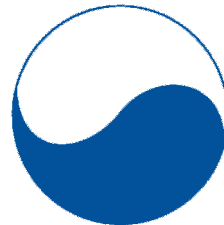


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# CORPORATE RESTRUCTURING IN KOREA FROM A BUSINESS PERSPECTIVE

by Oh Moon-suk

The currency crisis that hit Korea in 1997 aroused interest among scholars as well as the general public in the subject of corporate restructuring. The economic crisis drove many companies to bankruptcy, and unemployment surged. When the Korean people asked why they were suffering such hardship and tried to identify the causes, they concluded that problem-laden companies was one cause.

On many occasions, public opinion exerts a large influence in Korea. When laws and systems are insufficient, public opinion often provides the basis for government to advocate a certain policy. In the situation of the currency crisis, the Korean public recognized the need for corporate restructuring, and this recognition paved the way for the government to promote various corporate reform measures. In general, Korea's large business groups, or *chaebol*, were identified as the main culprit of the economic crisis, and it was recognized that they would have to be reformed. The discussion of corporate restructuring naturally took place at the level of the national economy; contributions to the discussion from the business community were generally seen as excuses, expressions of discontent, and other attempts of business to escape reform.

## Taking a Fresh Look at Korean Companies

In Korea, corporate restructuring has occurred mostly in the *chaebol* because they represent such a large proportion of the economy. For instance, the market value of the top 10 listed companies, excluding public companies, on the Korean stock market index (KOSPI) stands at about 200 trillion *won*, which is equivalent to about 52 percent of the total market value. *Chaebol* have a monopoly position in the country's key industries—semiconductors, motor vehicles, and electronics—and are leading exporters and investors. The top 100 companies are responsible for about 45 percent of total shipments from mining and manufacturing industries.

Korean *chaebol* thus have played a leading role in growth of the economy. At the same time, they have developed a number of structural problems. The most commonly mentioned problems are the system of linked companies and the owner-manager system. Resembling Japan's *keiretsu*, *chaebol* have formed huge conglomerates through complex cross investments and cross guarantees among subsidiaries. These types of business groups have generated a unique competitiveness through internalization of financing and various other transactions. Consequently, *chaebol* have easy access to funds in order to enter new businesses, and troubled subsidiaries can overcome liquidity problems with assistance from the parent group. It is also possible to create a captive market through intersubsidiary transactions. By having big organizations of affiliated businesses, *chaebol* achieved competitiveness that individual companies could not. *Chaebol* also have many weaknesses, however, which were manifested clearly during the currency crisis. Seeing the Japanese economy suffering a prolonged recession for the past decade, Korean people grew suspicious that a fundamental flaw existed in the Japanese-style system of linked companies.

The owner-manager system is a characteristic found in Korean *chaebol* but not in Japanese *keiretsu*. In the course of economic development in the 1960s, the Korean government offered opportunities to build large companies and granted special privileges to some of Korea's talented businesspeople. The government protected the domestic market, provided various financial aids and tax breaks, and facilitated imports of technology. In this supportive environment, some businesspeople demonstrated exceptional entrepreneurship and established the Korean economy's foundation for growth. They had strong leadership to boldly venture into overseas markets and initiate technological development. However, as the economy expanded and matured, doubts emerged about the desirability of the owner's direct involvement in management.

On the question of whether postcrisis corporate restructuring actually made substantial changes, one answer can be found by looking at the fate of Korea's 30 largest businesses. Every year, for various regulatory purposes, Korea names the top 30 conglomerates. During the postcrisis years, either a considerable number of the large companies in the top 30 had to leave the market after becoming insolvent, or the rankings changed. Of the 41 groups on the top 30 list during the four years following 1997, 17 entered workout programs or court supervision during those years. Most conglomerates in restructuring programs had to find new owners or accept management conditions imposed by creditor banks. This represented the collapse of large businesses that had once held an absolute position in the Korean economy. This came as a great shock to Korean people.

### **A Big Step toward Improving Financial Structure**

How was corporate restructuring affected by the strengths and weaknesses of Korean companies and the changes in government policy? First, companies' financial structures underwent substantial changes. The economic crisis revealed that companies had too much debt. In 1997, the Korean manufacturing sector's debt ratio stood at 396 percent. Total debts to sales also reached 66 percent. However, as of 2002, the manufacturing sector's debt ratio was down to 135 percent, and the total debt-to-sales ratio had come down to 32 percent.

The myth of being too big to fail is one major reason behind the huge growth in debt. Extant in Korea's economic system was a serious moral-hazard belief that large businesses do not fail. Most people believed that, if a large business failed, a domino effect would be triggered because of links with subsidiaries; this would in turn lead to insolvency of creditor banks. In such a case, the government inevitably would provide relief and prevent the crisis from affecting the whole financial sector. Thus, in the past, there was a widespread belief that large businesses within a *chaebol* structure do not fail; or, even if they do, investors or creditors would not be harmed. This belief led financial institutions to lend money to large businesses with little screening.

Indeed, Korea's large businesses showed substantial competitive advantage with monopolistic or oligopolistic positions in the domestic market. The prevailing belief that large businesses were exceptionally good at doing business allowed these businesses to enter and achieve success in various business fields. It would actually have been very difficult for Korea to achieve the international competitiveness it now has in industries like information technology, electronics, shipbuilding, and motor vehicles if it were not for the *chaebol*. The confidence of the Korean public in large companies helped them build considerable competitiveness and amass great amounts of capital and human power.

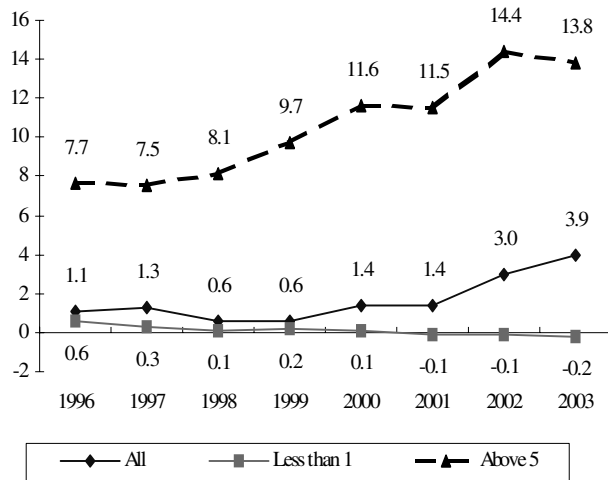
But people's confidence weakened quickly after the currency crisis, starting with the collapse of Hanbo Steel and Kia Motors in 1997. Some observers do not believe the structural problems of large companies were the biggest factor contributing to the crisis, but the reality of large businesses that was revealed was so disastrous that many believed it so. The external debt burden greatly increased because of the *won*'s depreciation, and many large businesses were driven to the brink of bankruptcy when interest rates skyrocketed and credits from debt-laden financial institutions shrank.

Following the crisis, the prescribed measures for corporate restructuring included reducing the debt ratio and dismantling the system of linked companies. The government ordered large businesses to bring the debt ratio down to below 200 percent, and it banned cross guarantees. It also set a limit on equity holdings in subsidiaries to restrain large groups from financially assisting or investing in subsidiaries. These measures contributed significantly to improving companies' financial health and debt repayment capacity.

The listed companies' debt service payments ratio tells the story. First, the overall debt repayment capacity improved considerably. The companies' interest coverage ratio, which registered only 0.6 during the currency crisis, had climbed to 3.9 by the third quarter of 2003 (*Figure 1*), thanks to marked improvements in financial structure and the sustained low interest rates that helped reduce much of the interest expense burden. As debt repayment capacity improved, the proportion of companies with a strong debt repay-

ment capacity went up while those with a weak debt repayment capacity declined. The share of companies with an interest coverage ratio of greater than 5 rose from less than 5 percent in 1998 to 36 percent in 2003, and that of companies with an interest coverage ratio of less than 1 halved from 60 percent in 1998 to 30 percent in 2003.

**Figure 1. Interest Coverage ratio**



Notes: 1. Based on the publicly listed non-financial companies that settle accounts in December and as of the end of each year. Year 2003 is as of end-September.

2. The number of companies analyzed: 588 in 1996, 594 in 1997, 575 in 1998, 573 in 1999, 560 in 2000, 559 in 2001, 551 in 2002 and 544 in 2003.

3. Based on the median value of companies' interest coverage ratio.

Of course, it raises concern that more than 30 percent of the listed companies still lack adequate debt repayment capacity. What is particularly worrying is that these companies' debt repayment capacity is deteriorating continuously. This underscores that effectively withdrawing insolvent companies from the market remains an important task. One fortunate aspect is that many of the companies with weak debt repayment capacity are medium- or small-size companies. Third quarter results from 2003 show that 47 percent of the 165 publicly listed companies with an interest coverage ratio of less than 1 consisted of medium- and small-size companies. Such companies made up only 28 percent of the 379 listed companies

with an interest coverage ratio higher than 1. The same pattern is found in the proportion of companies with an interest coverage ratio of less than 1 in terms of total assets, sales, and financial liabilities. The assets of companies with an interest coverage ratio of less than 1 accounted for 61 percent of total assets in 1998, but this share was down to 12 percent in 2003. In 1998, insolvent companies accounted for about 60 percent of corporate sales and financial liabilities, but the share came down to around 10 percent in 2003. It indicates that the probability of large companies going bankrupt and thereby causing systemic risk in the financial sector has diminished.

### Bringing Accounting Practices Up to Global Standards

Enhancement of corporate transparency was another demand made by the Korean public to companies after the crisis. Korea's accounting standards first had to be reinforced to be on a par with global standards. Market confidence in Korean companies plummeted when illicit accounting practices were exposed during the process of clearing up bad debts of insolvent companies. Distrust of corporate accounting became a major barrier to attracting foreign investors and selling off businesses. As part of the effort to regain external confidence, the Korean government amended accounting standards and regulations, and changed the audit system to make the preparation of consolidated financial statements an obligation for companies.

For companies, improving management transparency became a major concern as the importance of capital markets grew. Large companies had relied mainly on banks for funds, but the banks were no longer so willing to lend them money after the crisis. The banks themselves were busy clearing bad debts and raising their Bank for International Settlements (BIS) ratios. They applied stricter screening procedures, lending money only to companies with verified capacity to create cash and repay debt. Naturally, the banks cut down their lending to less-profitable large companies, leading a growing number of large companies to turn instead to the corporate bond market and the stock market to raise funds. These companies also secured capital from foreign investors. In the process, improved management transparency became a basic requisite for financing.

## Controversy over Improvement of Corporate Governance

Together with the strengthening of accounting standards went the overhauling of the structure of corporate governance. In light of the decline of many large companies, the onus was on the owners to restructure. At the time, however, Korea's large companies had no internal mechanism to remove the incumbent management for poor performance or failure and to appoint new management. In some cases, corporate decisions contradicted the interest of minority shareholders.

Meanwhile, in early 1999, the Organization for Economic Cooperation and Development (OECD) led the move to establish international standards of corporate governance. Such international efforts to improve corporate governance triggered the reform of Korea's corporate governance structure, in which the chief owner of a large company exercised absolute control. The OECD recommended that the corporate governance structure should protect shareholders' rights and correct any violation thereof; ensure the equitable treatment of all shareholders, including minority and foreign shareholders; respect the rights of stakeholders that are protected by law; ensure timely and accurate disclosure of all information regarding the corporation; and make the board of directors more accountable for its actions.

The Korean government increased the accountability of corporate boards and gave the boards greater responsibility for overseeing management. The government set up a committee consisting of private experts from the fields of business, finance, and law to draft a code of good practice for corporate governance that would raise boards' accountability and protect shareholders' rights.

The business world was astonished by appointment of outside members to boards of directors. Until then, people had known little about outside directors and their roles and had displayed little interest in them. However, the Korean government made it compulsory for all publicly listed corporations to appoint outside members to their boards. Starting in January 2000, large corporations with assets totaling more than 2 trillion *won* were obliged to appoint more than three

outside members, and the number was increased one year later so that outside members would comprise more than half of the board. To increase the autonomy of outside directors and ensure that independent outside directors were appointed by the management and majority shareholders, large companies were obliged to establish nomination committees for outside directors.

To give shareholders a greater role in monitoring the management, the government eased the prerequisites for representative litigation against the management and introduced a system of cumulative voting. In the past, all directors received their board appointments through straight up-or-down votes; this tended to result in the appointment of only those preferred by majority shareholders. Since the introduction in 1998 of cumulative voting, minority shareholders of some companies now have a vote for each share multiplied by the number of directors to be elected. This has allowed them to cast votes for candidates of their preference and has ensured that the candidates preferred by minority shareholders are elected even against opposition from majority shareholders. Not many companies have adopted cumulative voting, but in the future minority shareholders will probably demand increased cumulative voting.

The strengthening of the rights of minority shareholders has inspired a movement among civil groups for minority shareholders' rights. The civil groups in the forefront of the movement are putting pressure on companies through campaigns at general meetings of shareholders and in the courts as well as in the mass media. The civil groups have been particularly active in cases where minority shareholders' rights have been infringed by the actions of majority shareholders.

Class-action lawsuits—a legal concept to be introduced in Korea in 2005—are expected to strengthen the rights of minority shareholders by a significant degree. Minority shareholders would be able to file class actions against companies with assets totaling more than 2 trillion *won* for manipulation of share prices, false disclosure of information, and accounting malpractice. As even the filing of a class-action lawsuit can be quite damaging for companies because it often weakens their share prices and exerts considerable influence on management, Korean companies

are gearing up so they would not fall prey to such lawsuits.

Companies cannot ignore the task of enhancing management transparency. A number of issues in the corporate reforms could be subject to criticism, however. Are professional, salaried managers really more competent than owner-managers? Is the Anglo-American style of corporate governance, which strives for maximization of shareholder value, valid in a developing country like Korea? Is it desirable? What corporate governance structure is best suited to Korean conditions? Perhaps questions such as these will continue to surface as part of the reform process.

Every minority shareholder wants share prices to rise and dividend payments to be large. If companies aim for short-term share price gains and dividend payout increases, however, they may end up sacrificing long-term growth. In particular, it is highly possible that greater empowerment of minority shareholders will discourage companies from entering new, high-risk businesses; this may hinder entrepreneurship.

Potential abuse of the class-action system is also a concern. In some countries that have adopted the class-action system, excessive class-action litigation has been used to bully highly profitable companies rather than contribute to the enhancement of management transparency. This has led to calls for reform of the system. Korean companies are therefore demanding that, even if this system is introduced, strict prerequisites for litigation be applied to prevent disruption of operations.

Companies also contend that, despite the good intent of the outside board member system, it is premature given Korea's current circumstances. In reality, there are not too many experts who can adequately perform the role of outside members, which is why in many cases former bureaucrats and academics are elected to board positions. Consequently, at present, the system remains very much a formality.

In sum, the government is inviting new systems to enhance management transparency and improve corporate governance structure, and the role of the board of directors in upholding shareholders' value is expected to grow more important in the future. The holding-company structure is an example of changes

taking place in Korea's corporate governance. The LG Group used to have a system of linked companies similar to that of other *chaebol*, but now it has a Western-style holding-company structure. Intersubsidiary investment links have been abolished, while investment links between the holding company and subsidiaries have been simplified to increase management transparency and accommodate restructuring. The Hyundai Group is also dividing into smaller and more specialized groups through the separation of affiliates.

These moves have been induced by changes in the legislative environment and by pressures from the financial markets. In the markets, the companies that are considered to have an improved corporate governance structure stand out from the rest in terms of share price and credit ratings; this puts them in an advantageous position to access funds. Changes in laws and systems and market pressure will continue to cause changes in the ways companies manage themselves. People's ideas and customs do not change overnight, however; so the reforms of governance structure are progressing, but somewhat slowly.

### **Profitability Improvements Fall Short**

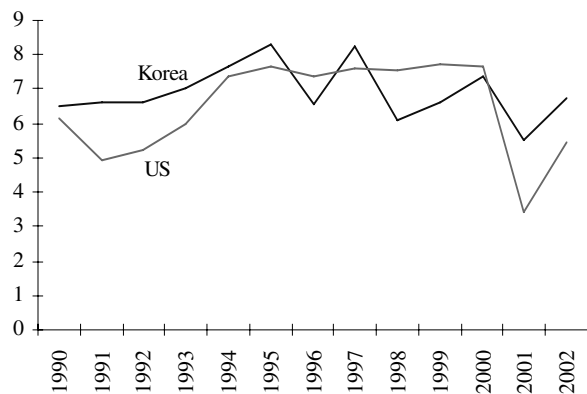
Korea's corporate restructuring has made progress in improving financial soundness and management transparency. An important change is that companies have turned their attention to profits rather than concerning themselves mainly with expansion, as they did before the currency crisis. How have these changes affected corporate profits? Thus far the result has not been completely satisfactory.

First, Korean companies seem to be using their assets more productively to create sales. Before the crisis, the asset growth rate tended to be greater than the sales growth rate. Under the expansionist growth strategy, Korean companies invested heavily in assets but generated only a small increase in sales. Following the crisis, however, the asset growth rate slowed because of investment sluggishness, and in 2000 and 2001 companies even sold off their less-profitable assets. Thus, after 1999, corporate restructuring began to have an impact, and the sales growth rate began to outpace the asset growth rate.

The return on operating activities has not improved much, however. Company profits can be divided into

operating profit from sales and net profit, which includes nonoperating profit. Korean manufacturers have a higher ratio of operating profit to sales than their U.S. counterparts, but the ratio has deteriorated since the currency crisis (*Figure 2*). Korean manufacturers' operating profit-to-sales ratio has stood at 6.9 percent for the past 13 years, slightly higher than the 6.5 percent of U.S. manufacturers. During the precrisis period, however, the Korean companies averaged 7.7 percent, compared with 6.5 percent during the postcrisis period.

**Figure 2. Ratio of Operating Profit to Sales**



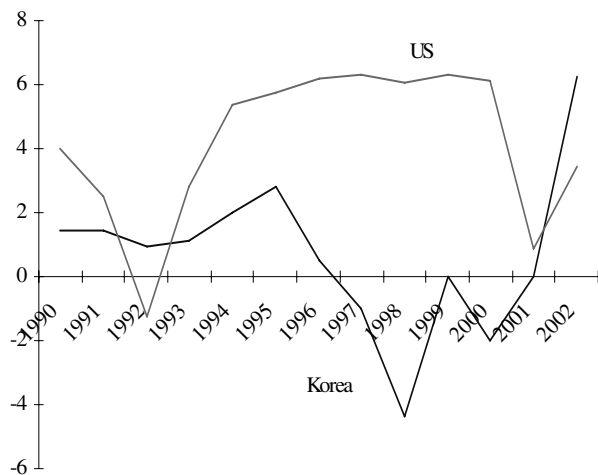
Note: Operating profit to sales ratio= Operating profit\*100/sales

Korean companies' profits drop farther if nonoperating profit is included. Their average net profit-to-sales ratio for the past 13 years has been 0.7 percent, significantly lower than the 4.2 percent average recorded by U.S. companies. This indicates that loss on nonoperating activities has pulled down the overall profitability. Interest expenses on excessive debt have been particularly damaging. Debt has shrunk through restructuring, however, and the ratio of net profits to sales has been improving rapidly since 2001 as a result. In 2002 it rose to 6.2 percent to surpass U.S. manufacturers (*Figure 3*).

Although improvements in the financial structure have had the effect of raising overall profitability, the ability to generate return through operating activities has not greatly improved. Recent improvements in per-

formance are attributed to debt reduction, interest rate cuts, and changes in the external environment such as the depreciation of the *won*. Since the crisis, interest rates have been kept low by weak corporate investment, and the depreciated *won* has helped Korean exporters improve their profit margins. Therefore, the quality of final corporate results is flawed. It is probable that profits of Korean companies will deteriorate again with adverse changes in the external environment.

**Figure 3. Ratio of Net Profit to Sales**



Note: Net profit to sales ratio= Net profit\*100/sales

### Korea's Economy at a Crossroads

Is Korea's corporate restructuring headed in the right direction? As the above discussion indicates, it is too early to find supporting evidence in corporate profitability or competitiveness. Nevertheless, there is no doubt that Korean companies have gained stability since lowering their debt level and that the interest expense burden has lessened considerably. Of course, many companies still have failed to improve their debt repayment capacity, but the possibility of systemic risk has been reduced greatly compared with the past.

Also, transparency in accounting and management has been enhanced significantly and will continue to improve. Korea will be persistent in strengthening its accounting standards and will promote the role of the

board of directors, but it is still unclear what shape the corporate governance structure will take. The trends seem to tilt toward shareholder value-oriented corporate governance, but it is uncertain that such a trend will last. Debates will continue about whether the recent investment sluggishness is associated with the changing corporate governance structure. Hence, it will be not only very important but also very interesting to see how issues like the strengthening of minority shareholders' rights and the class-action system affect Korean companies' management style and performance.

Corporate restructuring is expected to proceed with more respect for Korea's macroeconomic concerns. One such concern will be about Korea's economic system. When President Roh Moo-hyun came into office in 2003, he sparked debates on growth and distribution. The Korean economy has maintained a growth-oriented economic system for the past several decades. With per capita gross domestic product now reaching \$10,000, the Korean people's demand for a more equitable distribution is growing. Reflecting this, the incumbent government is placing a greater emphasis on distribution than its predecessor did. It is uncertain whether the economy will develop into a system of market principles and efficiency or into one of government intervention and equality.

Another concern is the policy direction of large businesses. Korea is juggling the two tasks of pressing on with corporate restructuring and securing a new growth engine. These two demands create very different social pressures on large businesses. On the one hand, large companies are still subject to reform. They need to be stopped from wielding concentrated economic power. If left to the market, large companies would continue to expand, and the smaller companies would suffer. On the other hand, large companies are a leading force behind Korea's growth. They are internationally competitive and drive Korean exports. Under market principles, it is natural for the role of large companies to expand.

Two contradictory demands can create confusion in public policies, and their relative importance can change depending on the government's disposition. So far, the Korean government's policy on large businesses has centered on promoting fair trade and eas-

ing the concentration of economic power. Proponents of market principles believe that fair-trade policies need to be reinforced further, but they also argue that the concentration of economic power needs no further consideration and that, for example, the limit on equity holdings in subsidiaries should be abolished. The government, however, has announced that the alleviation of concentrated economic power remains an important policy objective and that the equity holding restriction will remain for the time being. This shows that corporate restructuring is generally moving toward the Anglo-American style of capitalism but with a large undercurrent of Korea's own peculiar conditions. The Korean government and companies will continue to find themselves at a crossroads, and they will seek a new set of policies if business conditions turn less favorable or if companies perform unsatisfactorily.

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