

# ADJUSTMENT AND REFORM IN KOREA :

## FROM POLICY TO PRACTICE\*

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### Introduction

South Korea appears to have weathered the IMF Crisis thus far better than most with rapid structural reform and a return of confident foreign investors. The scale of Korea's bailout package of \$60 billion sparked fears of a prolonged recession or even depression, but the speed with which the nation began repaying the IMF account and garnering positive credit ratings has surprised many. How can we account for the pace of reform and recovery to date? Some suggest a strong, effective state role. Others point to businesses and firms with good technology and effective management. The debate over what caused the recovery has now been joined among South Korean academics, business leaders, and government officials. I offer here a brief survey of the programs and discussion based on interviews during a recent trip to Seoul.

Financial reform has drawn the lion's share of media attention on Korean efforts to address a crisis of finance "too much debt, too little equity, and too many soft loans from accommodating banks."<sup>1</sup> Strong Korean government support in writing off non-performing loans, some foreign investment, and a recovering domestic market have all played a role in restructuring the banking and finance sector. Although I focus on the less publicized task of corporate reform, two problems remain in the banking sector. One is the task of working with indebted firms to move back into profitability. I will describe the "Corporate Workout Program" below and only note here the difficulty of banks trying to reform industry. One industrialist at an indebted firm told me recently of the awkward position of Korean bankers working with ailing firms. Banks are usually not particularly interested in gaining ownership of a shaky firm, although debt to equity swaps have helped some Korean firms lower their debt ratios. Banks are even less interested in assuming temporary control of an enterprise in a competitive industry. What banks really want is to get their loans repaid.

A second, larger problem is the future of Korean banking which one foreign banker characterized two years ago as *collateral-oriented* rather than *profit-oriented*. Korean banks would base loan disbursement on a firm's assets, particularly real estate, machinery, buildings, and even inventory, rather than on annual sales and profit margins. This strategy worked only when real estate

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<sup>1</sup> Paul Krugman, "Recovery? Don't Bet on It." *Time*, June 21, 1999, pp. 32-37.

prices were growing annually, fueled in part by strong annual economic growth in industry. But slower growth in the future in a nation trying to balance social and economic development will force banks to evaluate credit-worthiness on market criteria. Krugman joined the chorus of critics of "crony capitalism" in the Asian financial crisis, but with more clarity than most. He cited an *entrepreneurship* which amounted to little more than the ability to leverage wealth through access to bank loans, and pondered the problem of entrepreneurs no longer able to rely on easy credit.

Entrepreneurship in South Korea has long been an interaction among individual capitalists, banks, and the state, demanding skills and leverage in dealing with the state as well as the market. I worry less about the resilient Korean entrepreneurial class than about the institutions of finance and of government oversight. The administration of President Kim Dae Jung which has won wide recognition for its role in nurturing economic development on the peninsula, continues to wrestle with its largely regulator role following liberalization of the local economy. Four decades earlier the administration of Park Chung Hee had assumed the mantle of economic direction at a time when markets and firms were far less complex, but the gradual withdrawal of the state from economic direction over the past decade, and a shift to economic oversight has left the state often at odds with the huge Korean *chaebol* or diversified family-owned conglomerates.

### **Korean Corporate Sector**

Five objectives have driven government policy for corporate reform.<sup>2</sup> Efforts to enhance transparency include consolidated financial statements, strengthening of voting rights for minority shareholders, compulsory appointment of outside directors, and establishment of an external auditor's committee for all publicly traded firms. Apart from consolidated reporting, these reforms have already been put into law bringing change to the structure of the firms. A phasing-out of cross-debt guarantees is cited as the second leading objective, and the most specific goal of the program. Leading Korean *chaebol* would maximize the value of their extensive assets of land, buildings, and equipment as collateral by letting one firm serve as guarantor of a loan for another of the group firms. By multiplying these ties into a dizzying array of cross-debt guarantees within the group, the *chaebol* were able to develop new credit lines despite huge debt to equity ratios. It is doubtful that the government can accomplish its goal of total elimination of cross-debt guarantees by March of 2000. Simply sorting out the lines of accountability, amounts, and then repaying or renegotiating those loans will require both time and additional capital. Perhaps more important in the short-term is legislation prohibiting new cross-debt guarantees between affiliates, and on the banking side, requests for cross-debt guarantees from financial institutions.

Improvement of corporate financial structures is a third goal of the program. Firms with debt to equity ratios exceeding 200% are consigned to a "workout program" of careful government scrutiny and controls. Indebted firms no longer have the option of simply reevaluating assets as in the past, and

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<sup>2</sup>"Corporate Reform," *Korea Times*, June 2, 1999, p. 20.

must raise capital either domestically on the stock market, induce foreign investment, or generate enough profits to pay both interest and principal on the debts. Some larger firms have attracted foreign capital investment, although only twelve of 725 listed companies on the Korean Stock Market today have a majority of foreign ownership.<sup>3</sup> The final two goals of the program look more broadly to structural reforms. The government has pressed forward with a streamlining of business activities to both modernize the structure of firms and consolidate corporate resources. Reform of bankruptcy procedures is one long-term goal, but remains problematic given the large number of indebted firms staving off closure today only through special government support. Improvement of merger and acquisition procedures would facilitate a rapid restructuring, though the efforts have not yet prompted much consolidation. Finally, the government program includes a familiar effort to make *chaebol* owners and managers more accountable, including a cumulative voting system among the shareholders, and strengthening of the voting rights of institutional investors.

If financial reform in South Korea has won plaudits abroad, the record of corporate reform is less positive. The government succeeded in pushing through a dramatic restructuring of the auto and electronics sectors, in effect brokering the exchange of assets and properties to force consolidation among the five major *chaebol*. Some still question the very feasibility of such a project, and reports of bankruptcy filings at Samsung Auto indicate the failure of a major part of the auto consolidation. One positive result of the government effort, however, may be the stimulus for voluntary consolidation and specialization at Samsung, Daewoo, Hyundai, LG, and SsangYong. Consolidation is linked directly to debt reduction and the selling of assets, as well as to induction of foreign capital for joint ventures. Government restrictions on new investment at the big five remain until debt to equity ratios improve.

The distinctive Korean form of family enterprise termed *chaebol* includes not simply the big five, but most of the top two hundred firms. Family-ownership, a prominent family role in management, often a diversified set of enterprises or at least separate production and distribution trims within a single sector distinguish these firms as well.<sup>4</sup> A report of additional programs or extensions necessary to complete the workout program at a majority of the 77 companies under supervision has cast a cloud on corporate restructuring.<sup>5</sup> Despite a two-year moratorium on debt repayments from 1998, more than forty firms will need additional time before they can begin to repay their loans. A review of the causes for the rescheduling, however, suggests some progress. Ailing firms have moved ahead with the merging of subsidiaries under the main firm, resolving the problem of cross-debt guarantees, and permitting the firm to realign itself within an industry. Internal mergers permit continuity for the absorbed affiliate, but add new debt burdens to the financial sheet of the main company. The report cites other accounting problems of inaccuracies in turnover and profit estimates, or of "unreasonable self-rescue plans." The latter problems belie the underdevelopment of bankruptcy

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<sup>3</sup> *Korea Times*, May 8, 1999, p. 8

<sup>4</sup> Myung Hun Kang. *The Korea Business Conglomerate : Chaebol Then and Now*. Korea Research Monograph 21 Berkeley : Institute of East Asian Studies , University of California Berkeley, 1996.

<sup>5</sup> "Majority of Workout Companies Need Debt Rescheduling." *Korea Times*, June 16, 1999, p. 8.

procedures in South Korea, and particularly the weakness of banking and government oversight and inspection of indebted firms. But given the gravity of the financial crisis in the Republic, a two-year time frame for debt repayment appears overly optimistic, especially for some larger firms with multiple subsidiaries. Recovery of demand in the Korean domestic market and in some export markets, should help bring a quick conclusion to the restructuring effort.

### **From Policy to Practice**

The Korean state has long been known for its ability to adapt planning pragmatically to meet market demands at home and abroad.<sup>6</sup> Recent success in guiding a restructuring program during the IMF Crisis draws on similar bureaucratic resources and experience, though in a new context of a more liberalized market and democratized polity. But if the mobilization of public opinion and bureaucratic resources necessary for implementation was important in the reform of the financial sector, so was the recent experience of reform and restructuring from the 1980s and even bureaucratic structures were already in place from the earlier administration of Y.S. Kim, following his efforts at "internationalization" of the Korean economy. Evidence for this argument can be found in the scholarship on the restructuring efforts of the late 1980s, particularly the shift from developmentalism to multiple goals of balanced social and economic development, democratization, and market liberalization.<sup>7</sup> Scholars today are looking closely to continuities in the restructuring plans between the earlier and contemporary periods, but it is already clear that the government was well equipped to address issues of reform.

Responsibility for effective political and social mobilization around reform goals was a daunting task for the incoming administration of former opposition leader Kim Dae Jung. His initial promise to include labor in a tripartite effort at planning and implementing reform has brought organized labor into major planning committees, but in the eyes of some has also sacrificed labor's interests to the demands of rapid structural reform. At the same time high levels of severance and unemployment have not prompted widespread labor opposition to the programs. Divided between the more cooperative Korean Federation of Trade Unions and the more independent Council of Korean

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<sup>6</sup> Eun Mee Kim. "Contradictions and Limits of a Development State : With Illustrations from the South Korean Case." *Social Problems*, vol. 40, no. 2, (May 1993) : 228-249; Peter Evans, "State Structures, Government-Business Relations, and Economic Transformation." pp. 63-87 in Sylvia Maxfield and Ben Ross Schneider, eds., *Business and the State in Developing Countries*. Ithaca : Cornell University Press,, 1997; Alice H. Amsden, *Asia's Next Giant : South Korea and Late Industrialization*. New York : Oxford University Press, 1989.

<sup>7</sup> Stephan Haggard and Chung-In Moon. "Institutions and Economic Policy : Theory and a Korean Case Study." *World Politics* vol. XLII, no. 2 (January 1990) : 210-237. Chung-in Moon."The demise of a Developmentalist state? Neoconservative Reforms and Political Consequences in South Korea."pp.67-84 in James Cotton, ed., *Politics and Policy in the New Korean State : From Roh Tae - Woo to Kim Young Sam* . New York : St. Martin's,1995. Chung - in Moon."The Politics of Structural Adjustment in South Korea : Analytical Issues and Comparative Implications." *Korea Journal* (Autumn 1991) : 55-68.

Trade Unions, organized labor remains a formidable voice on restructuring plans but has not yet solidified its position in a tripartite coalition. One problem is division between the two competing peak organizations, and another is the lack of a political base within the Korean National Assembly, despite the long links between President Kim and labor during his years as an opposition leader.<sup>8</sup>

Organized interests of the business community find themselves dependent in part on government initiatives for reform both in finance and the corporate sector. The gravity of the crisis at the banks and individual *chaebol* forced a working alliance with the Kim administration which might have been more adversarial in more prosperous times. Some argue today that the state reform plans have won praise at the expense of ignoring the role of firm management, as well as market competitiveness of the firms despite the extensive debt burdens. Only time will tell us more of the respective contributions of state and private sector to the reforms, but I would argue that the state has been particularly adept in pressing plans into action, prompting industries to move from planning to implementation. A brief contrast of reform within two large industrial sectors confronting declining competitiveness highlights the role of government in helping to plan and perhaps spur reform. But only firms within industries have the necessary human resources track complex changes in markets and maintain the necessary expertise in production.

Reform in the automobile sector has begun only recently with the government-led effort at integration of facilities. The government provided the stimulus and perhaps the necessary leverage to hasten consolidation. But at the level of assemblers, the consolidation of Samsung's recently developed auto production facilities, and of Kia's huge facilities will take time and capital and remarkable skills of organization and integration. What has not been addressed is the more difficult consolidation of auto parts makers on the peninsula, both major firms such as Mando Machinery, and the whole array of second and third-tier suppliers. State aid for small and medium-size enterprise will provide some support, but the reform remains clearly in the hands of individual firms and the larger *chaebol*. Reform in the textile industry, on the other hand, has been continuing for over a decade with the government and its semi-official Korean Federation of Textile Industries playing a limited role in planning, but leaving restructuring mainly to the efforts of the major spinners and synthetic fiber makers.<sup>9</sup> Vigorous efforts to relocate production abroad and upgrade production proved too little and too late for the larger commodity textile producers. Although the IMF Crisis did not bring government efforts for consolidation, it did force vulnerable larger spinners and a few synthetic fiber makers into "workout programs" which they may not survive. Where the state has played a more positive role is again in regional support for Small and Medium-size industries, particularly in the midstream sectors of weaving, knitting, cutting and dyeing. One continuity across sectoral reform in autos and textiles has

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<sup>8</sup> Dennis L. McNamara, "Korean Capitalism." pp. 139-150 in Dennis L. McNamara, ed., *Corporatism and Korean Capitalism*. London: Routledge Press, 1999.

<sup>9</sup> Dennis L. McNamara, "Global Adjustment in Korean Textiles." Forthcoming in *Journal of Technology and Management Creativity* (Manchester); and "From Patron to Partner : Korean State Role in the Textile Transition." pp. 95-109 in Dennis L. McNamara, ed., *Corporatism and Korean Capitalism*. London : Routledge Press, 1999.

been state initiative in planning and prompting, but without heavy infusions of capital at the level of major enterprises, yet some support for the wider network of medium and small industries.

### **Conclusion**

Some argue that Korea's market recovery is due largely to consumer spending prompted by government programs to stimulate the economy. At the same time recovery in export markets remains weak in some areas, strong in others, but without the strong demand across industries necessary to fuel long-term growth. Regarding the extent of reform, some argue that there is little evidence of deeper structural changes, despite the professed commitment of both government and business to extensive restructuring. And most recognize that reforms in banking and finance have not been matched in the corporate sector. Whether an optimist or pessimist at this point, it seems clear that reforms have only begun, and at their own pace in different sectors, depending on factors such as market demand and profitability, the extent of debt obligations in the sector, and the willingness of banks to offer new credit lines. At least three factors appear critical in successful corporate reform in South Korea over the coming few years. One is the continuing government pressure on private enterprise for rapid and extensive reform, and particularly for lowering debt ratios. The continued popularity of the Kim Dae Jung government appears critical, as well as its aggressive enforcement of the reform program now in place. At the level of firms, Korean companies will need to attract additional local and foreign capital whether through investment or sale, as well as increase earnings in recovering markets. Finally at the level of markets, South Korean industries need increased demand at home and abroad for their products in order to provide an engine of growth and income for reinvestment in new technologies.