement will come into effect after both countries agree on the details of the conditions of operation. It will solidify a basis for the preservation of fishery resources and for the establishment of fishery systems between the two countries.

#### ***Expansion of Airline Services***

After the establishment of diplomatic relations, tourism between the two countries increased at a rapid pace. About 990,000 South Koreans visited China in 1999, while 310,000 Chinese visited South Korea. This trend continued in 2000. Between January and October, 1,135,000 Koreans visited China, and 375,000 Chinese visited Korea. If this trend continued, by the end of the year the number of Koreans who visited China and Chinese who visited Korea will have been 1,350,000 and 450,000, respectively. With the sharp increase in tourism between the two countries, the demand for airline services has exploded, but the service now cannot satisfy this demand because of limited aviation routes and insufficient flights. To redress this situation, Korea and China held a meeting on aviation in September and agreed to expand service from 28 to 34 routes and from 120 to 250 flights per week. This agreement will go into effect in March 2001.

### **Prospects for Korean-Chinese Economic Relations in 2001**

During the second half of 2000, the South Korean economy experienced difficulties because of oil price fluctuations and the incomplete adjustment of the domestic economic system. Entering December, oil prices

have returned to normal, and the domestic political and economic situation has gradually settled down. Based on this situation, we expect that during the first half of 2001 the domestic economy will begin to recover. China will likely experience some confusion due to the rapid market openings and radical systemic adjustments associated with China's entry into the World Trade Organization (WTO), which is expected in the first half of 2001. This situation will have mixed effects on the expansion of bilateral trade and cooperation in investment. Furthermore, there may be some non-economic elements that affect economic relations between Korea and China, even after China's entry into the WTO. To deal with these factors, Korea needs to prepare some constructive solutions to tackle the balance of trade problem which China cites on numerous occasions.

## **Bilateral Trade**

### *South Korea's Export Target*

The South Korean target for exports to China in 2001 is \$22.6 billion, a 21.5 percent increase over exports in 2000. If China enters the WTO in 2001 as expected, the Chinese government will have to abolish or loosen various controls and regulations relating to trade. Also, 2001 will be the first year of the "Tenth Five-Year Plan," and there will be an increase in various projects. These conditions will promote bilateral trade between Korea and China. Furthermore, the Chinese government will continue the policy of stimulating domestic consumption in 2001, and the demand for high-quality household electric appliances, communication equipment, and environmental protection-related equipment will become stronger in proportion to the increase in private income.

### *The Trade Balance*

The biggest stumbling block in the development of South Korean-Chinese bilateral trade is the problem of the trade balance, about which China has repeatedly complained in recent years. The main reason for the trade imbalance lies in differences between the two

countries' industrial structures. It is therefore an unavoidable structural problem that is based on the principles of market economics. But Korea needs to make some effort to alleviate the problem, such as the cooperative development of new trade goods, measures to increase imports of Chinese goods, and expansion and development of Korean-Chinese economic relations.

The reason China has a large trade deficit with Korea is that there are products which China wishes to import from Korea, and, in accordance with the universal principle of market economics, when one buys more than one sells, a deficit is the result. China imports many intermediate inputs from Korea for its exports. For example, more than 11 percent of Korean exports to China in 1999 were electric and electronic parts from which Chinese firms produced such products as televisions for export. China would appear to gain more by seeking to expand and develop bilateral trade between the two countries rather than view the trade imbalance as the principal problem in bilateral economic relations. Reform of the license system, which controls import-export companies, improvement of export product quality, and more active attempts to open up the Korean market will be much more helpful in reducing the imbalance. As for Korea, it needs to concentrate its efforts on finding and developing its advantages.

## **New Ways of Investment**

In 1999 China absorbed 61 percent of the foreign investment realized in Asia's newly developing countries,<sup>4</sup> which means that China maintained the most stable investment climate in the region. Since 1992, many South Korean entrepreneurs have invested a good deal of money in China, but their success rate has been relatively low. In the 21<sup>st</sup> century, Korean investment in China will continue to increase, but Korean investors will have to conduct thorough feasibility studies of investment options, while concentrating on ways to reduce the failure rate. China also needs to clarify its domestic policies in order to induce more foreign investment, establish more reasonable foreign exchange policies, and bolster Chinese investment in Korea.

---

4. Essentially, all countries except Japan, Australia, and New Zealand.

## Cooperation in Other Economic Fields

Cooperative research on trilateral economic cooperation among South Korea, China, and Japan will be launched in 2001. The three countries will begin to study trilateral trade and investment, information technology reform, and development of trilateral information and communications flows. Korea and China will also organize a bilateral economic cooperation research group to find desirable ways to promote bilateral economic cooperation in the 21<sup>st</sup> century. South Korea has already stated several times that it will participate actively in the Western Development Plan, which the Chinese government launched in 2000. In 2001, Korea and China will study ways to cooperate on natural gas pipeline construction, social capital construction, natural resource development, and environmental protection. Also in 2001, China will chair the Asia-Pacific Economic Cooperation (APEC) group. South Korea, as a neighboring country, will participate and seek ways to help China to achieve success as the chair.

*Mr. Huh is Second Secretary for Economic Affairs at the Embassy of the Republic of Korea in Beijing.*

# CHANGES IN SOUTH KOREA'S POLICY TOWARD REGIONAL TRADE AGREEMENTS

by *Cheong Inkyo*

## Introduction

South Korea's unprecedented economic growth over the past three decades has enabled it to rank close to many advanced countries in terms of the scale of its economy and trade. The Korean government, for its part, decided that the economic meltdown of late 1997 was not a one-time incident, for which a rapid flow of short-term capital could be singled out as the culprit. Rather, the government's assessment was that the crisis should primarily be attributed to structural deficiencies that past administrations had failed to rectify.

In this regard, the South Korean government has adopted active measures for short-term economic recovery as well as for long-term economic soundness. The government has also changed its trade policies in order to adapt promptly to the changing world economic environment. One new policy that the government has decided to pursue is negotiation of free trade agreements (FTAs) with major trade partners.

This article discusses the Republic of Korea's new directions towards regionalism and future prospects, as well as progress on a free trade agreement with Chile.

## New Directions toward Regionalism

Though South Korea has achieved economic growth under the multilateral system of the GATT/WTO,<sup>1</sup> its reaction to the widening spread and deepening of regional trading blocs has been lukewarm due to domestic opposition to market opening under regional trading agreements. However, since the financial crisis began, the Korean government has been reevaluating the potential gains to be made by removing trade barriers on a preferential basis, and it has decided to pursue the establishment of preferential trading blocs.

One major motivation behind South Korea's new thinking on regionalism is the trade diversion caused by the growth of regional trading blocs. A 1995 WTO report discusses the causes of the rapidly rising number of regional trading blocs that were created in the early 1990s. That report concluded that the growing trends toward regionalism were insurance policies in the event of failure of the Uruguay Round of worldwide trade negotiations. An implication of that conclusion was that regional integration initiatives would weaken as the multilateral trading system became firmly established. Yet, following the inauguration of the WTO, the trend towards more regional trading blocs with deeper scope has continued. Regionalism is one of the most dominant trends in the world economy today. There were only 26 new regional trade agreements (RTAs) reported to GATT prior to 1969. Following a weakening in the pace of regional integration in the 1980s, the number of RTAs exploded in the 1990s. Thirty-five additional regional agreements were signed during 1995 and 1996, and 17 such agreements were reached in 1997 and 1998. This demonstrates that, rather than simply being an insurance policy against potential shortcomings of multilateral free trade, regionalism is seen as a viable commercial strategy that complements multilateral trade agreements.

In line with this increasing trend towards regional integration, Seoul has altered its past position of opposing regional trade blocs and is now cautiously investigating the establishment of FTAs with major trading countries. Not only was fear of being left out of the recent trend of growing regionalism a motivating factor for Korea's change, but the outbreak of the Asian financial crisis also played a large role in Korea's decision. Korea has opened most of its financial sectors to foreign investors and has implemented unilateral trade liberalization measures.

---

1. GATT/WTO = The General Agreement on Tariffs and Trade, and its successor institution, the World Trade Organization.

South Korea's new trade policy is aimed at promptly adapting to the changing economic environment, as well as resolving the nation's economic difficulties. Consequently, an ultimate goal of this policy is to transform Korea into an "open trading country," which makes a meaningful contribution to opening up the world economy at the international level, while at the national level the government remains committed to opening its market through parallel development of democracy and a market economy.

In addition, it is recognized that the supplier-oriented trade policy of the past must be changed into a consumer-oriented policy that maximizes the convenience and benefits to the general public. In terms of cost efficiency, the public's well-being is better served when the majority of consumers can be supplied with low-cost and high-quality goods rather than defending the interests of a minority of producers. Therefore, the government must perform the role of opening up the domestic market, so that its people can enjoy an abundance of low-cost and high-quality goods and services.

For example, the government abolished the import diversification program (IDP) at the end of June 1999. The IDP, which was introduced in early 1978, was a system of restricting imports from a specific country (targeting Japan) with which Korea was experiencing a serious trade deficit. The abolishment of the IDP is regarded as one of the government's most dramatic liberalization measures.

This liberalization has been viewed as beneficial by most Koreans, and there is a growing perception that the establishment of FTAs with major trading partners can bring significant welfare gains. Moreover, Korea has recognized the importance of stable export markets; it is thought that the current account deficit that preceded the financial crisis resulted in worsening international confidence in the Korean economy. Another important background factor in the current trend toward regionalism can be found in trade policymakers' recognition of the necessity to upgrade Korea's economic system to meet international standards.

The South Korean government, with its policy goal of building an "open trading country," is firmly committed to maintaining friendly trade relations with its trading partners, while also promoting strategic alliances in the form of FTAs and bilateral investment treaties

(BITs). Through such agreements, Korea seeks to establish alliances with its trading partners in order to secure a forward base in strategic regions and upgrade its national competitiveness. The government is also actively participating in the process of creating a new free trade framework, such as encouraging a new round of WTO multilateral trade negotiations to counter the threat of emerging protectionism.

The pursuit of FTAs is largely based on the view that an expansion of free trade within regional blocs will ultimately complement Korea's trade interests in today's rapidly changing world economic environment. An FTA is a good reminder of how expansion of free trade in the multilateral arena has significantly contributed to Korea's economic growth.

However, Korea's joining a free trade agreement does not mean that it is necessarily downplaying the role or significance of the multilateral trading system. Rather, it means that Korea pursues regional economic cooperation within the framework of the WTO in line with the growing presence of other regional groups, including the European Union (EU), the North American Free Trade Agreement (NAFTA), and the Association of Southeast Asian Nations (ASEAN). The Korean government thus plans to sign FTAs with its trade partners, starting with Chile.

Although Korea has employed a relatively passive trade policy in the past, in the coming era of unlimited competition Korea must be equipped with a more active and assertive policy in order to lay the foundation for national prosperity in the 21<sup>st</sup> century. Also, it is important to maintain friendly relations with trading partners and to secure stable export performance based on the competitiveness of domestic industries. In addition, Korea must attract additional foreign investment, not only for financial purposes, but also to acquire the advanced technology of foreign companies.

### **Chile as South Korea's First FTA Partner**

South Korea and Chile reached agreement on the basic principles of a free trade agreement during the Asia-Pacific Economic Cooperation (APEC) Leaders' meeting in Kuala Lumpur in November 1998, where great progress was made by working groups of both countries. The two nations' leaders then declared the offi-

cial launch of FTA negotiations at the Auckland APEC Leaders' meeting in September 1999. As of the end of 2000, three rounds of negotiations have been completed.

Korea chose Chile as its first FTA partner because of high complementarity in trade structure and because of Chile's plentiful experience in regional trading agreements. Chile chose Korea because it highly valued Korea's close linkages with neighboring Asian countries as well as Korea's growth potential due to strong reforms in several sectors of its economy.

The government is currently pursuing the establishment of FTAs with smaller strategic countries as a precursor to establishing trade agreements with its larger trade partners. This has been a response to the continued trend toward regional blocs, and the fact that the recent financial crisis has opened Korea's eyes to the necessity of further opening its economy.

Chile was chosen as the first candidate in Korea's pursuit of FTAs partly because Chile's exports are weighted toward primary goods such as copper and wood products, which are highly complementary to Korea's exports of manufactured goods such as automobiles and electronic products.

Aside from the economic aspects, political realities are also behind the choice of Chile as Korea's first potential free trade partner. While current domestic opinion is certainly more favorable to free trade than in the past, Korea's abandonment of its insistence that free trade be pursued in an open and multilateral approach is a major policy reversal.

However, the economic size of Chile is relatively small, and the trade volume between the two countries amounts to only a small percentage of South Korea's total trade. Korea's exports to Chile account for around 0.5 percent of Korea's total exports, while imports from Chile are less than 1.0 percent of Korea's total imports. With small trade volumes between two countries, any adjustment costs, such as labor displacement, will be relatively low. Further, the international response to Korea's new policy will be muted due to the non-threatening size of the agreement.

Some may say that the benefits to be gained from an FTA with a small country such as Chile would be very

small compared to an FTA with larger economies, such as the United States or Japan. But, while Koreans are increasingly accepting the need for opening their economy, their competitive disadvantages relative to the United States or Japan would inflict excessive adjustment costs. An FTA with a relatively small economy will require lower adjustment costs on the Korean economy, yet force Korea to update many of its outdated economic institutions and practices. Following this adjustment period, Korea would be in a much better position to enter into an FTA with Japan, the United States, or another major economy. It is thus in Korea's interests, at least initially, to pursue an FTA with a smaller country.

Moreover, Chile is one of the most active countries in terms of liberalizing trade and establishing FTAs. Chile has already signed FTAs with Mexico, Canada, Peru, Venezuela, Ecuador, and Columbia, and it is currently discussing the establishment of FTAs with the United States, Bolivia, Panama, Cuba, and the European Union, among others. Chile's rather open and non-confrontational approach should allow Korea to sign a relatively comprehensive FTA agreement that is unencumbered by numerous side agreements.

Thus, the agreement would set a favorable precedent for Korea with other countries. Chile's experience with free trade and with operating a relatively liberalized economic market should provide invaluable experience to South Korea, not only in its attempts to further liberalize its own economy, but also in pursuing FTAs with larger economies. Considering the economic size, purchasing power, and trade volume of Chile, it is predicted that Korea will not realize substantial tangible benefits from a Korea-Chile FTA in the short run. However, such an FTA may bring sizable gains to Korea in the long run as Korea learns from Chile's experience in having established multiple regional trading agreements. Furthermore, Chile can serve as a gateway to the South American market.

## Summary and Policy Implications

The government officially decided to negotiate an FTA with Chile in November 1998 and to pursue FTAs with large economies, such as Japan or the United States, in the long run after thorough examination of the economic effects of FTAs with these economies. Korea

has been negotiating the FTA with Chile since December 1999. The successful conclusion of this first Korean FTA will be of special importance, because other potential FTAs will heavily depend on the first model.

Most likely, negotiations will last one to two years. However, talks regarding sensitive areas of trade could potentially prolong the conclusion of the negotiations. Korea's manufacturing sector favors a Korea-Chile FTA, as most of Korea's exports to Chile consist of such manufactures as automobiles and electronic goods. However, the agricultural sector (fearing an increase of such Chilean exports as grapes and kiwis) and the fisheries industry are deeply concerned about a Korea-Chile FTA.

### **Multilateral Institutions and Potential Additional Free Trade Agreements**

Beyond the sensitive nature of various trade items, there are a number of other issues of concern surrounding Korea's FTA policy. One such question is the harmonization of multilateralism and regionalism. Korea has been one of the most active supporters of the GATT/WTO system. Developing countries such as South Korea, Taiwan, and Singapore have benefited from the more liberalized global trading environment under the present multilateral system. The significance of free trade under the multilateral system will not be diminished, even if Korea pursues the conclusion of FTAs. The government will continue to take full advantage of the WTO and actively participate in the framework-building processes of international trade organizations, including the WTO and the Organization for Economic Cooperation and Development (OECD), to ensure that trade rules are fair and favorable to weaker countries.

In addition to negotiations on a Korea-Chile FTA in 1999, South Korea examined the economic feasibility of an FTA with Japan, and the prognosis appeared positive. A Korean FTA with Japan is expected to yield substantial benefits from strengthening strategic alliances between firms of the two countries. A strategic alliance with Japan is especially critical, not only because of Japan's vast potential for providing investment capital, but also because the combination of Japan's advanced technology with Korea's production capability will substantially enhance the competitiveness of domestic businesses. Moreover, an effective

Korea-Japan partnership will mitigate Korea's trade imbalance with Japan. Korea has also been undertaking joint studies with New Zealand and Thailand in 2000 to look into the viability and feasibility of pursuing individual FTAs with each of those economies. These studies will provide the basis for an expansion of South Korea's policy towards FTAs.

*Dr. Cheong is a Research Fellow at the Korea Institute for International Economic Policy (KIEP) in Seoul.*



---

# NORTH-SOUTH ECONOMIC COOPERATION

## DEEPENING ECONOMIC COOPERATION WITH NORTH KOREA

by Hong Soon-jick

### North Korea's Practical Diplomacy to Revive its Economy

After Kim Jong-il's official recognition as party secretary (October 1997) and defense chief (September 1998), the new regime seems to have gained confidence in its political and military stability.

In the economy, however, North Korea experienced negative growth from 1990 until 1999. North Korean trade in 1999 was only one-third of 1990's total, while the GNP was only two-thirds as large. Although growth became positive in 1999, this was due to economic cooperation with South Korea and aid from the international community. North Korea's grain harvest in 2000 was expected to fall by more than one million tons from the previous year's harvest due to droughts and typhoons. Because of this situation, the North Korean government is putting top priority on normalizing and reviving the economy, and since 1998 Kim Jong-il has been on more site visits and has announced more slogans for economic recovery.

Despite these efforts, North Korea has realized that self-help can only go so far in reviving the devastated economy, and the country has begun actively pursuing better relations with South Korea and the rest of the world.

In its external relations, North Korea has put emphasis on improving relations with the United States, Japan, and other advanced western countries, as well as resuming its ties with former allies such as China and Russia. It is also making efforts to gain entry into international organizations. This is the so-called "world-wide diplomacy based on economic pragmatism." Progress has been made in relations with the United States, including announcement of postponing long-range missile tests after a high-level meeting between

North Korea and the United States in September 1999, North Korean Vice Minister of Defense Jo Myung-rok's visit to Washington, DC, and U.S. Secretary of State Madeline Albright's visit to North Korea in 2000. The North also gained an agreement from Japan, after 11 negotiating sessions, for 500,000 tons of food aid as well as acceptance of the principle of reparations for colonial rule. According to the *Tokyo Daily* (26 October 2000), the Japanese government is considering about \$9 billion (1 trillion *yen*) in aid to North Korea, with about 60 percent (\$5 billion) in grants, and the rest in loans. In addition, North Korea established diplomatic ties with Italy and Britain, and has proposed relations with the other European Union (EU) countries. Other agreements include diplomatic relations with Australia at the ambassadorial level, official diplomatic relations with the Philippines, an investment pact with Indonesia, and a double taxation agreement with Egypt. So far, North Korea has made investment pacts with 17 countries, and double taxation prevention agreements with six countries.

However, the North has realized that diplomatic progress will be limited without improved relations with the South, and it has shown a new commitment to inter-Korean relations.

### Inter-Korean Relations and Economic Cooperation

#### *A First Step on the March to Reunification*

Since the South-North summit in June 2000, inter-Korean relations have been progressing rapidly, aided by factors such as President Kim Dae-jung's engagement policy toward the North, political changes in the region around the peninsula, and the North's strategy for economic recovery. Currently, the peninsula is turning from the conflict and animosity of the past to a

new era of reconciliation and cooperation, hopefully leading ultimately to peace and prosperity.

In the 15 June Joint Declaration, South and North Korea agreed to recognize each other's regimes and to act on the principle of self-determination toward defacto unification on the peninsula. The fact that the declaration was a historic event broadcast both in Korea and abroad will help ensure its implementation. After the declaration, many changes have occurred in politics, the military, society, and culture, and efforts are underway to ease tensions on the peninsula and to promote reconciliation and cooperation. Some positive steps include the termination of propaganda broadcasts over the demilitarized zone, visits between separated family members, and talks between government ministers, including the defense ministers of both sides.

### ***Increased Trade, but Real Investment Is Still Lacking***

Even before the move to reconciliation, South-North trade had steadily increased, so that South Korea has been the North's third largest trading partner since 1995; in 1999, North Korea's trade dependency rate on the South was 18.2 percent. If we compare this rate with the figures for South Korea, where Japan accounts for 11.0 percent of trade and the United States accounts

for 20.5 percent, we can see the importance of South Korean trade to the North.

Except for a few projects, however, most South-North economic cooperation projects are on a small scale—around \$5 to \$10 million. The scope of traded products is also limited to imports of agricultural and fishery products and processing-on-commission (POC) trade in textiles. In 2000, South-North trade totaled \$425 million, a 27.5 percent increase from the previous year and the first time that inter-Korea trade has exceeded \$400 million. However, 44.4 percent of this trade consisted of non-business-based transactions, such as aid, goods related to the light water reactor project, and goods related to the Mt. Kumgang tourism project. Processing-on-commission trade, which accounted for more than one-half of paid-for trade, mainly consisted of simple manufacturing that did not require equipment transfers.

Inter-Korean investment is also underdeveloped. In late 2000, 39 firms were granted permission to establish cooperation partnership arrangements with North Korea, and 18 of these were given permission for specific projects. However, with the exception of Hyundai's Mt. Kumgang Tour, Pyung Hwa Motors' auto repair and assembly project, and Taechang's Mt.

**Table 1: Inter-Korean Trade** (unit: US\$ millions)

Year	North to South			South to North			Total		
	Amount	POC	Ratio, %	Amount	POC	Ratio, %	Amount	POC	Ratio, %
1989	18.9	-	-	0.1	-	-	18.7	-	-
1990	12.3	-	-	1.2	-	-	13.5	-	-
1991	105.7	-	-	5.5	-	-	111.3	-	-
1992	162.9	0.6	0.4	10.6	0.2	1.9	173.4	0.8	0.5
1993	178.2	3.0	1.7	8.4	4.0	47.8	186.6	7.0	3.8
1994	176.3	14.3	8.1	18.2	11.3	62.2	194.5	25.7	13.2
1995	222.9	21.2	9.5	64.4	24.7	38.4	287.3	45.9	16.0
1996	182.4	36.2	19.9	69.6	38.2	54.8	252.0	74.4	29.5
1997	193.1	42.9	22.2	115.3	36.2	31.4	308.3	79.1	25.6
1998	92.3	41.4	44.8	129.7	29.6	22.8	221.9	71.0	32.0
1999	121.6	53.7	44.2	211.8	45.9	21.7	333.4	99.6	29.9
2000	152.4	72.0	47.2	272.8	57.2	21.0	425.1	129.2	30.4
<b>Total</b>	1,618.5	285.3	17.6	907.5	247.3	27.3	2,526.2	537.2	21.1

Sources: *Inter-Korean Interchange and Cooperation Bureau, Ministry of Unification. December 2000, Inter-Korean Interchange & Cooperation and Humanitarian Projects (monthly report).*

Notes: *The figure for 1995 does not include rice or aid sent by the South to the North (150,100 tons, worth \$237.2 million). POC = Processing on Commission.*

Kumgang spring water project, most ventures are still in the planning stages. Furthermore, most of the projects in operation have not made a profit.

Reasons for the weak start in economic cooperation include the lingering political and military instability, lack of a legal and institutional framework in the North, high transport costs, the North's dilapidated infrastructure, the North's lack of purchasing power and product variety, and difficulty in finding markets for North Korean products.

## **Prospects for South-North Economic Cooperation in 2001**

### *Conditions are Improving*

In 2001, North Korea is expected to move on completely from dependence on the legacy of the deceased Kim Il-sung. The regime will also make a further effort to improve economic performance as well as Kim Jong-il's image as an economic leader in preparation for his 60<sup>th</sup> birthday in 2002. To achieve this, North Korea will maintain the basic principles of the socialist system while trying to develop an economic system that works. Internationally, North Korea will pursue a pragmatic policy by expanding economic cooperation and trying to attract further economic assistance. This can be seen by events such as the 2001 new year's announcement declaring that the 21<sup>st</sup> century will be the century of Kim Jong-il, emphasizing new thinking fit for a new era, and exhorting improvements in science and technology as well as in national competitiveness. Kim Jong-Il's visit in mid-January 2001 to Shanghai's Pudong district, a symbol of Chinese economic reform and external opening, also reflects this policy change.

While South-North economic cooperation from 1999 to the first half of 2000 evolved beyond the planning stage with the operation of the Mt. Kumgang Tour, progress after 2000 will depend on how much of the South-North Joint Declaration is implemented. The success of the inter-Korean summit has greatly improved conditions for economic cooperation. Much political uncertainty has been removed, and, with economic cooperation spreading from the private to the governmental level, North Korea is expected to take a more active stance.

North Korea's new attitude to inter-Korean economic cooperation can be seen in the fourth section of the 15 June Joint Declaration, which set a goal of "balanced development of the intra-Korean economy." This clause stated that the North recognizes its dire economic situation, and that it would focus on reviving its economy with the help of South Korea. North Korea's agreement to open for South Korean investment the politically sensitive border areas, including the Mt. Kumgang Tour and the Kaesong Industrial Area, is highly significant. This can be seen as a change to a more realistic and practical attitude by the North, in that it will rely a great deal on the South Korean government and companies. In this light, the numerous ministerial and working level talks bode well for economic cooperation.

Furthermore, in the fourth ministerial-level talks on 12 to 16 December 2000, the South and the North signed a four-point cooperation agreement. This set the foundation for legal and institutional mechanisms of economic cooperation, the lack of which had been major stumbling blocks. The agreement stated that each Korea will guarantee safe and fair business on its territory, and that account settlement methods and dispute settlement procedures will follow international standards. Along with the reconnection of the South-North railways, the economic cooperation agreement will usher in an era of direct trade on the peninsula.

The improvement in inter-Korean relations can lead to progress in North Korea's relations with the United States and Japan as well as further loosening of U.S. economic sanctions on North Korea. Prospects could also develop for obtaining funds from international financial organizations (such as the World Bank, the Asian Development Bank, and the International Monetary Fund) or for successfully negotiating reparations from Japan. If these negotiations are successful, North Korea's purchasing power will increase, and that would create more opportunities for South Korean firms to invest in the North. In particular, if normalization of North Korea's relations with Japan result in large-scale reparations (of around \$10 billion), this would provide crucial seed money to revive the North's economy. Such reparations are unlikely to be in cash, but in economic development projects by Japanese companies that will focus on infrastructure such as roads, railways, and ports. This would be a catalyst for South-North economic cooperation by stimulating consortium-

style investment in the North by the South Korean government and firms, investment which has thus far been limited due to the domestic economic downturn.

If the private economic cooperation expands to the government level, and the North takes a more active attitude to reform and opening its economy, economic cooperation may be expected to develop greatly. In President Kim's Berlin Declaration in March 2000, the South has already stated its intent to make large-scale investment in the North's infrastructure and agriculture.

In addition, it is expected that, besides large-scale projects such as the light water reactor project, Hyundai's Mt. Kumgang Tour and the Kaesong Industrial Area, Samsung's electronics complex and software joint development project, and the auto repair and assembly factory of Pyung Hwa Motors, investment by small and medium-sized firms will increase. Such expanded ventures would improve the chances for a "North Korean demand boom" policy. This would broaden the scope of economic cooperation. The structural change in infrastructure and agriculture mentioned in the Berlin Declaration, as well as raw material supply projects, would then become possible. A North Korean demand boom would include a broad range of projects, including restoration of railways and roads between South and North Korea, developing the Kaesong industrial area, electrical and energy support, aid in fertilizer, pesticides, and agricultural equipment, joint maintenance of water resources, tourism development, and help in the operation of existing factories.

### ***Economic Benefits for the North***

The North can reap numerous benefits from expanded economic cooperation. Direct benefits from large-scale investment include creation of infrastructure and facilities, employee wages paid by South Korean companies, sale of raw materials, and development of related industries and neighboring areas. Indirect benefits include attraction of foreign capital, improved country risk ratings and international image (which could lead to aid and loans from international organizations), and, in the long run, development into a transportation hub for Northeast Asia. These effects, however, depend on mutual trust and lower tension between South and North Korea as well as the profitability of the investment projects.

The Hyundai Group's North Korea projects have been the first to be realized. Hyundai Asan's Mt. Kumgang Tour has transported 350 thousand tourists in the two years since it started. In 2000, tourists increased by 56 percent from the previous year, and since the opening of the hot springs facility winter demand has grown to almost peak season levels. For permission to enter the North, Hyundai Asan will pay the North a total of \$942 million for the 6 years of operation until March 2005, and \$1.5 billion for 30 years until 2028, in a three-stage investment. To increase tourist demand, Hyundai plans to expand lodging and entertainment facilities as well as link the railways in the northern area of the East Sea (Sea of Japan). Meanwhile, by 2008, Hyundai plans to create an industrial area in Kaesong that covers 26.6 square kilometers (8 million *pyong*), employs 160 thousand persons, and exports goods worth \$20 billion. In the long run, Hyundai plans to build a 40 square kilometer (12 million *pyong*) city that can house 150 thousand families. To achieve this, the company plans to build a one million *pyong* (3.3 square kilometer) light industry export area in the first half of 2001 that can export \$2 billion worth of goods yearly. In the second stage (from 2002 to 2004) a three million *pyong* area that can produce \$6 billion yearly will be created, and in the third stage (from 2005 to 2008) a complex that includes electrical, electronics, and information technology production facilities will be built, producing \$12 billion worth of goods. Therefore, during the building of the complex, North Korea will produce or export a total of \$20 billion worth of goods and will reap economic benefits of more than \$10 billion in buildings, land, and infrastructure. In addition, the process is expected to attract \$1 billion in foreign currency from spending and raw material sales, railway operation, water use, and communications. A net foreign currency attraction of \$1 billion would exceed the net profit from North Korea's foreign trade (\$1.48 billion) or GNI (\$15.8 billion) figures for 1999.

Reconnection of the Kyonggi (or *Kyong-eui*) Railway. The railway reconnection project, which connects the two Koreas across the demilitarized zone, can be called a project for peace. If the Kyonggi Railway is reconnected, and is linked to the Trans-Siberian Railway (TSR), the Trans-Chinese Railway (TCR), the Trans-Manchurian Railway (TMR), and the Trans-Mongolian Railway (TMGR), North Korea will become a hub for freight transport in Northeast Asia. Most importantly, in addition to expanded trade and investment

**Table 2: Projected Revenue in 2005 from Reconnecting the Kyonggi Railway**

	Freight	Distance	Unit Price	North Korean Revenue
South North		300 Km	\$0.04	\$39.84 million
-Containers	166 thousand TEUs			\$19.92 million
-Regular	1,660 thousand TEUs			\$19.92 million
Korea China	220 thousand TEUs	420 Km	\$0.04	\$36.96 million
Korea/Japan to Europe	240 thousand TEUs	750 Km	\$0.04	\$72.00 million

Source: Ahn Byung-min. 2000. *Reconnection of the Kyonggi Railway: Effects and Future Prospects*. Seoul: The Korea Transport Institute (September).

- Notes:
1. North Korean Revenue = Freight x Distance x Unit Price, at exchange rate of 1,100 won per dollar.
  2. Regular freight charge of \$0.04 per kilometer-ton.
  3. TEUs = Twenty-foot Equivalent Units: the amount of freight that can fit in one 20-foot container.

with the South, North Korea is forecast to earn a huge transport revenue of \$149 million in 2005.

### ***Speed and Scope Depend on the North's Attitude and Fund-raising***

The projects mentioned above are still in the early phases, and results will not appear in the short term. Prospects for the mid to long term are not completely certain, given the vicissitudes in South-North relations and the new Bush administration in the United States.

North Korea is still under sanctions from the United States, being labeled a terrorist-supporting state and violator of the missile technology control regime (MTCR). North Korea does not receive normal trade status or access to the generalized system of preferences from the United States or other western countries. As a result, the North faces tariffs that are 2 to 10 times higher than those faced by almost all other countries. Therefore, despite permission to trade, North Korea's manufactured goods, such as textiles, clothing, electrical and electronic products, footwear, bags, and toys, will not be able to compete with Chinese products in the United States market without a 30 to 50 percent reduction in FOB export prices.

Therefore, the speed and scope of economic cooperation will vary drastically, depending on North Korea's attitude toward reform and the opening of its economy, the fund-raising ability of the South Korean government and enterprises, and the cooperation and participation of the international community. Even if the North shows a cooperative attitude and discussion is held on expanding relations, progress depends on how the ideas are implemented.

Many observers think that it will take at least two or three years under favorable conditions for visible results to emerge. For large-scale projects such as infrastructure, South Korean government spending will be inevitable, but the current economic stagnation in the South will put a limit to such efforts. In addition, it may take a long time before North Korea can gain entry to and receive loans from international financial institutions such as the World Bank or Asian Development Bank. Finally, attracting private investment through build-operate-transfer (BOT) methods or project financing will also be a challenge because of uncertain profitability.

From the view of companies, at least in the short term, the improvement in conditions for economic cooperation after the summit has been more psychological than practical. This is especially true for investment projects, which require large-scale capital and involve higher risk than trade. Therefore, Koreans will need to keep a cool head while preserving their warm heart for economic cooperation. These points do not dismiss the recent progress in economic cooperation. Such psychological changes will improve the prospects for future cooperative efforts.

A foundation for expanding inter-Korean economic cooperation has been created. South and North should work under the principles of mutual and balanced, win-win development. Carefully furthering economic cooperation based on a realistic view is the way to achieve balanced development and prosperity on the Korean peninsula.

**Table 3: Conditions for South-North Economic Cooperation in 2001**

		<b>Positive Factors</b>	<b>Negative Factors</b>
<b>South Korea</b>	<b>Political</b>	<ul style="list-style-type: none"> <li>• More focus on South-North relations after President Kim Dae-jung's selection for the Nobel Peace Prize.</li> <li>• Inter-Korean Summit.</li> <li>• Strengthening of a cooperative framework with neighboring countries to increase the chance of South-North discussion of military issues.</li> </ul>	<ul style="list-style-type: none"> <li>• Going into the latter half of Kim Dae-jung administration, louder demands from the opposition for North Korea policy changes.</li> <li>• Worries of possible armed provocation of diversion.</li> </ul>
	<b>Economic</b>	<ul style="list-style-type: none"> <li>• Signing of agreement for South-North economic cooperation.</li> <li>• Creation of a committee for promoting South-North economic cooperation.</li> <li>• Further loosening of U.S. economic sanctions against North Korea.</li> <li>• Maintaining investment in the Mt. Kumgang tours and development of the Kaesong Industrial Area.</li> <li>• Progress on reconnecting the Kyonggi railway and supplying electricity to the North.</li> <li>• Progress on negotiation of Japanese reparations to North Korea.</li> <li>• Decisive new measures expected for economic cooperation.</li> </ul>	<ul style="list-style-type: none"> <li>• Slower economic growth.</li> <li>• Corporate restructuring and financial jitters</li> <li>• Move to profit-based investments in North Korea from investments primarily aimed at establishing market presence and corporate image.</li> </ul>
<b>North Korea</b>	<b>Political</b>	<ul style="list-style-type: none"> <li>• Stability of Kim Jong-il regime</li> <li>• Strengthened policy for creating a strong economy and targeting science and technology.</li> <li>• Expansion of domestic reforms and international opening</li> </ul>	<ul style="list-style-type: none"> <li>• North Korea' priority of improving relations with the United States before S. Korea.</li> <li>• Limited strategy for reform and opening.</li> <li>• U.S. relations with China will become strained if the Bush administration pursues a national missile defense (NMD) system.</li> </ul>
	<b>Economic</b>	<ul style="list-style-type: none"> <li>• Stronger efforts to revive the North Korean economy in preparation for Kim Jong-il's 60th birthday in 2002.</li> <li>• Acute need for South Korea's aid in 2001 due to a reduction of food output.</li> <li>• Visit of North Korean economic observation committee to the South.</li> </ul>	<ul style="list-style-type: none"> <li>• Increased aid from international organization would decrease importance of cooperation with South Korea.</li> </ul>

*Dr. Hong is a Research Fellow at the Center for Reunification of the Korean Economy at the Hyundai Research Institute in Seoul.*

# DEVELOPMENT PRIORITIES FOR NORTH KOREA

by Bradley O. Babson

As the year 2000 winds to a close, the prospects are much brighter than anyone expected that North Korea may at last be emerging from its isolation. The remarkable developments in inter-Korean relations since the summit meeting in June have already yielded tangible results, and there has been significant progress in expansion of North Korea's relations with a growing number of countries. While many difficulties and potential stumbling blocks lie on the road ahead, it is now possible to see more clearly the steps that need to be taken for North Korea to become a broadly accepted member of the international community, put its economic house on a sound and sustainable footing, and participate more fully in the international economy. This paper explores some of the issues in economic and social development that need to be given priority attention by both North Korea and the international community in the coming months and years, if this transition is going to be successful.

## **Integrate Economic Security in the Concept of Regional Stability and Security**

The sharp contraction of North Korea's economy and the human suffering that has occurred there in the last decade have raised fears of potential economic collapse and resultant breakdown of social and political stability. While the economic and humanitarian situation seems to have stabilized, due in large part to foreign assistance, the systemic breakdown of North Korean industry remains a major obstacle to recovery and achievement of a sustainable foundation for future economic and social development. Also, the potential for reversal of the fragile recovery in agricultural production should not be discounted.<sup>1</sup> Top priority for a better future will be to integrate economic security into the

underlying thinking about the construction of a new architecture for regional security on the Korean peninsula. This means that North Korean policy makers will need to incorporate new concepts of economic management and rationality into their calculations of national security interests, including the notion of economic interdependence that lies at the heart of what it means to integrate with South Korea's economy and the global economy. For the international community as well, it is important to accept that viability and future growth of the North Korean economy need to be central, not peripheral, aspects of strategic engagement.

## **Make Future Investment Decisions Based on Sound Economic Principles**

A cardinal rule for the future should be that major undertakings must have economic logic. Where private investment is involved, a sound commercial logic should also be strictly followed. This principle should underpin evaluation of future investments in North Korea. Good decision making requires North Korea to be willing to incorporate basic principles of market economics into the economic policy and management system. But it is equally important that North Korea's foreign partners insist on sound commercial practices when entering into agreements with North Korea. Discipline is needed to minimize the adoption of corrupt practices or concessions that undermine the economic and commercial viability of projects.

## **Invest Heavily in Education and Training**

In order to be able to make sensible decisions, North Korean officials and enterprise managers need to understand the concepts and methods of basic economics

---

1. Recent statements by the UN and U.S. Representative Tony Hall following assessment visits to North Korea suggest that the humanitarian situation is still highly tenuous, and that the UN appeal for food assistance in 2001 is likely to be substantially higher than for 2000.

and commerce. The international community can be most helpful to North Korea by supporting a large-scale educational agenda. This applies both to public projects such as prioritizing investments for rehabilitation of infrastructure and shaping a new industrial policy, and to trade and investment relations with foreign private investors.

## **Undertake Major Price Reform**

If decisions are going to be based on economic factors, it is also necessary to be able to determine what the economic benefits and costs will be. In market economies, the role of prices is central to the efficient allocation of resources. Distortions in North Korea's pricing system are so large that neither the exchange rate nor state-determined prices for commodities or labor can form the basis for viable economic or commercial planning and decision making. A sweeping price reform is needed to enable both North Korea and its foreign partners to negotiate with a clear understanding of how to measure success.<sup>2</sup>

## **Rationalize the Economics of Projects That Have Been Initiated for Political Reasons**

It will not serve North Korea's longer-term interests to continue to ignore the economic irrationality of large-scale projects that have been negotiated with foreigners and South Koreans. The most visible of these is the Mount Kumgang Tourism Project, which has already cost the financially troubled Hyundai Corporation over \$200 million of losses. It is also important to ensure that the expanding processing-on-commission trade between the two Koreas is commercially sound. The best way to do this will be to focus on lowering the major cost factors, particularly transport costs.<sup>3</sup>

However, the most critical politically-inspired project that must be rationalized is the light water nuclear reactor project being constructed with the Korean Peninsula Energy Development Organization (KEDO). Nuclear power is generally considered base power in a national generation program, and as such it can only be economically used if it is integrated in the national grid as part of a national power development program. In North Korea, the nuclear plants under construction are not sited near the grid, and there is currently no provision for financing and construction of a transmission line to meet this gap. Moreover, the grid itself is in need of major rehabilitation to be able to transmit base power without huge losses and is not presently capable of efficiently absorbing the power to be generated by the KEDO project. No provision exists to address these larger system distribution issues. Nor does a national power development program exist that is based on normal energy sector planning principles, including concepts such as least cost generation plans in deciding optimal fuel mix. Power has historically been priced in the North Korean economy with no relationship to its economic cost, and as such, like in Russia and its former Soviet satellite states, the economy as a whole has been distorted by overdependence on energy that has been priced far below its economic value. Once the nuclear plants have been commissioned, they will need to be operated and maintained, and the resources must be generated to cover these ongoing costs as well as to finance the repayment of the loan that KEDO is making to North Korea for the construction costs. How will North Korea generate the cash flow to meet these future financial obligations?

Thus there are many loose ends and issues that must be addressed if the expenditure of \$4.6 billion for the construction of the nuclear reactors is going to have any positive benefit for the North Korean economy and if North Korea is going to meet its financial obliga-

---

2. It is noteworthy that, in the recent agreements on inter-Korean economic relations, the need for an accounting device to value inter-Korean trade was explicitly addressed. Initially, the U.S. dollar will play this role, but discussion also took place regarding the possible creation of a new Korean currency for this purpose.

3. According to data from the Federation of Korean Industries, in the case of textile products processed in North Korea and sold in South Korea, transportation accounts for 40 per cent of total production costs. Cost of transporting a 20-foot container from Incheon port to Nampo is four times higher than the cost of shipping the same container to China.

tions to KEDO and not sink even further into external debt than it already is. As it stands today, North Korea stands to lose, not gain, if the KEDO nuclear project continues the way it is headed.

## **Resolve Outstanding External Debt**

North Korea does not have a good reputation in honoring its foreign debts. Reversing this image will be crucially important if North Korea is going to attract large-scale funding for viable commercial projects in the future. A good place to start is with the roughly \$3 billion in principal and interest payments due on loans from commercial banks in the 1970s. Some process involving the London Club<sup>4</sup> would be one approach. Debt to Japan could be discussed in the context of normalization of relations talks now underway. When South Korea normalized relations with Japan in 1965, agreement on handling of outstanding debt was part of the package deal. A more difficult area will be the large amount of transferable ruble debt that North Korea incurred to the former Soviet Union. The agreement recently reached between Vietnam and Russia on a similar transferable ruble debt issue could be used as a model for resolving the North Korean situation.<sup>5</sup>

## **Develop a Capacity for Macroeconomic Policy Making and Management**

North Korea will need to learn how to formulate and manage macroeconomic policy in new ways as it allows market mechanisms to become more fully a part of its economy. This will require building up the information systems to support the policy-making process and the institutional capacities to manage both monetary and fiscal programs. As in other transition economies, it will take time to develop the information, legal, and financial institutions needed to do this. To support this process, North Korea should become a member of and develop good working relationships with the International Financial Institutions (IFIs), especially the International Monetary Fund (IMF), the World Bank, and the Asian Development Bank (ADB).

The IFIs can be enlisted to play a major role in providing practical advice, training, and technical assistance in both macroeconomic and microeconomic capacity building, in addition to being a source of resources to assist the rebuilding of the North Korean economy. While membership will be required before any significant financial assistance could be expected, advice and technical assistance could be extended earlier if supported by the Executive Directors of these institutions. IMF assistance would be primarily directed to macroeconomic policy and management and short-term balance of payments requirements. Assistance from the multilateral development banks would be primarily directed to institution building and rehabilitation, and longer-term development of the economy, particularly through support for structural reform and implementation of sectoral strategies.

## **Develop Planning and Administrative Mechanisms to Accompany a Gradual Shift from External Humanitarian Aid to Official Development Assistance**

Most of the support provided by the international community to North Korea in recent years has been in the form of humanitarian aid for food and health care channeled through United Nations organizations and non-governmental organizations (NGOs). As the agenda shifts to focus more on official development assistance (ODA), North Korea will need to build skills and organizational capacity to plan and manage technical assistance and capital investment projects that have very different requirements than humanitarian projects.

To some extent, there already are development activities underway with North Korea, such as the agricultural rehabilitation work supported by the International Fund for Agricultural Development (IFAD) and the United Nations Development Program (UNDP), some of the projects supported by the World Food Program in introducing new crops and double cropping techniques, and in the activities of some NGOs, such as the windmill electricity generation project supported

---

4. The London Club consists of commercial creditors, whereas the Paris Club consists of bilateral official creditors.

5. Essentially, the agreement involves an exchange rate acceptable to Russia, combined with a percentage of debt that will be forgiven by Russia that is acceptable to Vietnam, resulting in a net debt repayment that is acceptable to both parties.

by the Nautilus Institute and production of germ-free potato seeds under a World Vision project. KEDO also is a good example of development cooperation through the ongoing work on site construction for the planned two nuclear power plants. In fact, the practical issues that KEDO has already confronted will be valuable lessons for future foreign-assisted large-scale projects in North Korea, and the protocol agreements that have been negotiated will be important precedent-setting models.

Nevertheless, the prospect of an economic rehabilitation and development effort supported by foreign investors, bilateral ODA donors, and multilateral institutions would require a sophistication in planning and aid coordination that does not exist in North Korea today. A key issue will be managing the project planning and decision processes that will require involvement of many actors within the North Korean government as well as foreign partners. The present highly centralized system of decision making will not be able to cope with an expansion of technical, political and financial issues needing to be addressed and resolved in order to move the program ahead. There will also be a need to build new aid coordination mechanisms beyond the Roundtable framework that UNDP has established, with some success, for dialogue on agricultural rehabilitation.

### **Prepare a Plan for Infrastructure Rehabilitation That is Linked to Overall Macroeconomic Policy and Realistic Expectations of Mobilizing Resources**

At the center of North Korea's future economic development strategy will be the need to rehabilitate the energy and transport infrastructures. Because the investment requirements are huge, what is needed is a proper foundation of economic and sector assessment studies to determine the best strategy and priorities for investment. For the power sector, such studies should not only address the issues relating to the most economic fuel mix for investment of future generation capacity and system distribution needs, but also demand management in industry, agriculture and household use. It will be crucial to place the nuclear power project under construction by KEDO into an overall sector development strategy. Similarly, transport sector strategies should be developed for rehabilitation of the

roads, ports, and railways, and projects should be prioritized. The issues relating to inter-modal coordination in planning and development of the trucking industry also need to be addressed in order to come up with a rational plan for sector development. Without the foundation of well-prepared sector strategies, investment supported by private investment and foreign ODA will be extremely difficult to justify on anything other than purely political grounds.

### **Integrate the Agricultural Rehabilitation and Environment Protection Program (AREP) into a More Broadly Conceived Framework of Development Planning**

The AREP program prepared with the assistance of the UNDP represents the most advanced sector development strategy effort that has been undertaken by North Korea in cooperation with the international community. Three Roundtable meetings involving governments, international organizations, and NGOs active in North Korea have been convened since June 1998 to discuss the plan and its progress. Overall, the AREP has not yielded the results expected, partly because the appeal for sharply expanded development assistance was politically premature for most donors, and partly because the problems faced by the agriculture sector cannot be solved through investments and management changes within the sector alone. The links to wider economic policies, especially those affecting industry, and the problems faced by the power and transport sectors, cannot be ignored for a viable strategy to be put in place to deal with rehabilitation of agriculture. A new effort is needed to prepare a sector strategy that makes these linkages explicit and identifies the complementary policies and investments that will be needed to put North Korea's agriculture on a viable long term path.

### **Initiate a Debate on Future Industrial Policy**

North Korea's future economic security lies in its ability to increase foreign trade and to earn the foreign exchange needed to provide the North Korean people with genuine food security. Rehabilitation of agriculture can help, but it cannot deliver this security without complementary development of the industrial sector.

The collapse of North Korea's industrial sector has been astonishing, even by the standards of the former Soviet Union. The reshaping of North Korean industrial policy will be perhaps the most important component of the future development strategy. To be viable in today's world economy, North Korean industry will have to be competitive and meet standards for international trade. How best to restructure the enterprise sector in North Korea, and what this implies for foreign investment and overall economic management, are questions that will need thorough debate. The sooner this starts in a way that includes the perspectives of foreign investors and future trading partners, the better for the overall process of North Korea's development and integration with the international economic system.

### **Assess the Medium and Longer-term Implications of Development for the Education System and Social Protection Mechanisms**

A major consequence of North Korea's opening up to the world will be introduction of new information about the way the world works, new technologies, new ways of communicating and working, new incentives for enterprises and individuals, and new relationships. Altogether, it is likely that the social shock that accompanies this process will pose a major challenge for the North Korean leadership and will have huge implications for North Korean society. At center stage will be the future evolution of the North Korean educational system, which at the very least will need to accommodate a large influx of foreign knowledge, learning materials, and academic relationships with foreign institutions. More fundamentally, the ideological and organizational underpinnings of the system will come under threat and will require adaptation to the new realities.

The same is true for North Korea's social safety net. The extreme socialism that has formed the heart of North Korea's identity since the late 1940s cannot survive the opening up of the economy to the influence of market mechanisms and will need to evolve. The policy of allowing informal markets as mechanisms for households to meet their basic consumption needs demonstrates that at some level the current leadership real-

izes that the formal system of state socialism cannot deliver social protection to the whole population. But the leap from tacit acceptance to intentional and wholesale change of the formal system seems a very long way off. Despite the sensitivity of the issues involved for the North Korean leadership, it will be important for the international community to be able to begin a dialogue about the social system issues early in the process of beginning to support North Korea's economic rehabilitation and development. The temptation will be to downplay or ignore these issues, but the cost of this would be to leave unaddressed the fundamental questions that in the end will determine the course of North Korean decision making.

### **Conclusions**

It is hard to imagine that the development priorities outlined in this paper will actually be followed. The scope is too broad, the sensitivities too high, and the challenges too daunting. But unless these issues are addressed, North Korea's future will be bleak. The most important question for the international community is how to begin a dialogue with North Korea on both substantive and process issues relating to economic development and social change. However, until the political and security issues that shape North Korea's relations with the international community have been resolved in a way that satisfies all major players, it is unlikely that the tasks of addressing North Korea's development problems will receive the attention they require.

*Bradley O. Babson, recently retired after 26 years at the World Bank, is now an independent East Asian specialist and advisor to the World Bank on North Korea.*

# DOING BUSINESS IN NORTH KOREA

by Michael A. Hay

## Introduction

Crystal ball-gazing is a hazardous enterprise at the best of times, and no more so than in the case of the Democratic People's Republic of Korea (DPRK). This became all too evident on 13 June 2000, when the DPRK permitted the world to gorge itself on an unprecedented feast of live television footage of the North-South summit, starting with the hearty double handshake from Chairman Kim Jong-il with his counterpart, President Kim Dae-jung of the Republic of Korea (ROK), and capped by the remarkable parting embrace of the two leaders at Sunan (Pyongyang) Airport on the 15th. The unannounced arrival of Chairman Kim at the airport to greet his visitor in person was only the first in a series of superbly choreographed moves in a public relations masterstroke by the DPRK which prompted Korea-watchers worldwide to scramble to revise their texts. Few could have predicted it, and even fewer did.

To the extent that one may detect patterns of behavior over the past eighteen months in North Korea, it is perhaps not inappropriate to attempt some observations as to potential future developments. Such observations here are offered largely from the perspective of business relations, as the writer makes no pretense of commenting in depth on any other facet of dealing with the DPRK. Rather than offer a detailed analysis of legislation in the field of foreign investment, this article describes the current business climate in North Korea, to the extent that it can be discerned from the perspective of the writer's own experiences, and offers certain advice on practical aspects of business relations with the North. Finally, the writer will attempt to place such recent developments within the context of events unfolding outside the DPRK, without which any analysis is largely an exercise in futility.

## The Summit ... What Now for Business?

Post-summit, what is the climate for foreign businesses in North Korea? One thing has not changed. If one is looking to get rich quickly with limited effort, then there are far better places to try than in the DPRK. However, for companies which are either big enough to have grandiose plans, equally grandiose coffers and staying power to match, or else are compact in size so as to offer a niche project, product, or service with a defined time line, then it is definitely a place worth looking at. More and more people seem to be waking up to that fact.

Flights to Pyongyang are full. Passenger flights on the national carrier, Air Koryo, from Beijing, the main hub for getting to Pyongyang, now frequently have lengthy waiting lists, as do the flights to and from Berlin, Macau, Moscow, and Vladivostok. These are now filled with more than diplomats and representatives of non-governmental organizations (NGOs). Many business people from both multinational companies and small or medium-sized enterprises are traveling to North Korea. Some are coming in on a "look-see," others with well-focused game plans and time lines. They make for an interesting mix—the DPRK is not exactly the first country that springs to mind when one thinks of, for example, "sports marketing." Then again, those corporations which look to the long term, and those Korea-watchers who look for trends (as opposed to the latest incident or twist and turn in the rocky road of relations, DPRK-style) will hardly be surprised by such interest. And, at least as things currently stand, it is virtually inconceivable that the 2002 World Cup will not, one way or another, have a DPRK "component," however that manifests itself.

So what has changed things? The North-South summit was certainly a major part, but let us not forget the achievements of the Perry Process,<sup>1</sup> that policy of con-

---

1. Former U.S. Secretary of Defense William Perry was commissioned by President Clinton in the spring of 1999 to reassess U.S. relations with North Korea, and he submitted his major conclusions to the President and the Congress in September 1999.

structive but firm engagement with North Korea adopted by the United States. Those who believe that America only woke up to the existence of the DPRK on 19 June 2000, when President Clinton formally abolished some trade sanctions, would do well to check, among other milestone dates, the news reports for 17 September 1999. Contrary to many headlines, Clinton did not that day lift sanctions—but he did publicly and clearly announce to the world the change in policy that nine months later led to the 19 June 2000 announcement.

And what then is that change? Specifically, the Foreign Assets Control Regulations, 31 CFR (Code of Federal Regulations), Part 500, have been amended with the addition of Section 500.586. A subsection of this new provision, which is somewhat detailed, reads as follows:

***Section 500.586 Authorization of new transactions concerning certain North Korean property.***

*(a) Subject to the limitations in paragraph (b) of this section, transactions in which North Korea or a national thereof has an interest are authorized where:*

*(1) the property comes within the jurisdiction of the United States or into the control or possession of a person subject to the jurisdiction of the United States on or after June 19, 2000; or*

*(2) the interest in the property of North Korea or a North Korean national arises on or after June 19, 2000.*

While that “paragraph (b)” not unreasonably serves the function of assisting the U.S. Department of the Treasury’s Office of Foreign Assets Control to determine whether the transaction in question raises implications with respect to the *Arms Export Control Act*, one simple fact emerges from the changed regulations. A considerable array of sanctions has been lifted. What is less clear, however, is precisely how the revised regulations will be interpreted and applied, and how the change has affected and will affect the attitude of U.S. companies. While unquestionably less risk-averse and more adventurous than their European counterparts in foreign markets, it would seem that U.S. corporations, which have already learned that they ignore the Foreign Corrupt Practices Act at their peril, are hardly

likely to rush into a “gray area” of the law when this time it is the Trading With the Enemy Act that is at issue.

Therein lies the irony. For when it comes to dealing with the DPRK, traditionally those that could (European) wouldn’t, and those that would (U.S.) couldn’t, bound by fear of the law. The changes under U.S. law may therefore take time to filter through, and for the moment it appears that a considerable number of U.S. corporations interested in doing business in the DPRK are—no doubt guided by their in-house counsel—showing uncommon courtesy to their domestic competitors, along the lines of “you first.”

This hesitancy, however, is unlikely to last. The result is likely to be a healthy jostling between U.S.A., Inc. and Europe, Ltd., given in particular the spate of recent developments on the diplomatic front involving European Union countries establishing relations with the DPRK. And on the North Korean side, a largely unnoticed, but truly dramatic, development was the accreditation of the Pyongyang Chamber of Commerce (PCC) on 3 May 2000 by none other than the International Chamber of Commerce. The PCC is proving to be a dynamic and cooperative entity with which one can certainly “do business.”

## **Doing Business**

No single article can even remotely claim to cover such a subject in any depth. However, some general comments can be made. Negotiations with the DPRK can be refreshingly frank and straightforward. Furthermore, one may venture the observation that, compared to early spring 2000, there has been a perceptible shift in the approach and vocabulary evident in business negotiations. A further point to bear in mind, however, is that one should not underestimate the lingering hostility and suspicion which still remains towards the South. It is therefore a fallacy to presume that the best conduit toward doing business in the North is automatically one’s Seoul-based foreign subsidiary. It **may** be. However, there is no hard and fast rule. Second, the experiences of (foreign) Company A in negotiations with representatives from Ministry X may differ wildly from the experience of Company B, which, in its attempts to establish a presence, is dealing with governmental entity Y.

The division and compartmentalization of roles and information between and among the various bodies in the DPRK with which one deals at various times is quite striking. In that regard, one would do well to act with care in one's choice of intermediary organization for the purpose of visiting the DPRK, for it is important to end up with the governmental entity appropriate to one's area of activity, a point which cannot be stressed strongly enough. Failure to go through the appropriate channels can make one's efforts fruitless or even counterproductive. Accordingly, the view ahead depends on the road one is on; which explains the widely differing views that one can find among business visitors, as in —“Are we talking about the same country?” One might suggest that this is, in part, a function of the particular sector of one's business, which in turn will dictate the counterpart DPRK body involved, and, as in any country, various bodies may have different viewpoints. Equally, there is luck, both in the individual relationships one forms and the mode of entry one chooses into the DPRK—not the means of transport, but the travel agency, as it were. One should not be surprised that some of the most successful foreign entities dealing with the DPRK are some of the most low-key and modest in operational structure. Record counts more than “reputation,” since the latter is all too often a synonym for marketing, and, if there is one golden rule (so far), it is discretion when doing business in North Korea—discretion both in country and outside the country.

The key is to concentrate at all times and also to be aware of one's limitations. When it comes to visiting the country in a business capacity, reliance on foreign entities with an established track record of relations with investment-oriented DPRK organs is critical. When choosing one's foreign “travel agency,” of which there are several, the key question is not so much “How many times have you been in?” but, given the ever-changing climate in the DPRK: “*When* were you last in?”

The writer confesses to having not had one single experience of systemic obstructionism when dealing with the DPRK on business negotiations. Negotiations have been robust, rough, and at times seriously wearing, certainly. (This is hardly surprising when the people of the peninsula as a whole are generally considered masters at the game, as many who have spent any time in South Korea will readily confirm.) True, there are serious daily inconveniences, either on the ground in

Pyongyang or in the basic interactions with institutions in “getting things done.” However, if the writer has observed any “trend” in the last nine months or so of 2000, especially, it is an enhanced willingness to cooperate shown by a number of government entities charged with overseeing foreign investment. The writer can think of not one single DPRK entity which has “failed to come through” on important requests for cooperation and assistance.

## Stepping Back

Dealing with the DPRK is not unlike golf—at any given time you are only one stroke away from your potentially greatest humiliation. One may also liken negotiating with DPRK counterparts to logging pilot flying hours—you never forget your first time, and every additional minute spent thereafter is all part of a precious learning process. Similarly, one may be assured that, in any negotiations of considerable duration, there will be air turbulence, which frequently comes in one of two forms. There is the somewhat predictable air turbulence, light to moderate in nature, which one can generally see coming, even if one cannot pinpoint far in advance when exactly it will hit. Far worse is the clear air turbulence that, as any pilot will confirm, can make for a very bumpy, if not downright hazardous, ride. As for the landing, one never can be sure as to whether it is a good one or a hard one until the very last moment.

In short, “unpredictability” is a word rarely far from the mind when considering negotiations with the DPRK. To suggest, however, that there is no logic to such behavior could not be further from the truth. Analyzing the “why” and “how” may be most helpful, but that most difficult of tasks is best left to the “commercial airline pilots” of negotiations in this field, and the writer is not one of them. From a practical perspective, however, of far more immediate value from the business perspective is the “when” of such behavior—in other words, attempting to gain a sense, with every take-off and landing, as to what one may expect to observe along the route, so as not to be too ruffled at the end of it all.

Having gone on the record in November 1999 to the effect that few areas in the world were as likely as the Korean peninsula to gate crash global headlines, it is

not unpleasant to see one was not too far off the mark. However, the day one classifies oneself as an “expert” on issues North Korean is the day to unplug the keyboard for good and take up fly-fishing instead.

Which brings us to a general comment regarding business with the DPRK. Be it negotiating a business deal, or implementing one, one may, to continue down the list of metaphors, liken it to being a fly on the elephant’s trunk. All one knows, and all one needs to know, in effect, is that small area of the trunk which represents one’s immediate surroundings. One’s view of the rest of the animal (all connected) is obstructed or otherwise impossible. Similarly, the movements of the trunk are dictated elsewhere, in a manner and by a mechanism which you will never get to know and therefore need not bother attempting to discern. If one can live with that, then one has a chance of surviving the business climate; otherwise, one would be well-advised to avoid such activity, for it can only lead to difficulties in the long term for both sides. Given such inherent constraints, though, a daily monitoring of reputable news sources as to what is going on both in and in relation to the Korean peninsula is a must.

## The Bigger Picture

As 2001 begins, droplets of rain have finally begun to fall from the storm clouds which have been gathering in South Korea. President Kim Dae-jung has come back from Norway with the Nobel Peace Prize in his pocket—an astounding achievement by any standards—only to face sniping from many quarters back home. The “costs” of the effort at rapprochement with North Korea are increasingly being criticized, as reciprocity is perceived by many to be minimal, and the South’s economy seems to be slowing. The sentiment is eminently understandable if one considers the “bone-carving pain” which the country suffered in the past three years. The “bigger picture” is noticeably of less interest than the pocketbook to the men and women in the street in Seoul, who are now experiencing flashbacks to that most awful of periods which for Korea commenced around September 1997, ushered in by, among other things, the serious market instability precipitated by the collapse of Hanbo Steel much earlier that year.

What has this to do with the DPRK? A lot. We are arguably coming up to one of the most delicate phases

in the metamorphosing matrix of North Korean relations with the rest of the world, notably with respect to South Korea, the United States, and Japan, with the wild card being how the rapidly developing rapprochement of the DPRK with the European Union alters matters. One of the most unpredictable aspects is the uncertainty which attends any potential drying up of the financial well down South. If that happens, it may cause serious jitters on the part of the international community.

If economic hardship comes back in South Korea in any form, the DPRK will realize, if it does not already, that the flow of direct funds and assistance from the South will dry up substantially. In theory, this specter should enhance the position of foreign businesses, since it should become obvious that cooperation with entities in addition to those of South Korea is a priority, on the principle that, at times like this, one needs all the friends one can get. Nevertheless, how precisely this would filter down to the negotiating table in business dealings on the DPRK side is impossible to predict.

Resentment, however, cuts both ways. It does not take a leap of logic to imagine a scenario whereby, with both sides of the 38th parallel economically hurting in their different ways, the United States could be seen to be the one spoiling the party and withholding the hang-over cure through its opposition, together with Japan, to DPRK membership in such institutions as the International Monetary Fund and the World Bank. In this regard, Washington will need its very best people on the ground in Seoul and elsewhere. Looking back, it is fair to say that, whatever one’s particular political colors, the quiet, consistent—and that is the key, consistent—policy reflected by the Perry Process, and implemented by Dr. Perry and his largely unsung colleagues, will in time come to be regarded as one of the true highlights of an otherwise seriously beleaguered Clinton administration. It is to be hoped that the new administration in Washington will follow suit.

*Mr. Hay is a New York attorney based, since 1991, in private practice in Seoul. He is also Senior Legal Advisor to the Beijing-based Foreign Business Development Association, an independent business association serving international corporations doing business with the DPRK.*

### **Practical Tips on Doing Business in North Korea**

- Throw out any comparisons with Vietnam, Thailand, or others before even thinking about doing business with North Korea.
- Electrical voltage is 220 volts; blackouts and brownouts are common, so common sense dictates investing in a flashlight.
- Bring along a portable printer with your notebook computer, plus appropriate adaptors and plugs.
- Leave your cellular phone home. Otherwise you will be required to surrender it for the duration of your stay.
- Do not expect to be able to stay in daily contact with your head office while in the DPRK.
- Exercise great discretion with respect to photography; if in doubt, ask, every time.
- Try not to ruffle feathers; it is far better to start one's visit on a high than on a hiccup.
- Do not confuse South Korean *won* currency for North Korean *won*. The official exchange rate of the DPRK *won* is about 2.13 to the dollar; then again, expect to chop off zeros on price tags in Pyongyang.
- Expect to be pleasantly surprised by Pyongyang. Close scrutiny will indeed reveal some serious blemishes, but, overall, the city is attractive and well laid out. The capital boasts two luxury hotels, the more established Koryo and the newer Yanggakdo, the latter on an islet in the middle of the Taedong River, which cuts through the city.
- Excellent Kaesung ginseng products and domestically produced cosmetics and spirits make good souvenirs. The Koryo Hotel in particular has a well-stocked gift market.
- If you are not going in with a specific business purpose, do not try to suggest otherwise to your hosts. DPRK officials have had years of experience of foreign corporations signing meaningless "agreements" which ultimately led to nothing. "MOU fatigue" is very much in evidence among DPRK officials, and they do not enjoy the symptoms.
- Your hosts will have gone to great lengths to arrange meetings. Reciprocate these efforts and courtesy by turning up on time and being well-prepared. They will be.
- Expect an excellent command of English among your DPRK counterparts. This applies both in negotiations and document review. Expect draft contracts to be dissected in detail.
- Remember that your behavior in the DPRK will weigh heavily in any decision as to whether you get back in. This advice may also apply to what you say, do, or write publicly after you have left.
- Discretion is the key, both in your preparations for entry and once you are there. Avoid fanfare.