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CORPORATE DEBT RESOLUTION AND THE ROLE OF FOREIGN CAPITAL IN THE POST-CRISIS RESTRUCTURING OF THE REPUBLIC OF KOREA

CHAN-HYUN SOHN

The outbreak of the financial crisis in the Republic of Korea in 1997 exposed the structural weaknesses in the country's economy. Heated debates have failed to generate definitive answers on just what caused the financial crisis. Considering the importance of restructuring the corporate sector, this paper analyzed how the resolution of corporate debts was accomplished and examined the role of foreign capital in Korea's post-crisis corporate restructuring. Special attention was given to the measures devised to recover nonperforming loans for the liquidation of corporate debts, to the foreign capital inflows through cross-border M&As or privatization processes, and to the changes in control through corporate governance reforms. This paper concluded that the resolution of corporate debts has been satisfactory and successful and that foreign capital contributed significantly to effective corporate restructuring and debt resolution in the post-crisis restructuring of Korea.

I. INTRODUCTION

THE outbreak of the financial crisis in the Republic of Korea in 1997 revealed the structural weaknesses in the country's economy. Naturally, policymakers and experts in diverse fields from economics and finance to social policy have sought remedies, not only to address the crisis but also to prevent another one from occurring and to provide a sound base on which to build a healthier economy.

Heated debates on just what caused the financial crisis have not yet led to universally agreed answers. However this paper suggests, based on the Korean experience, that the corporate sector played a major role.

Realizing the importance of the need for restructuring the corporate sector, this paper aims to analyze how the resolution of corporate debts was accomplished and to determine the role of foreign capital in Korea's post-crisis corporate restructuring. Emphasis is placed on the measures devised to recover nonperforming loans for the liquidation of corporate debts, including foreign capital inflows through cross-border M&As or privatization processes, as well as the changes in control associated with corporate governance reform.

The paper consists of six parts. Following this section, Section II traces the evolution of the financial crisis in Korea and analyzes the restructuring initiative. Section III considers various corporate debt resolution intermediaries focusing on the Korea Asset Management Corporation (KAMCO), a specialized debt resolution agency. Section IV studies the role of foreign capital in corporate restructuring, especially through cross-border M&As and in privatization. Then, Section V examines the changes in the corporate sector, in particular regarding the corporate governance and control system, and discusses how they have led to better corporate performance. This paper is concluded in Section VI.

II. EVOLUTION OF THE FINANCIAL CRISIS AND RESTRUCTURING INITIATIVE

A. *Underlying Weaknesses of the Corporate Sector*

On the surface, the financial crisis that struck many Asian regions seemed to have stemmed from liquidity problems, that is, low foreign reserves and excessive short-term foreign debts. Indeed, Korea's short-term foreign debts amounted to more than six times the value of its foreign reserves. However, at the core of Korea's crisis stood the inefficiency of the corporate sector, a problem which expanded during the country's high growth period.

The inefficiency finally surfaced in the form of a series of large-scale bankruptcies. The number of bankruptcies, including those of the *chaebols*, the large conglomerates, increased by about 50 per cent near the onset of the crisis from 11,589 in 1996 to 17,168 in 1997. This succession of bankruptcies increased the level of uncertainty in the Korean economy and shook investors' confidence. Banking and financial crises were immediate.

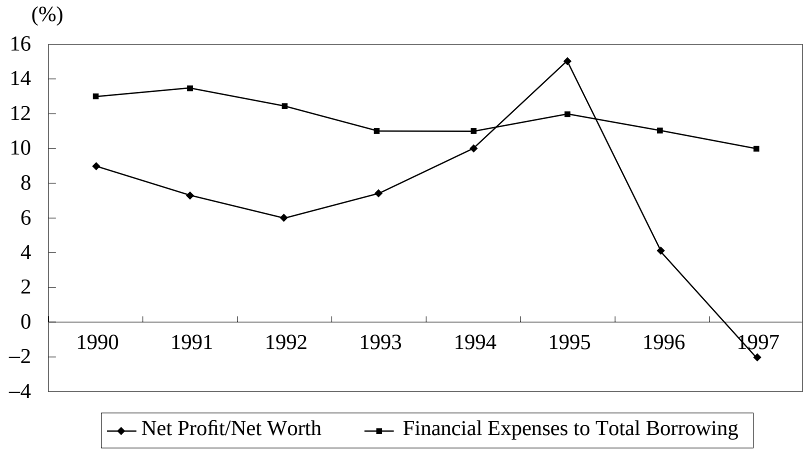
Three characteristics of Korean corporations are to blame. First, excessive and inefficient investment and highly leveraged and diversified businesses were financed by debts. Figure 1 shows that in the 1990s, the profitability of Korean manufacturing firms was substantially below the opportunity cost of capital, thereby leaving them with a cash flow shortage and structurally vulnerable to external shocks.

As global economic conditions changed and competition got fiercer in both domestic and world markets in the late 1980s, debt-financed growth became ever riskier.[1] What was most critical, though, was the short-term liquidity problem that plagued the corporate sector in general.

Second, the collusive relationship between the government and business groups led to inefficient allocation of capital in the financial system. Through its strong control of the financial sector, the government implicitly directed loans to selected companies, in particular *chaebols*, without prudential regulations. This often re-

[1] The warning signs of bankruptcy and high systemic risk appeared in mid-1996. They included over-capacity in investment sector and cash flow shocks.

Fig. 1. Profitability and Financial Expenses of Korean Manufacturing Firms



Source: Cited from Lim (2001); original sources are Bank of Korea, *Financial Statement Analysis*, various issues.

sulted in the situation where some companies could not repay debts. The inability of the corporate sector to pay the debt service is equivalent to the inability of the financial institutions to dispose of the nonperforming loans (NPLs). Thus the demise of the corporate and financial sectors were intertwined: the increasing number of bankruptcies in the corporate sector burdened the financial sector with NPLs. The size of NPLs sharply increased after the financial crisis. Table I shows this trend.

Third, the traditional and inefficient corporate governance persisted. The owners, who were often the controlling shareholders and usually nonprofessional managers, were deeply involved in corporate governance. The headquarters of *chaebols* controlled affiliates with a relatively small share of their equity through a centralized hierarchy system known as the "control pyramid system."[2] In fact, the average number of affiliates of the top thirty *chaebols* increased from sixteen in 1983 to twenty-seven in 1997, while the mean percentage of shareholdings decreased from 15.8 per cent to 8.5 per cent during the same period. This type of corporate governance contributed to poor performance and low firm value, reflecting the inefficiency in the corporate sector.

The above factors are the main causes of the corporate sector inefficiency. Therefore it was imperative that the main focus for overcoming the financial crisis be

[2] The control pyramid system refers to the system in which a certain shareholder controls the management of the main businesses and becomes the dominant shareholder of other business lines by controlling the assets of other businesses with a small amount of assets (KERI 2000).

TABLE I

TREND OF NONPERFORMING LOANS

(Trillion won)

	1997	1998	1999	2000	2001
Total NPLs	97.5	146.7	128.9	157.9	133.1

Source: PFOC and MOFE (2002) and Lim (2002).
Note: NPLs are based on the forward-looking criteria (FLC).

placed on the corporate sector, especially in the case of corporate debt management and restructuring.[3] The key element for the viability and soundness of the sector is cash flow. Various measures for implementing reform, as will be shown in later sections, did succeed in lowering the debt-equity ratio and improving the interest coverage ratio of the corporate sector. But measures to improve the cash flows of the cash-strapped corporate sector, in particular by attracting foreign capital inflows, were urgently needed.

B. *General Framework of Corporate Sector Reforms*

The corporate sector reforms can largely be divided into two pillar measures—corporate debt restructuring and corporate governance reforms.

Corporate debt restructuring involved rectifying the first two problems specified in the previous section, namely, corporate financial restructuring and debt resolution, while corporate governance reforms dealt with the third problem. Here the focus will be placed on approaches to corporate restructuring based on the five major principles as follows: (1) significantly improving the capital structure, (2) identifying core businesses and strengthening cooperative relationships with small and medium-sized companies, (3) improving the transparency of corporate management, (4) dismantling cross-debt guarantees, and (5) enhancing the accountability of both controlling shareholders and their management.[4]

At the onset of the financial crisis, there were few institutional systems and market mechanisms that could deal with large-scale insolvency. To provide a systematic mechanism, ways to improve the existing court-based procedures as well as to introduce an out-of-court settlement procedure were sought. Nonviable companies were liquidated or rehabilitated through these two main mechanisms during this period.

[3] More detailed arguments and comprehensive review of financial and corporate restructuring are found in Lieberman and Mako (1998), Zang and Wang (1998), Aiyer (1999), Ahn (2001), Mako (2001b), and Sohn (2002).

[4] Considering the changes in the conditions and new problems, the following three tasks were further added on August 15, 1999: (1) improving the managerial governance of the nonbank financial institutions, (2) eliminating cross-financing and illegal intra-group transactions, and (3) preventing irregular inheritances and donations.

The court-based restructuring system is composed of three elements: bankruptcy, composition, and reorganization. Bankruptcy is a procedure in which a debtor's assets are liquidated by a court-appointed liquidator. Composition is a settlement procedure between the debtor and creditors, in which a debtor handles its own estate. It is available to enterprises that owe less than 250 billion won, for it offers very few guarantees to the creditors. In the reorganization procedure, the court directs the creditors to handle the debtor, and the latter's estate is administered by an external administrator under the supervision of the creditor. Creditors and debtors can start any of the procedures, if there is evidence of cash flow insolvency.

Although there actually was a court-based insolvency system before the financial crisis, it barely functioned and was very inefficient.[5] Reforming the court-based rehabilitation system involved revising the bankruptcy law in February 1998: the court could accept and hear cases even when the file was not complete, consolidation of related cases under the same court was made possible, deadlines for the approval and submission of reorganization plans were shortened to between twelve and eighteen months, and it became possible to switch from the composition or reorganization options to bankruptcy proceedings. In addition, harsher punishments were meted out to the former managers who were responsible for the company's insolvency. These penalties, intended to make the culpable managers take full responsibility for their mismanagement, included compulsive retirement of shares and deprivation of managerial rights in the reorganization procedure.

Out-of-court workout procedures involved dividing the companies into three groups according to their restructuring capacity, and applying different restructuring approaches. The first group included the top five *chaebols*—Hyundai, Samsung, LG, Daewoo, and SK—which were considered to have the capacity to absorb the resulting losses. They were allowed to pursue "self-directed restructuring." An additional program called Big Deals was incorporated by the December 1998 Agreement[6] to reorganize diversified business lines,[7] and reduce the overcapacity and the high debt-equity ratios of the *chaebols*. In fact it was a restructuring option available only to these top *chaebols*.

Next was the "6 to 64" *chaebols* group, which consisted of the 64 largest con-

[5] Out of more than 17,000 insolvency cases reported by the Bank of Korea in 1997, only 492 cases were filed before the court. Only forty-one judges, some of which were not specialists in commercial law, were assigned to deal with bankruptcy cases, and the proceedings lasted several years (KERI 2001).

[6] The agreement also emphasized the reduction of debt-equity ratios. Other aspects included the exit of nonviable firms, independent management of *chaebol* affiliates, the elimination of intra-group debt guarantees, and the transparency of corporate management.

[7] The Korean conglomerates, *chaebols*, under the government's protection, diversified their affiliates and business areas. The average number of affiliates for the thirty largest conglomerates continued to increase from 19.7 in 1992 to 27.3 in 1997; meanwhile, the average number of business areas also increased from sixteen to twenty during the same period (OECD 1998).

glomerates excluding the top five. They were considered to be unable to restructure successfully on their own, and voluntary out-of-court workout programs were carried out. Daewoo, one of the top five *chaebols*, failed to "self-restructure" and received workout programs. A voluntary workout consists of an out-of-court settlement process between the creditors and debtors, based on the principle of "debt burden sharing" with financial institutions.[8]

The third group included the small- and medium-sized companies. Since their financial structure was too weak to bear the cost of restructuring, support came from their creditor financial institutions and the central bank during the restructuring process.[9]

As the pace of reform and growth slowed, and the financial sector was being threatened by high credit risks in mid-2000, the second round of reforms was launched to address the problems and restore confidence in the Korean economy. Corporate restructuring from 2001 was executed on the basis of a series of systems established at the former stage. Government intervention was reduced to establish a more market-based restructuring system. The Corporate Restructuring Promotion Law (effective until 2005) and its Enforcement Ordinance were promulgated to efficiently dispose of and reduce the NPLs of financial institutions.

III. CORPORATE DEBT RESOLUTION

Corporate debts were resolved through a special resolution agency. The Korea Asset Management Corporation (KAMCO) was the first of its kind in Korea, and other institutions including the Corporate Restructuring Fund, Corporate Restructuring Company, Corporate Restructuring Vehicle, and Corporate Restructuring Real Estate Investment Trust were established to assist in the resolution of corporate debts.

[8] At the end of 2000, 104 firms including Daewoo Group affiliates were nominated for the workout process. Of the 104 companies nominated, 36 firms have graduated and 34 remained in the program. Among the remaining 34 firms, 8 dropped out, 11 were ejected, and 15 merged with other companies. Ten of the 34 remaining companies were affiliates of the Daewoo Group, while 15 were affiliates of the medium *chaebols* and 9 were small and medium-sized firms.

[9] Small and medium-sized firms were divided into three groups: priority support group, conditional support group, and others. For the firms in the first two categories, accounting for almost 95 per cent of all small and medium-sized firms, banks were ordered to roll over loans maturing by December 1998. Second, various budgetary support programs were introduced. Loan guarantees of 33 trillion won to small firms and additional budgetary support of 2.2 trillion won were granted. The sum of 1.6 trillion won was raised through the "Corporate Restructuring Fund" to assist small companies. The central bank relaxed its rules on credit ceiling to encourage banks to support small firms. Third, tax incentives were given: income tax or corporate tax was reduced by half for newly established small and medium-sized firms during their first five years of start-up and tax benefits associated with facility investments were increased.

A. *Korea Asset Management Corporation*

KAMCO, originally a subsidiary of the Korea Development Bank, was specially reorganized into a resolution agency when the financial crisis broke out.[10]

The main role of KAMCO, as the only bad bank,[11] was to help corporate restructuring by clearing the nonperforming loans (NPLs) of financial institutions and normalizing their functions. It bought nonperforming assets from banks and other financial institutions with the government's debt-guarantees and public funds.[12] NPLs were resold through three channels: (1) sale in the form of loans, (2) sale in the form of real estate, and (3) sale after management of NPLs. More specifically, sale in the form of loans was achieved by asset-backed securities (ABS), outright sale, and equity partnerships; sale in the form of real estate was carried out by auction and KAMCO public sales; and sale after management of NPLs by sale of real assets such as factories.

To issue ABS, KAMCO established a paper company called Special Purpose Vehicle (SPV) and transferred NPLs, which the paper company subsequently cleared by issuing ABS with the transferred loans as collateral. ABS worth 4.1 trillion won were issued by June 2002, while NPLs worth 27.7 trillion won were disposed of during the same period. KAMCO introduced equity partnerships with the private and foreign sectors expecting higher recoveries by enhancing the stability and specialization rather than conventional sales methods.[13] Between 1999 and 2001, six equity partnerships were established, with a total asset book value of 3.5 trillion won. The first three partnerships aimed at the co-management of NPLs, while the second three aimed at more comprehensive asset management.

As shown in Table II, KAMCO purchases of NPLs have been constantly increasing. The total purchase of NPLs at the end of 2001 accounted for 76.0 per cent of total NPLs worth 133.1 trillion won. The share of the remaining NPLs to the total has significantly decreased, suggesting the active role of KAMCO in purchasing and clearing the NPLs.

Although the total amount of NPLs increased sharply from 1999 to 2000 due to the new addition of Daewoo's NPLs and the introduction of a new asset classifica-

[10] KAMCO was set up in 1997 as a bad bank under the Act on Efficient Management of NPLs of Financial Institutions and Establishment of KAMCO. The institution was renamed as KAMCO in 1999.

[11] A bad bank is the bank that specializes in the resolution of bad loans.

[12] The Non-Performing Asset Management Fund, a form of public funds, collected a total of 20.6 trillion won and had 12.1 trillion won as available capital in 1998 (KERI 2001).

[13] The advantage of the equity partnerships is that they can maximize the returns by introducing an incentive system for general partners (the investors) while minimizing the holding period of the assets. Another advantage is that KAMCO does not have to bear the full burden of collection expenses. On the other hand, there are some weaknesses in equity partnerships. For example, KAMCO has to bear the risk of trusting foreign investors who may make poor business decisions (KAMCO 2000).

TABLE II

TREND OF NONPERFORMING LOANS AND KAMCO PURCHASES

(Trillion won)

	1997	1998	1999	2000	2001
Total NPLs (A)	97.5	146.7	128.9	157.9	133.1
KAMCO purchases (B)	11.1	44.0	62.2	95.2	101.2
Actual value	7.1	19.4	23.9	36.8	38.7
Remaining NPLs (A – B)	86.4	102.7	66.7	62.7	32.0
Remaining NPLs/total credit (%)	13.3	17.7	11.3	10.2	4.9
Share of the remaining NPLs to total NPLs (A – B)/(A)	88.6	70.0	51.7	39.7	24.0

Sources: PFOC and MOFE (2001, 2002), KAMCO (2002), and Lim (2002).
Note: All figures were taken at the end of year.

tion standard, namely, forward-looking criteria,[14] their share as a proportion of total loans decreased from 11.3 per cent to 10.2 per cent during the same period. More remarkable is the fall of the remaining NPLs to total loans, from 17.7 per cent in 1998 to 4.9 per cent in 2001. Another clear indicator of KAMCO's significant role in clearing NPLs is evidenced by the decreasing share of remaining NPLs, which fell from 88.6 per cent in 1997 to 24.0 per cent of total NPLs in 2001. By 2001, NPL resolution was almost completed.

As shown in Table III, as of June 2002, total NPLs with a face value of 105.4 trillion won had been purchased at the price of 39.4 trillion won. Public funds were used to purchase the NPLs. Of these, NPLs worth 24.4 trillion won were cleared, with a recovery of 27.7 trillion won, showing a very high recovery ratio of 113 per cent. In addition, NPLs worth 59.8 trillion won, which accounted for 56.7 per cent of the total NPLs purchased as of June 2002, were disposed of. So far, 27.7 trillion won, about 70.3 per cent of the 39.4 trillion won that had been invested, have been recovered. Such a high recovery ratio can be attributed to appropriate uses of various NPL disposal methods with different characteristics. For a large-scale disposal of NPLs through international bids and the issuance of ABS in 1999, diverse methods such as sale to asset management companies and corporate restructuring companies were introduced and the outcome has significantly improved since 2000.

[14] Prior to the crisis, only loans in arrears of six months or more had been classified as NPLs. In estimating the "true" magnitude of NPLs at the end of March 1998, however, Korea followed internationally acceptable standards and included loans in arrears of three months or more. In December 1999, financial institutions adopted a forward-looking approach in asset classification, taking into account the future performance of borrowers in addition to their track record in debt service. The forward-looking criteria (FLC) forced the creditors to make a more realistic assessment of loan risks based on borrowers' managerial competence, financial conditions, and future cash flow (Lim 2002).

TABLE III

STATUS OF NONPERFORMING LOANS RESOLUTION

(Trillion won)

Amount of NPLs	105.4	(100.0%)
Purchasing value	39.4	
Resolved NPLs	59.8	(56.7%)
Purchasing value	24.4	
Recovered value	27.7	
International bid	3.2	
Issuance of ABS	4.1	
Sale to AMC, CRC	1.9	
Sale of individual loans	0.6	
Court auction	3.1	
Repurchases and cancellation	9.7	
Voluntary repayment	5.1	
Remaining NPLs	45.6	(43.3%)
Purchasing value	15.0	

Sources: KAMCO (2002) and PFOC and MOFE (2002).
Note: Figures were taken at the end of June 2002.

By taking over the NPLs of financial institutions, KAMCO has successfully resolved debts and thereby improved asset mobility and asset soundness. The average BIS capital adequacy ratio of ordinary banks increased significantly from 7.0 per cent in 1997 to 10.8 per cent in March 2002, and the share of NPLs of banks decreased from 16.9 per cent in1998 to 2.8 per cent of the total amount of loans by 2001 (FSC 2002). Foreign investment and foreign reserves increased,[15] and the growth of small and medium-sized venture enterprises was induced.

Another major role of KAMCO, apart from the resolution of debts, was to provide assistance for the recovery of transferred insolvent companies. These are companies that may have been fundamentally competitive but became insolvent due to a temporary lack of financial resources. The assistance included withholding auction of the company, withholding execution of security rights, adjustment of the redemption period and interest rates, financial assistance to debt-equity swaps and investment of NPLs, and provision of new loans and debt guarantees.

KAMCO also contributed to attracting foreign capital through various channels, including international bids, issuance of ABS, and sale to corporate restructuring and asset management companies.

Overall, the real contribution of KAMCO to more successful corporate restructuring was that by attracting capital from both domestic and foreign investors, it

15 Foreign exchange reserves, which recorded $3.4 billion in December 1997, increased up to $112.4 billion in June 2002.

introduced a market mechanism in which nonperforming assets could be liquidated.

B. *Other Debt-Restructuring Intermediaries*

Other debt-restructuring intermediaries assisted KAMCO's operations, including the Corporate Restructuring Fund, Corporate Restructuring Company (CRC) and vulture funds, Corporate Restructuring Vehicle, and Corporate Restructuring Real Estate Investment Trust.

CRCs and vulture funds were established under the Industrial Development Law in February 1999 for the facilitation of market-induced corporate restructuring. CRCs are joint-stock corporations based on commercial law, whose main function was to carry out corporate restructuring through takeovers, management restructuring, and sales of insolvent corporations.[16] They also invested in and purchased the assets of restructuring companies, mediated M&As, and handled business for composition, reorganization, and bankruptcies. In addition, CRCs, as asset owners, issued ABS via Special Purpose Vehicles (SPVs) and managed assets. An important contribution of CRCs, apart from asset management, was that they transmitted a more advanced asset management know-how. They also played a central role in corporate restructuring, being the basis of other debt-restructuring intermediaries.

For investment funds they used vulture funds as well as their own capital. The functions of vulture funds, such as management of assets or management of restructuring of insolvent companies, were fulfilled by the CRCs.

Other debt-restructuring intermediaries operates through CRCs. The Corporate Restructuring Fund is a paper company, a form of mutual fund created under the Securities and Investment Trust Law. It was established to extend support to troubled small and medium-sized businesses and some leading companies. The Corporate Restructuring Vehicle was set up as a device for market-induced restructuring. It is also a paper company, a type of mutual fund for a limited period of time. It generated profits through asset operations and distributed them to shareholders. Its functions included facilitating the disposal of assets by creditor banks, facilitating effective management and governance, and stimulating capital market development.

Finally, Corporate Restructuring Real Estate Investment Trusts were introduced through the enactment of the Real Estate Investment Trust Law in April 2001. During the financial crisis, real estate was a collateral for many distressed corporations. Real Estate Investment Trusts, by speedily converting real estate into capital, helped to improve the liquidity and cash flow of the companies and thus promoted corpo-

[16] Insolvent corporations were taken over through the acquisition of stocks or through merger and divestiture. Then their management was restructured through a group of managers or a board of directors from the CRC. Investment funds were paid back within five years through sales of stock and assets.

rate restructuring activities. They were also expected to provide minority investors with more investment opportunities and develop the real estate market.

Most of all, for the better operation of these debt-restructuring intermediaries, foreign capital inflows and the foreign know-how of debt restructuring were important.

IV. ROLE OF FOREIGN CAPITAL IN CORPORATE RESTRUCTURING

Foreign capital was important as the only source of liquidity to improve the cash flow of the cash-strapped, highly leveraged, and indebted corporate sector of Korea. Ultimately it promoted and funded market-oriented corporate restructuring, and also brought other nonfinancial and nontangible benefits such as foreign participation in management or financial market discipline.

Bold reforms were carried out to attract foreign direct investment (FDI) which was first allowed to be introduced into Korean enterprises, although to a limited degree,[17] in April 1998. Because of continuous efforts, foreign investments in Korea have increased sharply since 1998.[18] This was largely due to the government's initiatives to deregulate the financial market and open it more to foreigners, but the devaluation of assets at the onset of the crisis was also a contributory factor. Foreign corporations, on the other hand, pursued globalization and increased the market share through investments in Korea.

This section focuses on the two major forms of foreign investment—cross-border M&As and investment in privatization of state-owned enterprises—and examines their role in the process of corporate restructuring.

A. *Cross-Border M&As*

Cross-border mergers and acquisitions increased significantly after prominent efforts to encourage them were initiated in 1997. M&As by foreign firms increased especially after the financial crisis, in response to deregulation of laws restricting hostile M&As, but also to lower asset prices and depreciation of the won. In addition, there were abundant acquisition opportunities, as many of the distressed firms were selling off parts of their business lines in the process of restructuring. In many cases, rescue funds flowed in from existing foreign partners to ease liquidity constraints. Common forms of M&As have included: existing foreign partners buying out Korean joint venture partners; existing foreign investors expanding through acquisition; and creating new establishments in collaboration with Korean partners to acquire existing business units (Yun forthcoming).

Several key industries had been opened up, including construction, leasing, securities, and futures brokerage, with a liberalization rate of 98.9 per cent by May

[17] At that time, FDI was still prohibited in thirty-one business lines.

[18] The foreign investments until 1999 were focused on the financial and corporate sectors, but extended to the real estate market in 2000.

TABLE IV

PATTERN OF INWARD FDI IN 1998

(U.S.$ million)

Classification	Acquisition of Newly Issued Stocks			M&A			Long-Term Loans	Total
	New	Added	Subtotal	AOS	AA	Subtotal		
Invested amount	1,020	2,049	3,069	820	2,930	3,750	1,019	7,838
Percentage	(13.0)	(26.1)	(39.2)	(10.5)	(37.4)	(47.8)	(13.0)	(100.0)
Investment size per case	46.4	42.7	43.8	27.3	154.2	76.5	113.2	61.2

Source: Rhee (1999) based on the data of the Ministry of Commerce, Industry and Energy.
Note: Only investments exceeding U.S.$10 million were considered. AOS = acquisition of outstanding stocks; AA = acquisition of assets.

1998.[19] In May 1998, the rule limiting foreign ownership to not more than 10 per cent without the approval of the board of directors was eased to allow 33 per cent foreign ownership. The ceiling on total foreign shareholdings in individual companies was completely abolished in May 1999. In addition, all forms of M&As, including hostile takeovers, were fully liberalized by the same time—before the financial crisis, even friendly M&As were limited to cases where the total assets of the companies involved did not exceed 2 trillion won. Furthermore, two stock market rules—the rule requiring statutory tender offers in the case of purchase of 25 per cent or more, and the rule requiring disclosure of incremental acquisitions of stakes larger than 5 per cent—were abolished.

Because of these deregulation efforts in cross-border M&As, foreign purchase of shares and assets of Korean companies increased. In 1998, sales of newly issued and outstanding corporate stocks and corporate assets bought by the foreign investors reached $1.84 billion and $2.93 billion. Together they accounted for 60.9 per cent of the total foreign investment in that year. In case of acquisition of outstanding stocks, the foreign companies acquired the shares of troubled domestic joint venture partner companies and subsequently became the sole owners. In case of acquisition of newly issued stocks, the investments took the form of joint ventures through additional infusion of capital into existing businesses, and establishment of new companies through asset acquisition. These forms of investment are close to M&As (Rhee 1999).

As Table IV shows, a large bulk of foreign direct investment took place through M&As rather than greenfield investments. More specifically, a large part of corporate restructuring was carried out through foreigners' acquisition of assets and outstanding stocks. In 1998, for example, M&As accounted for 47.8 per cent of all FDI inflows and, in particular, acquisition of assets accounted for 37.4 per cent.

19 This effort raised M&As by foreign companies sevenfold, which accounted for a fifth of all such deals in Korea in 1998 (OECD 1999).

TABLE V

TREND OF FDI AND CROSS-BORDER M&As

(U.S.$ million)

	1995	1996	1997	1998	1999	2000	2001
FDI inflow (A)	1,776	2,325	2,844	5,412	9,333	9,283	3,198
M&A sales (B)	192	564	836	3,973	10,062	6,448	3,648
Ratio (B/A)	10.8	24.3	29.4	73.4	100.0*	69.5	100.0*
FDI outflow (C)	3,552	4,670	4,449	4,740	4,198	4,999	2,600
M&A purchase (D)	1,392	1,659	2,379	187	1,097	1,712	175
Ratio (D/C)	39.2	35.5	53.5	3.9	26.1	34.2	6.7

Source: UNCTAD (2002).

* FDI includes cross-border M&As and greenfield investments. Thus, theoretically the ratio (B/A) cannot exceed 100 per cent, but calculations from the data yield figures larger than 100 per cent. This is because the figure for FDI had been measured on an arrival basis while cross-border M&As had been measured on a notification basis. All calculated figures exceeding 100 per cent were thus adjusted to 100 per cent.

Official statistics, however, considerably underestimate the extent of cross-border M&As because the acquisition of assets and business units are represented as acquisition of new shares. Nevertheless, Table V clearly shows that the level of M&As increased dramatically from $192 million in 1995 to $3.65 billion in 2001. Particularly noteworthy is the sudden jump of inward M&As from $836 million in 1997 to $3.97 billion and $10.06 billion in 1998 and 1999, respectively. FDI inflows also increased from $1.78 billion in 1995 to $9.28 billion in 2000. The low figures in 2001 could be attributed to the global economic recession.

This massive scale of foreign purchases of the shares and assets of Korean companies eventually enlarged the scope and scale of their businesses. For example, the total sales of the four foreign companies—Nokia TMC, Motorola Korea, Hewlett-Packard Korea, and BASF Korea—ranked within the top 200 companies in the domestic market.[20] In particular, the growth rate of total sales of Motorola Korea recorded a value of 270 per cent in 1999.

As a result of the increase in cross-border M&As, foreign companies expanded their market shares in Korea. In the petrochemicals, paper, pharmacy, and food industries, foreigners have accounted for over 50 per cent of the markets since 1997. In the acetic acid, rolled aluminum, disposable diapers, feminine pads, and polyurethane materials markets, they have accounted for over 70 per cent.

Apart from bringing foreign capital, cross-border M&As have been instrumental in introducing global management practices, such as good capital structure, profit orientation, efficient management process, and merit-based personnel system, to

[20] Each ranked 82nd, 118th, 147th, and 167th, respectively (Yoo 2000).

Korea (Rhee 1999). The market competition was also affected—domestic companies now face fiercer competition in both domestic and global markets.

B. *Privatization*

A second new channel for FDI consists of privatization. On July 3, 1998, the first privatization plans for public enterprises were announced. The plans included 32 public enterprises—11 public investment and financing institutions and their 21 subsidiaries—out of 108.[21] Privatization was characterized by two stages—immediate and phased privatization. As a general rule, more market-oriented public enterprises were privatized, and when early privatization was not immediately feasible, privatization followed structural reforms of the enterprises with yearly checkup programs. The former case included five public enterprises and the latter case included six others. The number of public enterprises subject to privatization accounted for only 30 per cent of 108 public enterprises, but in terms of the number of employees and sales revenues, they accounted for 70 per cent (Cho 2001).

Foreign investors could acquire shares of Korean companies without being restricted by foreign investment ceilings except in five designated companies—POSCO (Pohang Iron and Steel Corporation), Korea Electric Power Corporation, Korea Telecom, Korea Gas Corporation, and Korea Tobacco and Ginseng Corporation—although the specified ceilings varied for different state-owned enterprises (Yun and Park 1999). However, in the process of privatization, the government gradually reduced the level of regulation: POSCO's 30 per cent ceiling on the acquisition of shares by foreigners and 3 per cent ceiling for a single foreign investor were lifted in 2001, while the restrictions on the acquisition of Korean Tobacco and Ginseng Corporation by a single person were eliminated in 2000.

International offers in the process of privatization have mainly taken the form of depository receipts (DRs) issuance. The issuance of DRs was an attractive way of privatizing Korean public enterprises because it allowed relatively easier access to the international capital markets and ownership of shares could be dispersed with little threat of an M&A, since purchases were made mainly by institutional investors.

Looking at the outcomes so far, foreign investors and capital, indeed, have been deeply involved in the process of privatization. A remarkable example is POSCO, which successfully offered its shares in the form of DRs: it sold the government's shareholdings (3.14 per cent) and the shareholdings of the Korea Development Bank (2.73 per cent) through the issuance of DRs at the NYSE in New York and LSE in London; further shareholdings of Korea Development Bank in the amounts of 8 per cent and 4.6 per cent were sold in 1999 and 2000, respectively.

[21] Public enterprises include 13 public investment institutions and their 30 subsidiaries and 13 public financing institutions and their 52 subsidiaries.

Korea Electric Power Corporation issued foreign DRs twice—14.5 per cent of total shares in 1999 and 17.8 per cent in 2001—and issued foreign exchangeable bonds and bonds with warrants—11.8 per cent of total shares—in December 2001. Korea Tobacco and Ginseng Corporation issued 10 per cent of its shares owned by the Industrial Bank of Korea as foreign exchangeable bonds in 2000, and in 2001, 19.8 per cent owned by the government and Industrial Bank of Korea was transformed into foreign DRs and exchangeable bonds. The government currently plans to sell its shareholdings of government-run banks which account for 33 per cent of total shares in the domestic (19 per cent) and foreign (14 per cent) markets. Korea Electric Power Corporation sold the government's share of 5 per cent on the NYSE through DRs and, in 2000, the facilities of the Korea District Heating Corporation were sold to LG-Caltex.

Korea Electric Power Corporation was privatized in the form of DRs issuance and trade sale of generation plants. Its foreign share as of June 1999 amounted to 25.8 per cent. POSCO was privatized in the form of DRs and sale of Korea Development Bank shares. Foreign share of the company was 51.0 per cent in 1999. Finally Korea Telecom was privatized in the form of DRs and strategic tie-ins with foreign telecommunication firms. Foreign share of the company amounted to 19.4 per cent in 1999. However, without strategic cooperation with foreign telecommunication companies, it is still difficult to promote privatization.

As discussed so far, in addition to KAMCO's sale of NPLs to foreigners through indirect methods such as international auctions, issuance of ABS, and sale to CRCs, cross-border M&As and privatization contributed significantly to increasing foreign capital inflows. As such, the role of foreign capital has been significant and important in helping corporate restructuring.

V. CORPORATE GOVERNANCE AND CHANGES IN CONTROL

Many authors have suggested that the problem of huge debt burden on Korean enterprises was due to the inherent problem of *chaebol*-type governance and ownership structure. Approaches to deal with this problem can thus fundamentally change and improve the corporate sector of Korea. In this section, the various reforms undertaken to attempt to bring changes to corporate governance and control are examined and the outcomes are assessed.

A. *Toward a New Governance*

Corporate governance structure is the system that commands and controls a corporation.[22] Recognizing that the numerous problems in the corporate governance

[22] Cadbury Committee Report (1992) gives this definition. Normally, corporate governance structure refers to a systematic relationship between an owner and the management. In a broad sense, it

structure played a major role in the financial crisis of the Korean economy, various reforms have been sought.

The reforms focused on four major areas: (1) improving the transparency of corporate management, (2) strengthening financial market discipline, (3) strengthening internal governance, and (4) prohibiting inappropriate intra-group relationships. Improving the transparency included the introduction of consolidated financial statements, and appointment of outside auditors. Strengthening financial market discipline included the strengthening of deregulation of bank loans, and liberalization of M&As. Strengthening internal governance included the introduction of the outside director system, protection of the rights of minority shareholders and institutional investors, and strengthening of the responsibility of major shareholders. Finally, prohibition of inappropriate intra-group transactions included the following: harsher punishments for unfair internal transactions, revival of some regulations, and abolition of debt guarantees. The main contents of the corporate governance reforms are summarized in Table VI.

Several cases of changes in corporate governance could be observed after the reforms. In particular, the changes in corporate laws and regulations have been quite dramatic (Park 2000). Improvements in the transparency were apparent in 1996 as the shareholders of Oriental Brewery Company requested to inspect the company's books—the first such case in Korean corporate history. These actions posed a serious threat to the management of the company. The case of Samsung Electronics shows how the voice of minority shareholders could be heard after the reforms. Shareholders of the company had been questioning a large suspicious loss and inefficiencies in some investment projects. In 1998, they eventually filed a shareholder derivative action suit against the directors of the company on various accounts including illegal insider transactions among affiliates. The management was also fined by the district court for not disclosing the contents of the minutes of the board of directors' meeting, which was requested by the shareholders. In turn, in 1998, SK Telecom was forced to elect two outside directors and an independent auditor chosen by the shareholders. The outside directors actually cancelled two deals between firms in the group. In 1997, the Fair Trade Commission ordered the company to recover the subsidy provided to its affiliate, SK Logistics.

B. *Changes in Control*

The major characteristic of the *chaebols* is the concentration of ownership. The founding families of a *chaebol* group normally own a large share of the firms. The common practice in the management of *chaebols* is that the owners, who are often

indicates that there is a systematic process to maintain and manage a clear or implied contract among the persons concerned of the corporation, such as shareholders, creditors, employees, and so on.

TABLE VI

CORPORATE GOVERNANCE REFORM MEASURES

Classification	Main Contents
(1) Improving the transparency	1. Introduction of consolidated financial statements 2. Obligation of establishing an election committee for the assignment of outside auditors for listed companies and affiliates of the *chaebols*
(2) Strengthening financial market discipline	1. Regulation of bank loans: —Debt-equity ratio 200 per cent became a de facto limit in provision of loans —Prohibition of new loans with guarantee by affiliated firms —Establishing a system for constant assessment of corporate credit risk, including the introduction of forward-looking criteria (FLC) 2. Liberalization of M&A market: —Permitting hostile takeovers —Abolition of regulations on foreigners' shareholding
(3) Strengthening internal governance	1. Outside director system: —A quarter of the board of directors should be outside directors 2. Responsibility of major shareholders: —Registration of the controlling shareholder as the representative director of leading affiliates —Removal of the "Chairman's Office" 3. Rights of minority shareholders: —Loosening conditions for derivative suits, inspection of accounting books, and request for the dismissal of directors and auditors by shareholders —Introduction of a cumulative voting system when appointing directors 4. Rights of institutional investors: —Allowing voting rights for shares in funds managed by investment trust companies and bank trust accounts
(4) Prohibiting inappropriate intra-group relations	1. Strengthening punishment on "unfair" internal transactions 2. Revival of regulation on the amount of investment in related firms to 25 per cent of net assets of a business group 3. Abolition of cross-debt guarantee

Source: Tabulated from Sohn (2002) and Chang and Shin (2002).

nonprofessional managers, have greater voting power than other shareholders and thus can exercise exclusive control of the firm. Moreover, it has been suggested that in these *chaebols*, controlling shareholders exercise control in excess of their holdings through a hierarchical chain of ownership (Chang 2002). This is an example of the nonseparation of ownership and management in *chaebols*.

Agency theories suggest two different strategies. According to one strategy, based on the convergence-of-interest hypothesis, nonseparation of ownership and management is beneficial to the performance of the firms because there is less conflict of interest between the two groups. In the other strategy, based on the entrenchment hypothesis, it is suggested that the firm value decreases as managerial ownership increases, because managers—be they professional or the owners—hold a substantial share of the firm which would provide them with voting power that guarantees their employment with a handsome salary.[23] The two very different strategies, however, converge to an agreed conventional wisdom that the ownership structure affects the firm performance or value.

Many previous studies had focused on issues of concentrated ownership or nonseparation of ownership and management. This paper, however, pays attention to another characteristic of the *chaebols*—the single-nationality of ownership. Here, the managerial aspects that could be improved by making ownership multinational are being illustrated.

The massive inflow of foreign capital after the financial crisis through cross-border M&As, privatization, and the sale of KAMCO's assets brought major changes in corporate control and ownership. Foreign investment can exert significant effects on corporate management, especially in terms of sharing control and power.[24] The experience of three companies, Hansol PCS, the Korea First Bank, and Samsung Heavy Industry illustrates the point very well.

Hansol PCS, a mobile phone operator and a subsidiary of Hansol, a major *chaebol*, received investment from Bell Canada International and AIG, an American investment fund. Thirty-eight per cent of the total outstanding shares of Hansol PCS was divided between the two investors. They consequently adopted "super majority voting rights," which gave minority shareholders enhanced power and gained about 33–49 per cent of voting rights by electing four representatives to the board.

The Korea First Bank also came under foreign ownership. Although it was the largest bank in Korea in terms of assets and profits, when it became insolvent in 1998, its nonperforming loans reached $3.2 billion. Soon Newbridge Capital acquired 50.99 per cent of shares and a foreign manager was elected as president and chief executive officer of the bank. The most important change in the Korea First Bank from the entry of foreign capital and management was the general reorgani-

23 Theories are well summarized in the report of Cho and Chae (2002).
24 Case studied by Yun (forthcoming).

zation of the bank involving the organizational structure redesigned after the western style division system, an employee reward mechanism, and new business strategy.

Volvo's acquisition of Samsung Heavy Industry significantly contributed to the management of the Korean firm. The so-called "flat management" introduced by Volvo reduced direct and indirect transaction costs by eliminating steps in the decision-making process.

VI. ASSESSMENT AND CONCLUSION

The Korean economy has almost recovered and reached its pre-crisis level, based on its macroeconomic performances. The GDP growth rate recovered and reached the pre-crisis level of 5.5 per cent in 2001 from –6.7 per cent in 1998. Foreign exchange reserves, owing to a trade surplus that has continued for the last four years, recorded over $112.4 billion in June 2002 from $3.4 billion in December 1997. The foreign exchange rate appreciated to about 1,200 won to U.S.$1.00 in June 2002 from 1,840 won in January 1998. In addition, the interest rate decreased to 5.4 per cent from over 19.0 per cent. Moreover, the unemployment rate dropped to 2.7 per cent from 6.8 per cent. Owing to its rapid economic recovery, Korea was able to repay its IMF loans in August 2001, two years and eight months earlier than originally scheduled.

The sharp recovery of the post-crisis Korean economy can be best assessed and reflected in the various sovereign ratings of the global credit rating agencies. In March 2002, Moody's raised Korea's sovereign rating to A3, as seen in Table VII. This is a rise from Korea's rating of Ba1 during the crisis period, the lowest level it had ever received, and only two levels below the country's pre-crisis rating. Both S&P and Fitch IBCA also raised the sovereign rating to A– and A, respectively.

Structural reforms, especially corporate restructuring, contributed significantly to Korea's rapid economic recovery. In the Article IV consultation with Korea in February 2002, the IMF expressed its appreciation for the "sustained implementa-

TABLE VII

TREND IN KOREA'S SOVEREIGN RATING

Rating Agency	Pre-crisis	During the Crisis	Post-crisis
Fitch IBCA	AA–	B– (–12)	A (+10)
S&P	AA–	B+ (–10)	A– (+7)
Moody's	A1	Ba1 (–6)	A3 (+4)

Source: Ministry of Finance and Economy, "S&P Raises Korea's Sovereign Rating," Press Release, July 24, 2002.
Note: The numbers in the parentheses denote the changes in the stages from the pre-crisis period for the second column and during the crisis period for the third column.

TABLE VIII

FINANCIAL INDICATORS

	1995	1996	1997	1998	1999	2000	2001
Debt-equity ratio	286.8	317.1	396.3	303.0	214.7	210.6	182.2
Ordinary income to sales	3.6	1.0	–0.3	–1.9	1.7	1.3	0.4
Operating income to sales	8.3	6.5	8.3	6.1	6.6	7.4	5.5
Return on equity	11.02	11.03	2.02	–4.21	0.04	–5.8	0.02
Return on assets	2.83	0.5	–0.93	–3.59	0.01	–1.9	0.01
Interest coverage ratio	149.6	112.1	129.1	68.3	96.1	157.2	132.6

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

tion of structural reform," stating that the Korean government policy enhanced market discipline, along with macroeconomic fundamentals, and therefore the resilience of its economy.[25] During the five years since the financial crisis, the financial situation of Korean corporations markedly improved.[26]

Table VIII lists various financial indicators that clearly show improvements. Both the debt-equity ratio and interest coverage ratio have shown improvements since the financial crisis. But these figures can be misleading guides of the viability and soundness of firms. The fall in debt-equity ratio might have been induced by the revaluation of equity, rather than by an actual reduction in debts. Also, the improvement in the interest coverage ratio may be due to the cut in interest rates after 1999 rather than to improved profitability.[27]

However, as discussed earlier, it is clear that the sharp increase in foreign capital in the form of FDI inflows, particularly in cross-border M&As, significantly contributed to successful corporate restructuring. Cash flows also increased through other channels: KAMCO's operations including international bidding, issuance of ABS, and sales to CRCs and AMCs,[28] cross-border M&As, and foreign inward privatization.

Also, it appears that various restructuring intermediaries, in particular KAMCO, have successfully contributed to the resolution of corporate debts. NPLs have continuously been purchased and cleared, and the share of remaining NPLs to the total has significantly decreased from 88.6 per cent in 1997 to 24.0 per cent in 2001. In

25 Ministry of Finance and Economy (2002, p. 24).

26 On the other hand, it cannot be ignored that favorable external conditions—an information technology boom in the United States and a low interest rate in the world market between 1999 and 2000—also exerted positive impacts on the recovery of the Korean economy. Especially, the low interest rate in the world market gave the Korean government the leeway to steadily achieve economic recovery in spite of its low interest rate policy, evading the problem of capital outflow.

27 A review and comparison of the pre- and post-crisis corporate performance can be found in Chopra et al. (2001) and Richards et al. (2002).

28 International bidding, issuance of ABS and sales to AMCs and CRCs account for about one-third of KAMCO's total operations.

particular, the remaining NPLs to total credit decreased to less than 5 per cent in 2001. As of June 2002, KAMCO had recovered 27.7 trillion won, or 113 per cent of the purchasing value of NPLs, making profits of 3.3 trillion won. Also as of June 2002, the remaining NPLs accounted for 43.3 per cent of the total NPLs. However, if Daewoo's NPLs are excluded, KAMCO's operations have been very successful, clearing almost three-quarters of the total NPLs.[29] Korea's performance in resolving corporate debts can be compared with that of other crisis-struck countries. While Korea cleared three-quarters of its total NPLs, Indonesia cleared 9 per cent and Malaysia 85 per cent.[30]

The financial crisis and the resulting reform measures suggest some lessons. First, the importance of short-term cash flows and liquidity of the firms must be recognized. The objective of the firms and restructuring of the corporate sector should not focus only on conventional targets such as growth, productivity, and profitability, but also on the efficient management of cash flows. Second, although the resolution of corporate debts has been successful, there should be continuous legal and institutional efforts to resolve the remaining NPLs. Third, the benefits and importance of foreign capital are now recognized. Thus both financial and corporate sectors must continue to attract more foreign capital, not only to reinforce the on-going corporate restructuring, but also to improve the viability and soundness of the corporate sector. Fourth, the changes in corporate governance and ownership structure must successfully be linked to better corporate performance.

This paper analyzed various corporate sector reforms encompassing corporate debt restructuring and corporate governance reforms and identified two major factors behind this rapid rehabilitation of the Korean economy as follows: the successful resolution of corporate debts and large inflows of foreign capital through such channels as cross-border M&As and privatization, which have improved, among other things, the cash flows of the corporate sector. Thus the conclusion of this paper is straightforward. First, the resolution of corporate debts has been satisfactory and successful. Second, foreign capital has contributed significantly to effective corporate restructuring and debt resolution. However, to draw more concrete and firmer conclusions, we need more detailed and in-depth research to identify the precise channels through which corporate debts were resolved. As yet, comprehensive statistics and research on the role of foreign capital in corporate restructuring are still lacking. We consider that this current study may pave the way for further investigations.

[29] Daewoo's NPLs have remained uncleared following political difficulties.

[30] The official figure for Korea is 40 per cent, but as mentioned previously, the exclusion of Daewoo's NPLs leads to three-quarters. Malaysia recorded the highest rate among the crisis-ridden countries (Mako 2001a).

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