

**Chaebol Restructuring and
Family Business in Korea**

Kim Ky Won

Department of Economics,
Korea National Open University
KOREA

I . Introduction

The purpose of this paper is to examine the restructuring process of the Korean chaebol (family-managed conglomerates) and its impact on family business practices since the outbreak of the 1997 financial crisis in Korea. In November of that year, the financial crisis forced the Korean government to ask the International Monetary Fund (IMF) for an emergency bailout loan. Since then, the restructuring of the corporate sector, particularly the chaebol, has been an urgent task for the Korean economy. This task was necessitated by market forces, and there was also a strong demand by the majority of the Korean public. Furthermore, it was one of the conditionalities of the IMF loan. Michel Camdessus, managing director of the IMF at the time, once called for the dismantling of the chaebol, even though he later toned down his statement.

Deeper analysis has yet to be made about the underlying causes of the Korean financial crisis, the relative importance of each cause, and the relationships among them. However, a consensus is now made among economists that externally, the hastily implemented financial liberalization, including capital market opening, was responsible for the crisis, and that internally, structural defects in the corporate sector were also to blame. In 1997, Korea was experiencing a series of chaebol bankruptcies running up to the crisis. That is why virtually everyone accepted the necessity of chaebol restructuring when it was proposed. In this regard, however, it is worth mentioning that the chaebol were principal engines that had powered the rapid economic growth of the past several decades and had their own *raison d'être* in internal and external contexts, which led to the serious controversies, with respect to the details of the restructuring, such as the goals, methods, and pace.

The government's chaebol restructuring was launched in January 1998, based on the five principles agreed to by then President-elect Kim Dae-jung and the chaebol heads. These were: a) enhancing transparency in corporate management; b) eliminating intra-group debt guarantees; c) improving firms' capital structure; d) concentrating on core competencies; and e) increasing the accountability of controlling shareholders and management. A later presidential announcement in August 1999, added three supplementary items to the chaebol reform agenda: a)

prohibiting industrial capital's domination of finance; b) suppressing circular investment and unfair transactions among chaebol affiliates; and c) preventing improper bequests or gifts to chaebol heirs.

Some of these "5+3" principles concerned the fundamental reform of the chaebol structure, namely corporate governance reform. Others, c) – d) in the first five principles, dealt with the immediate financial distress of the chaebol. In chaebol restructuring, the latter needed more urgent measures and sometimes gave rise to conflicts with the former. In order to clean up distressed firms, the government utilized court-supervised insolvency, out-of-court workouts, "Big Deals," etc. During this process, as was distinct from other previous corporate restructurings, the Korean government sought to rely on foreign capital as an effective means of restructuring, lifted the existing barriers to its entry and even gave some preferential privileges.

In their early stages of development, enterprises naturally take the form of family businesses. As they grow in size and diversify into various sectors, they begin to develop managerial hierarchies and employ professional managers. And by so doing, according to Alfred Chandler, they are getting transformed into managerial business where founding families are separated from the management (Chandler 1977). Korean chaebol also took this path in a way, developing managerial hierarchies and transferring some strategic decision-making to professional managers, the extent of which differed among the chaebol. Unlike Chandler's expectations, the chaebol did not fully comply with his model and the Korean economy was still dominated by the chaebol system until the financial crisis. However, after the onset of the crisis, the massive inflow of foreign capital together with corporate governance reform brought significant changes to the chaebol. Some of the chaebol affiliates were sold off for foreign capital and the remaining chaebol were subject to constraints by non-controlling shareholders.

The remainder of this essay is organized as follows. The second section briefly describes the growth and crisis of the chaebol. The third section discusses the disposal process of ailing firms and the fourth section deals with the corporate governance reform of the chaebol. Finally, the fifth section examines the changes in family business and also ascertains the reasons why the chaebol system still persists in Korea.

II. The Growth and Crisis of the Chaebol

The chaebol's origin in Korea is usually traced back to 1945, when Korea was liberated from Japan and the subsequent Syngman Rhee administration, though a few chaebol started their business during the colonial period (Kim Ky Won 1990). The end of the Japanese colonial rule in 1945 confronted Korea with the crucial tasks of reassigning property rights and re-establishing the external trade and foreign exchange regime of the country. These tasks were the very means by which the chaebol built up their wealth. Firstly, they participated in the disposal process of vested properties ("enemy properties"), formerly Japanese-owned industrial properties. The Korean government typically set the assessed value of those properties far below the market value, thereby giving windfall gains to favored businessmen.

Korea was in severe shortage of consumer goods after liberation and therefore the import trade market brought business opportunities to the chaebol. Furthermore, the overvaluation of the Korean currency had the effect of guaranteeing enormous profits for the import traders. U.S. aid also provided raw materials such as cotton, sugar, and wheat flour for the main industries of the 1950s, in which the top chaebol had a major presence. In addition, the chaebol were able to gain access to operating money at low interest rates from Korean banks.

After the downfall of the Rhee administration and the short-lived and unstable administration that followed, a military coup in 1961 placed Park Chung-Hee as leader of South Korea. The Park government sought to promote exports with the massive introduction of foreign loans. The President himself spearheaded an effort to boost exports, offering various incentives based on export performance. Domestic loans were conferred on the chaebol at very low real interest rates. Moreover, state-owned banks provided explicit repayment guarantees to foreign financial institutions on loans extended to the chaebol. Thus the risk partnership between government and business was formed and the government acted not only as a guarantor, but also as a monitor of loans. When the investment boom in the late 1960s produced a number of firms that could not meet their foreign debt obligations, the government held the incumbent owners accountable by taking over managerial control of their companies.

As Korea's participation in the Vietnam War created profitable opportunities for the chaebol in the 1960s, the construction boom in the Middle East did the same thing

in the 1970s. Furthermore, the drive to expand heavy and chemical industries (HCI), officially launched in 1973, played a crucial role of entrenching the chaebol in the Korean economy. During this drive, a myriad of small and medium-sized enterprises in the light manufacturing industries were in effect pushed aside by a select group of chaebol that expanded their business empires, thanks to the generous government support. In contrast to the 1960s, government support during the HCI drive was not contingent on export market performance and had a strong industry-specific bias (Lim Wonhyuk 2003, 47). Along with the Emergency Decree of 1972, which placed an immediate moratorium on the payment of all corporate debt to the curb lenders, this drive transformed the government-business risk partnership in favor of the chaebol, exacerbating their moral hazard of undertaking excessive investment without being afraid of failing – the “too big to fail” mentality.

By the end of the 1970s, the chaebol system took roots, in terms of their internal organization and external dominance over the national economy. Internally, the chaebol instituted a modern hiring method and a managerial hierarchy. They also established group headquarters (called a secretarial office or a planning and coordination office) to ensure the family control of the diversified affiliates. In the underdeveloped market economy of Korea, these headquarters worked as a complementary internal organization supplying crucial inputs such as financial capital, managerial skills, or information. On the external side, the chaebol grew to control businesses across most of the important industries, including manufacturing, distribution, construction, and so on. The ten largest chaebol increased their share of GNP from 4.7% (1974) to 9.7% (1979) (Kang Myung-Iun 1996). The number of affiliates of the 30 largest chaebol rose from 126 in 1970 to 429 in 1979, with the average number of affiliates changing from 4.2 to 14.3 during the same period (Kang Chul-Kyu et al. 1989, 115).

However, Korea found itself in a severe economic crisis in 1979 and the chaebol sector was a major culprit. Its expansion into uncompetitive businesses endangered macroeconomic growth and stability. Therefore, newly elected President Chun Doo-Hwan scaled down the HCI drive and sought business swaps among the chaebol in 1981, in order to dispose of overlapping investments. Yet the swaps did not proceed as smoothly as expected due to the chaebol's strong opposition. In the mid-1980s, the government generously rescheduled, or wrote-off, 74 percent of non-

performing loans to the chaebol, financed through special assistance from the central bank. In the 1980s, the increasing ownership of non-banking financial institutions (NBFIs) by the chaebol allowed the NBFIs to emerge as another financing source for the chaebol. Capital markets were also deregulated substantially, further enhancing the availability of direct financing for the chaebol.

Here, one important point to note is that the government began to realize the social and political problems associated with the chaebol in the 1980s and imposed some legal restraints on the chaebol's ownership structure and their borrowing practices. The problem was the chaebol's concentration of economic power, which could be converted to political power. Still, conspicuously missing from the government's idea of the chaebol problem were corporate governance issues.

The chaebol suffered from low profitability in the early 1990s, recovering in 1994-1995 thanks to the semiconductor boom, but declining again sharply in 1996-1997. The profitability decrease implied that the efficiency of investment was deteriorating. Accordingly, the percentage of loans extended to potentially non-performing firms rose in 1992-1993, then declined in the 1994-1995 business cycle boom, and then rose rapidly again in 1996-1998. That percentage in 1997 was above 25% (Shin Inseok ed. 2000, 78). The corporate debt to GDP ratio gradually increased until 1995, but increased substantially after that. The debt to equity ratio was also extremely high, around the 2.5 level in the 1990s for all listed companies, and an even higher 4.0 for the largest 30 chaebol. The government sought to improve the financial structure of the chaebol by means of a "sector specialization" policy, but their efforts were fruitless.

This deterioration of the chaebol's management was partially associated with the characteristics of the chaebol system called dynastic dictatorship.¹ The dynastic dictatorship of the chaebol worked fairly well, at least during the founder's generation. However, by the early 1980s, the drawbacks of the chaebol system became apparent, such as questionable judgment by aging first-generation founders or the emergence of second- or third-generation chaebol heads. The damage caused by this dynastic system became severe as the expansion in both size and scope of business, and the

¹ Chaebol heads are dictatorial in that within their corporations, they wield power unchecked by any internal mechanism. They are dynastic in the sense that this power is bequeathed to their children regardless of management abilities.

rapid progress of globalization complicated management. In the case of Hyundai, the aging founder made numerous misjudgments about new businesses and personal ventures, such as a belated entry into the semi-conductor industry, a failed lumber project in Russia, and a campaign for President in 1992. Other cases of misjudgment by incompetent heirs were identified at Ssang-yong, Sammi, Jinro, and other chaebol groups.

Combined with the incompetence of many chaebol leaders, the increase in agency costs made matters worse. As the chaebol expanded rapidly, the ownership share of the founding families decreased proportionately. The founding families owned less than 10 percent of company shares, but with affiliated firms holding more than 30 percent, they maintained an iron grip on the control over the group. This extreme separation of ownership rights (cash-flow rights) from control rights created severe conflicts of interest between controlling shareholders and non-controlling shareholders (Bebchuk 1999).² Controlling shareholders (chaebol heads) were prone to seeking private benefits of control at the expense of non-controlling shareholders. High-risk business was undertaken without sufficient consideration of its prospect. The cost of its failure was paid by chaebol heads according to their ownership share while the benefit was much larger than their ownership share. Poor corporate governance mechanisms exacerbated this situation.

In January 1997, Hanbo, the 14th largest chaebol, went bankrupt, signifying that the chaebol were no longer "too big to fail." Kia, the 7th largest group, followed suit and in aggregate, some nine large chaebol defaulted even before the IMF bailout began. As mentioned above, corporate management crises have erupted into national issues from time to time during the history of Korea's accelerated economic growth. Prominent examples include the disposal of ailing firms during the period from the late 1960s to the early 1970s, and during the early to mid 1980s. However, around the time of the financial crisis, the problem took a serious turn as half of the top 30 chaebol found themselves facing bankruptcy, and even the biggest chaebol such as Daewoo and Hyundai were teetering on the brink of failure. Moreover, financial liberalization in the 1990s made the chaebol's bankruptcy a global problem, causing

² In cases of the 37 largest chaebol, controlling families hold 43.7 percent of control rights with 25.2 percent of cash-flow rights. In cases of the top four chaebol, their control rights were 35 percent, while cash-flow rights were only 8.7 percent. (Mail Daily Newspaper 2003. 9. 30.)

the foreign currency crisis. Confronting this situation domestically, as before, was no longer a possible option.

III. Cleaning Up Distressed Firms

The following chronology summarizes the key events in the post-crisis restructuring of the chaebol.

<1997>	
January	Hanbo Group is declared bankrupt.
April	Default Deferral Agreement among banks and other financial institutions is established.
July	Kia Group is designated for Default Deferral.
December	Korea and the IMF agree to the terms of a bailout loan.
<1998>	
January	President-elect Kim Dae-jung and chaebol heads agree on 5-item corporate restructuring agenda.
Feb. - March	Korean Banks and chaebol agree on Capital Structure Improvement Plan.
Feb. - May	Law is amended to ease requirements for exercising minority shareholder's rights.
May	Korean Banks establish Corporate Viability Assessment Committee.
June	Financial Supervisory Commission (FSC) announces a list of 55 firms to be closed.
June	Workout program begins as 210 financial institutions sign Corporate Restructuring Agreement.
July	Fair Trade Commission (FTC) announces first investigation results on illegal intra-group transactions within the five largest chaebol and imposes penalties on them.
September	Big deals in seven business lines is announced by the five largest chaebol.
December	Meeting between President Kim Dae-jung and chaebol heads produces agreement on chaebol reform issues, including reductions of subsidiary companies. Big deal talks begin on swapping Samsung Motors and Daewoo Electronics.
<1999>	
April	Introduction of Primary Creditor Line System for the 60 largest chaebol.
June	Samsung Motors files for court receivership
August	President Kim Dae-jung announces three supplementary principles for chaebol reform.
August	Workout programs are announced for 12 Daewoo subsidiaries.
December	Tax laws concerning bequests and transfers are tightened. The Securities and Exchange Act is amended to expand outside directorship. Total equity ceiling is reintroduced.
<2000>	
February	Government holds meeting to launch second four-sector restructuring program.
February	Government-IBRD consultation on corporate and financial

	restructuring ends.
March-May	Hyundai management crisis breaks out concerning the succession of the group head and Hyundai Engineering & Construction solvency problem.
October	Laws concerning Corporate Restructuring Vehicles (CRVs) are enacted.
November	Government announces another list of 52 firms to be closed.
December	Corporate Restructuring Coordination Committee, which had overseen the corporate workout program, is abolished.
<2001>	
March	Permanent Assessment System of Corporate Credit Risks is established.
May	A list of 1,544 companies to be subjected to continuing viability assessment is announced.
May	The Chaebol strongly demand the easing of regulations, while characterizing chaebol reform as a leftist movement. After a meeting between government and corporate sector representatives, the loosening of regulations against the chaebol system is agreed to.
September	Restructuring Facilitation Act is enacted.
December	Bill to ease restrictions on chaebol, including the total equity investment ceiling, is passed by National Assembly.
December	Court rules in favor of the plaintiff in a derivative suit against Samsung Electronics' directors.
<2002>	
April	Daewoo Motors is sold to General Motors.
<2003>	
February	Crisis in SK Group breaks out. Its head is arrested for fraud.
April	LG Huling Company is established.
November	Sovereign Asset Management Limited, a foreign investment fund, demands the resignation of the top SK management.
November	Management crisis in LG Card breaks out.
Nov.-Dec.	Feud among Hyundai families breaks out concerning the control of Hyundai Group.
Nov.-Dec.	Investigation into the presidential campaign scandal continues. Illegal funding by the chaebol is disclosed.
December	Samsung Group's staff are prosecuted for illegal transfers of group assets to the third-generation heir.

A string of bankruptcies of the chaebol affiliates, running up to the 1997 crisis, prompted the government to designate “the resolution of ailing firms” as its first priority in chaebol restructuring, while it considered corporate governance reform as the fundamental component in chaebol restructuring. At the onset of the financial crisis, few institutional systems and market mechanisms were available to deal with large-scale insolvency. In need of a systematic mechanism, ways to introduce out-of-court settlement procedures as well as to improve the existing court-based procedures were sought.

The government preferred out-of-court procedures to legal resolutions, because it sought to ameliorate the impact of a chain reaction of bankruptcies. Apparently the administration's distrust of the judiciary's expertise and promptness was a factor in this decision. The popular misconception of court receivership as a process for liquidation instead of rebuilding was also an influencing factor. Thus, the government decided on the principle that corporate restructuring would be directed by creditor financial institutions. Since banks were also subject to restructuring, and, as the government ended up being the largest shareholder in numerous banks as a result of financial sector restructuring, this effectively meant that the government would direct the chaebol restructuring program through banks and other financial institutions.

The government first had the creditor banks classify chaebol-affiliated companies into three categories: normal, viable, and non-viable. Non-viable firms would be liquidated, but viable firms belonging to the five largest chaebol would be resolved through 'self-directed restructuring' or the big deals, and viable firms belonging to the other chaebol would be required to undergo workout programs supervised by the creditor banks. The reason for differentiating between the top five chaebol firms and the others was that the five largest chaebol were judged to be capable of restructuring themselves. However, this differentiation caused the top five chaebol to delay the restructuring and therefore, the government had to prod them again in December 1998 to proceed with restructuring.

Accordingly, a list of 55 firms to be liquidated was announced in June 1998, and a second list was drawn up in November 2000. Thereafter, instead of such liquidations en masse, a standing system was set up to judge corporate viability on a continuing basis. Since June 2001, the system has evaluated 1,097 potentially non-viable firms, which had been given precautionary or lower credit ratings by creditor banks, recorded an interest coverage ratio of less than 1, or had shown other signs of insolvency during the past three years. Of those firms, 141 were found to be non-viable.³ However, all these announcements of firms to be liquidated ended up undermining their own purpose by limiting the lists mainly to smaller companies. As a result, more than 25 percent of large companies still remain unable to generate operating profits to cover even their interest costs (Kim Joon-Kyung, 2003.11.12).

³ Refer to Economic Policy Coordination Meeting (2002).

Creditor financial institutions have been loath to realize potential losses by closing down non-viable firms.

Table 1 Summary of Big Deals

Business	Progress
Oil refining	Hyundai Oil Refinery absorbs the oil refinery business of Hanhwa energy.
Semiconductors	Hyundai Electronics absorbs LG Semiconductors and renames itself Hynix Semiconductor.
Train manufacturing	Train manufacturing business separated from Hyundai Precision (renamed as Hyundai Mobis), Daewoo Heavy Industries, and Hanjin Heavy Industries are merged into a new company. Thereafter, Hyundai Mobis secures control over the consolidated company.
Aerospace	Samsung Aerospace, Daewoo Heavy Industries, and Hyundai Space & Aircraft consolidate their aerospace companies into Korea Aerospace Industries.
Power generators	Samsung Heavy Industries and Hyundai Heavy Industries transfer their power generator business to Hanjung.
Ship engines	Samsung Heavy Industries' ship engine business merges into Hanjung, which establishes a new consolidated company.
Petrochemicals	Big deal between Samsung General Chemicals and Hyundai Petrochemicals fails. Samsung seeks resurrection through an equity increase supported by other Samsung affiliates.
Automobile and Electronics	Big deal talks to swap Samsung Motors and Daewoo Electronics fail.

Source : MOCIE(2001) and various newspaper articles.

The Big deals program called on the chaebol to dispose of non-core business lines and to focus limited corporate resources on a few core activities. As was mentioned in the previous section, the Korean government has repeatedly interfered with market mechanisms to dissolve structural excess capacity since the early 1980s. The sector specialization policy in the 1990s was also an attempt to indirectly channel the business lines of the chaebol into core activities. This turned out to be a failure in the 1997 crisis, so the government came up with the big deals which included special tax exemptions and financial support. The gist of the big deals is summarized in Table 1.

The big deals consisted of three methods: first, one chaebol transferring some business to another chaebol; second, two or more chaebol consolidating their affiliates into a new company; third, two chaebol exchanging their affiliates. Thus, the big deals achieved overall reductions of 15 percent in assets, 13.8 percent in manpower, and 25.8 percent in debts. However, big deals in some industries aggravated the overproduction problem rather than solving it. In the semiconductor industry, the financial problems were only amplified. The aerospace industry also drifted aimlessly without management leadership and labor-management relations became more complex with the emergence of plural labor unions. The possibility of a second big deal was brought up in 2001 for seven other industrial sectors suffering from excess capacity, but this idea was subsequently dropped.

The workout program was an extension of the 'default deferral agreement' system before the 1997 crisis. Going beyond merely agreeing to defer payment defaults, the workout program aimed to rehabilitate distressed firms through debt adjustments such as debt/equity conversions, interest rate reductions, and write-offs. Furthermore, creditors in the workout program actively pursued loss sharing among shareholders, management, and creditors. They also urged business restructuring, including transfer of control rights. In July 1998, with encouragement from the Financial Supervisory Commission, 210 local financial institutions contractually bound themselves to the Corporate Restructuring Agreement (CRA) and embarked on workout programs as an alternative to court receivership. The workout programs are differentiated from court receivership in that under a workout program, credit banks, not the court, lead the whole process. The workout programs are more flexible in their operation compared with court-led restructuring procedures, and therefore reduce the rehabilitation time of failing firms. On the other hand, the lack of any legal authority in the workout programs can delay the overall rehabilitation process and increase the potential costs of financial distress, because conflicts among creditors, especially between large and small creditors, can be a source of inefficiency.

The initial workout program applied to the nation's 64 biggest chaebol and their affiliates, but they did not include the top five chaebol. Daewoo, one of the top five chaebol, was included in August 1999. As of September 2003, out of the 104 companies initially selected, twenty one dropped out of the program due to disagreement on loss sharing between creditors and firms or because liquidation was

later deemed more appropriate. Nineteen merged with other companies. Forty-one companies successfully completed their restructuring and graduated from the program. Five companies out of these forty-one were still awaiting sale, and the remaining twenty-three were still under workout programs.⁴ Initially, the workout program was to be finished by the end of 1999, but in consultations with the World Bank, it was extended beyond the original schedule. However, no new firms have been allowed into the program since July 2000. It has been succeeded by restructuring programs under the new Restructuring Facilitation Act, enacted in July 2001, which sought to solve the conflicts of interest among creditors. In response to the management crisis of Hyundai Engineering & Construction and Hynix Semiconductor in 2000-2001, the government came up with the Bond Market Stabilization Fund and the System of Prompt Underwriting of Bonds to refinance their corporate bonds, and subsequently applied the new law to those two ailing companies.

There has been criticism that the workout program made the corporate debt problem worse by prolonging the fates of firms that should have been liquidated immediately, such as Dong-Ah Construction. The lack of expertise and moral hazard among creditor-appointed managers has also been controversial. Some have criticized that workout firms were hindering fair competition by price dumping.

As a way of cleaning up the distressed chaebol, the government also asked that they reduce their debt/equity ratios to a level below 200 percent by the end of 1999, as per the Financial Structure Improvement Agreements. In order to quickly reduce this index, which averaged 509 percent at the end of 1997, the chaebol had to resort to selling off affiliated companies, asset sales, and capital increases (including foreign capital). As a result of these measures, the average debt/equity ratio of the 30 largest chaebol fell to 171 percent by the end of 2000.⁵ As for the 70 largest chaebol, the ratio of total borrowings to total assets decreased from 55 percent in 1997 to 28 percent in 2002. Accordingly, the interest payment coverage ratio – the ratio of earnings before interest payments and taxes plus depreciation and amortization to interest expenses – for the 70 largest chaebol, rose from 1.1 in 1997 to 3.7 in 2002 (Kim Joon-Kyung 2003).

4 Refer to Maily Business Newspaper (2003. 10. 4)) and Park Kyung Suh (2003. 189).

5 There has been criticism that as a way of reducing debt-equity ratio, the chaebol have focused on equity increases, particularly through investments by affiliates, rather than reducing their overall debts.

As a consequence of selling-off non-core affiliates, the overdiversified or tentacles-style chaebol management has improved a lot but has by no means disappeared. The number of affiliated companies in the 30 largest chaebol dropped from 819 in 1997 to 544 in 2000, but subsequently rose again to 624 in 2001. As for the average number of the types of businesses the 30 chaebol engaged in, a slight reduction occurred, from 19.8 in 1997 to 15.7 in 2001. Diversification in itself is not necessarily harmful. The number of affiliated companies can grow as the industrial structure changes, and there is nothing wrong with choosing to participate in a new industry. However, the Korean chaebol lack a well-developed system for rational decision making in investments, making them prone to indiscriminate diversification, which has not improved much since the 1997 crisis. A good example was the recent fad among the chaebol to jump into the credit card business, which later brought about significant losses to Samsung, LG, and Hyundai Motors Group.

The chaebol's relative weight in the national economy has not changed greatly, either. The 30 largest chaebol maintained a similar presence in the economy both before and after the crisis, as measured against GDP, value-added in manufacturing, and total assets and sales: The share in GDP and value-added in manufacturing changed from 13.6 and 30.5 to 12.9 and 30.3 respectively, in 1996-2000. Among the 30 largest chaebol, Samsung Group has established unchallenged superiority. Samsung Group single-handedly accounts for about 28% of the total value of listed stocks as of December 2003, compared to 12.6% in June 1995. This amount exceeds the aggregate listed stock value of the other top 15 chaebol. Total net profits by the 30 largest chaebol added up to only 2.3 trillion won, but Samsung alone earned 7.4 trillion won in 2000.⁶

During the process of cleaning up distressed firms, foreign capital became very important. In the past, the government urged other chaebol to take over a failing chaebol, but this policy changed. Following the crisis, the government sought to sell failing firms overseas, and almost completely eliminated restrictions on foreign capital's purchase of domestic company shares.⁷ Moreover, the Foreign Investment Promotion Act of 1998 streamlined procedures and strengthened tax incentives for

(Mako 2002, 217)

⁶ Refer to Choi Sung-No (2001, 63-64) and Maily Business Newspaper (2003, 12, 13).

⁷ The liberalization rate is now 99.8% in terms of the number of the business sectors open for FDI out

Table 2. FDI in Korea on Approval Basis (value unit: US\$ billion)

Year	1962-90	91	92	93	94	95	96	97	98	99	2000	01	02
Value	7.87	1.40	0.89	1.04	1.32	1.95	3.20	6.97	8.85	15.54	15.22	11.29	9.10
No. of Project	5337	510	444	458	646	873	967	1055	1401	2104	4140	3340	2402

Source: MOCIE (2003 b)

foreign investors. As can be seen in Table 2, foreign direct investment (FDI) surged in 1999-2000 as a result of chaebol restructuring, even though it subsequently declined after 2000. Foreign ownership of listed stocks also increased from 16.7 percent in early 1998 to 40.2 percent by the end of October 2003. Of the 500 largest multinationals, 197 had invested in 607 Korean companies by the end of 2001. For some large firms such as Samsung Electronics and POSCO, foreign ownership amounted to over 50 percent. The number of Korean firms with foreign equity investors increased from 4,419 at the end of 1997 to 12,909 by the end of 2002. At the same time, these firms accounted for 13, 13, and 7 percent of production, export, and employment respectively in Korea.⁸ Foreign equity claims a dominant share in some industries, including automotive parts, oil refinery, paper, seeds, rolled aluminum, and alcoholic beverages (Park Sang-il et.al. 2001).

IV. Corporate Governance Reform

During the period of government-led development, the government acted as the principal and monitor, and the chaebol were the agents who implemented the government's development program. The incentive was provided through government subsidies to the business sectors based on the investment and export performance. However, as the economy grew both in size and complexity, and developed toward a more market-oriented system, the reasoning of government intervention as the principal waned. Yet a new corporate governance system was not instituted to replace

of a total of 1,121 business sectors. (Kwon Oh Yul 2003,45)

⁸ Refer to MOCIE (2003a) with regard to the FDI-related statistics here.

the old one. Chaebol heads exercised discretionary power and control because of the ownership structure of the chaebol and the lack of checks and balances.

Under these circumstances, not surprisingly, when the financial crisis hit in 1997, a consensus emerged that the high leverage, overdiversification, and the resulting failure of the chaebol were traced back to poor corporate governance. Consequently, the Korean government under pressure from the IMF and the World Bank initiated various measures for corporate governance reform that could be classified into internal governance reform and external governance reform.⁹

First, one must explore the internal governance reform for enhancing corporate accountability. The most important item was strengthening non-controlling shareholder rights that were virtually non-existent before the crisis. Although this did not go so far as to secure shareholder's rights to file derivative suits even for single shares, as in the U.S. or Japan, requirements for exercising shareholder's rights were relaxed considerably, as can be seen in Table 3.

Table 3. Minimum Requirements of Shareholdings (%)

	Commercial Act (unlisted companies)		Securities and Exchange Act (listed companies)	
	Before	Current	Before	Current
To file a derivative suit	5	1	1(0.5)	0.01
To request the dismissal of directors or internal auditors	5	3	1(0.5)	0.5(0.25)
To request injunction against directors' illegal actions	5	1	1(0.5)	0.05(0.025)
To review accounting books	5	3	3(1.5)	0.1(0.05)
To request cumulative voting	5	3	None	1
To recommend outside director	5	3	None	1(0.5)

Note: "Before" refers to the period before the 1997 crisis. "Current" figures are as of December 2003. Percentage figures in parentheses are for firms with over 100 billion won in capital.¹⁰

Source: Kenneth L. Judd and Young Ki Lee (2000)

⁹ The World Bank had more direct influence on chaebol restructuring than the IMF.

¹⁰ As of December 2003, the exchange rate is approximately 1,200 won to the US dollar.

For example, the minimum level of shareholding in a listed company required for a derivative suit was lowered from 1 percent to 0.01 percent. Other requirements were not relaxed as dramatically, but still saw great improvements over the past. The court's decision in a derivative suit against Samsung Electronics' directors in 2001 (the first trial) and 2003 (the second trial) that ordered compensation to the company demonstrated the power of non-controlling minority shareholder's rights.

However, even with the relaxation of minimum requirement of shareholdings, it remains difficult to secure the shares necessary for a suit if it is against a large company. Moreover, these suits are "public-benefit" suits in the sense that the corporations, and not the plaintiffs, are compensated even if the court should rule in favor of the plaintiffs. Therefore, derivative suits are viewed as special "civic movements," rather than as ordinary activities by the average shareholder. It is also possible that the chaebol will only avoid the risk of lawsuits without remedying their corporate governance by stylistically refining board meetings and by obtaining director's and officer's liability insurance.

The government also granted voting rights to institutional investors. Whereas in the U.S. this right can be exercised to even expel management, in Korea its significance does not go much beyond granting minority shareholder rights to institutional investors because of the overwhelming dominance of chaebol heads over their companies. Furthermore, since most institutional investors maintain business relations with the chaebol, it is questionable whether they will exercise their rights even as minority shareholders. It is also reported that at general meetings of stockholders, they very seldom vote against management. The exceptions are with the National Pension Fund and foreign institutional investors.

The government granted the Korea Deposit Insurance Corporation (KDIC), charged with the responsibility for recovering public funds, legal powers to investigate the heads of bankrupt firms in order to recover any expropriated funds. Furthermore, chaebol heads were asked to donate their private property as a way of "pain-sharing," which was also a Tripartite (labor-management-government) Commission agreement. The government actually extracted private property donations from some chaebol heads in the face of the Samsung Motors and Hyundai Group management crises. Some chaebol heads were persecuted for illegal activities. And yet appropriating chaebol leaders' property and persecuting them to appease the

public did not go so far as to transform the chaebol system itself, as had happened with the *Zaibatsu* in Japan.

Several measures were introduced to enhance corporate transparency. In accounting standards, the government has required the 30 largest chaebol to prepare chaebol-wide consolidated financial statements since 1999. This, in and of itself, does not guarantee chaebol transparency. The point is not whether the chaebol prepare consolidated or separate financial statements, but whether the practice of window-dressing their financial records is eradicated. To this end the government has strengthened the penalties for improper auditing by accountants. Some accounting firms were closed as a consequence, but there is an inherent limitation because accounting firms must cater to the needs of their clients, the corporations, to a considerable extent. A sample survey by the Financial Supervisory Service shows that at least 30 percent of listed corporations have engaged in window-dressing practices during the three years since 1998 (FSS 2001). In the case of the presidential campaign scandal that broke out in 2003, it was disclosed that all of the top four chaebol provided presidential candidates with enormous amounts of illegal money by window-dressing their records. The bill to allow class action lawsuits against this window-dressing practice, stock price manipulation, and false disclosures was approved by the National Assembly in December 2003 and it would contribute greatly to enhancing accounting transparency.

The government also mandated the disclosure of board meeting results for inter-affiliate transactions larger than 10 billion won or 10 percent of capital. Furthermore, the Fair Trade Commission (FTC) stepped up its policing of anti-competitive intra-group transactions, in an attempt to promote independent management by preventing unfair competition practices that resulted from flotilla-type management in the intra-chaebol network. In the past, the monitoring of inter-affiliate transactions had been limited to goods and services, but this was expanded to include assets, funds, and personnel. The five largest chaebol have been investigated several times, and the smaller chaebol have also been systematically scrutinized and fined for violations. The FTC was also granted powers to trace bank accounts to make its policing more effective. Since inter-affiliate transactions are an inevitable by-product of the business group system, however, it is not easy to determine whether

they are illegal. Indeed, in some cases, the FTC's determination was repealed by the courts.

Severing the ties of intra-group guaranteed debts was another measure against the flotilla-style management. Even before the crisis, the chaebol had been required to reduce their debt guarantees to below 100 percent of their capital by March 1998. The Kim Dae-jung government took this one step further and disallowed new guarantees as of April 1998 and required existing guarantees to be discontinued by March 2000.

The government accepted the chaebol's request to allow pure holding companies the majority of whose assets are comprised of subsidiary companies' stocks, under the rationale that doing so would help the chaebol's restructuring and improve their transparency. Because of opposition by citizens' groups claiming that the pure holding company system could be abused to consolidate the controlling family's power in the chaebol, some restrictions were added. Liabilities of a holding company were restricted to not more than 100 percent of capital and the holding company was required to secure more than 30% of a listed subsidiary's shares. Furthermore, companies grouped under an industrial holding company were not permitted to have an ownership share of financial companies. As of March 2003, seventeen holding companies, including LG, were established.

The government also strengthened the outside director system, requiring at least one outside director for listed companies in 1998, which was changed to one quarter of the directing board in 1999. In 2000, this was further strengthened to require more than half of the board to consist of outside directors in the case of large firms with assets over 2 trillion won. These firms were also required to establish audit committees, with two thirds or more of the members to be appointed from the outside. In the election of audit committee members, the voting rights of large shareholders were limited to three percent, following the relevant stipulation of commercial codes.¹¹ By the end of 2002, 1,392 outside directors were working for 616 companies (SERI 2003.3.12).

However, the crucial issue here is who appoints the outside directors. In Korea's chaebol system, it is almost impossible to appoint an outside director who

¹¹ This 3 percent restriction does not apply to the total shares of the controlling family, but to each individual shareholder. Hence there is little chance that an auditor independent from the management will be appointed.

can express views against the will of the top management.¹² Therefore, practically all outside directors sit on the board not to monitor or check management, but as fillers or lobbyists. According to a survey, outside directors approved 99.3% of the issues discussed in board meetings (Cho Myeong-Hyeon 2003,300). The fact that board meetings are now actually convened is an improvement from the past. Although a cumulative voting system has been introduced in order to allow the appointment of independent outside directors, because it was not mandatory most chaebol firms have modified their articles of incorporation in order to nullify this system. If investment and trust companies, the National Pension Fund, and commercial banks involve themselves in the appointment of outside directors proactively, then the independence of outside directors can expect great improvements.¹³

The government once urged the chaebol to dissolve group secretarial offices, which had functioned as the coordinator of chaebol group activities. However, those organizations were indispensable to the chaebol as long as the chaebol head holds effective control over his business group. The chaebol secretarial offices have survived merely by renaming themselves group restructuring headquarters and with a token reduction of their staff. In the case of LG, where a holding company system was introduced, the restructuring headquarters have been replaced again by the holding company.

Together with the above measures to improve internal corporate governance, steps to improve external corporate governance have also been implemented. The Korean corporate governance system lacked an active market for corporate control, unlike the corporate governance system in America. In this regard, the government relaxed restrictions on Mergers & Acquisitions (M&A) in 1998. The intention was to weed out incompetent or corrupt managers by making the market for managers more active. The new laws streamlined merger procedures and enhanced the rights of shareholders in takeovers. They abolished the minimum proportion of shares that must be bought in a tender offer to ease the burden on the acquiring companies. The government also allowed the operation of funds exclusively set up for M&A, and significantly relaxed restrictions against stock purchases by foreigners.

12 One exception is SK Telecom, in which foreigners hold a very large stake.

13 Some banks have appointed outside directors to the boards of companies in workout programs, which should be encouraged. Recently, some outside directors have been appointed who were nominated by institutional investors such as investment & trust companies.

At the same time, however, the government made M&A extremely difficult by virtually abolishing limits on the chaebol's total equity investment and relaxing restrictions against a company buying its own stock. In 2001, by virtually removing the restrictions on voting rights of a chaebol-affiliated institutional investor over a company belonging to the same chaebol, the government also opened the way for chaebol heads to use customer funds to strengthen their control over chaebol-affiliated companies.¹⁴ Stepping on both the brake and the accelerator in this fashion, it is no wonder that reform has been so disorganized.

Table 4. Changes in the Internal Ownership of the 30 Largest Business Groups

Ownership	1997	1998	1999	2000	2001
Chaebol head	3.7%	3.1%	2.0%	1.5%	1.9%
Relatives	4.8%	4.8%	3.4%	3.0%	2.3%
Affiliated companies	33.7%	35.7%	44.1%	36.6%	35.9%
Corporate equity shares	0.8%	0.9%	1.0%	2.3%	4.2%
Total	43.0%	44.5%	50.5%	43.4%	44.3%

Note: 1) POSCO was included among the 30 largest business groups as of April 2001, but the table reports figures that exclude POSCO, in the interests of consistency and because POSCO does not belong to the chaebol.

2) Limits on total equity ownership have been changed so that they apply not to the 30 largest chaebol, but to the chaebol with assets over 5 trillion won since 2002.

Therefore, no data has been available for the 30 largest chaebol since 2002.

Source: FTC (2001)

The above-mentioned ceiling on total equity investment, which was 25 percent of net assets, was related to the ownership structure of the chaebol. The ownership structure is created so that the chaebol heads control the group with their own small proportion of total shares and inter-affiliate shareholdings. Abolishing the ceiling on total equity investment was intended not only to reduce the debt-equity ratio of the

¹⁴ This measure was specifically associated with Samsung Group, whose financial affiliate, Samsung Life Insurance, was contributing much to the control of its head.

chaebol, but also to allow the chaebol heads to strengthen their hold over their business groups. Table 4 shows that chaebol heads have maintained their control through shares held by affiliated companies even though their own individual shares have been reduced.¹⁵

Unfavorable public opinion forced the government to bring back the chaebol equity investment ceiling in late 1999, but as the effective date of April 2002 for the re-introduced ceiling approached, the chaebol stepped up their effort to water down the restrictions. As a result, the restriction was virtually nullified as many exceptions have been allowed. In the case of Hyundai Motors Company / Hyundai Motors Group, by taking advantage of these loosened restrictions, the chaebol head strengthened his hold over the group. Hyundai Motors Company, together with two affiliates, Kia Motors and Hyundai Mobis, has formed a circular ownership relationship (HMC->KM->HM->HMC), thereby increasing the artificial control power of the chaebol head.

Another area of external corporate governance reform is creditor rights. In the period before the crisis, Korean banks and non-bank financial institutions should have closely monitored the management of the highly leveraged chaebol. However, they failed to play this role because of their own poor corporate governance structure and the "too big to fail" hypothesis. Since the financial crisis, they have been undergoing reform to their governance structure. Furthermore, numerous banks and financial institutions have been closed, meaning the end of "Banks do not fail" hypothesis. Hence, a bank-led monitoring mechanism has been reorganized for corporate governance reform of the chaebol. Insolvency laws have also been changed to enhance creditor rights and to rehabilitate the ailing firms smoothly. It is to be noted that the disappearance of the "too big too fail" hypothesis after the crisis would contribute significantly to disciplining the chaebol.

In summary, the government has made some progress in enhancing accountability and transparency in chaebol management. However, more remains to be done, as the recent presidential campaign scandal clearly demonstrates. Moreover, the government failed to improve the chaebol ownership structure. Inconsistency in

¹⁵ Abe (2002) has shown that in cases of Samsung, LG and SK, dominant affiliates have greatly increased their shareholdings of other affiliates, while family ownership of those dominant affiliates has decreased.

reforming chaebol ownership-control structure has become an impediment to reforming the chaebol system.

V. Whither the Chaebol?

In the wake of the 1997 crisis, the chaebol experienced unprecedented restructuring as was discussed in the previous sections. The issues here are how much change has occurred in Korea's system of family businesses, and what is the likely direction of this change in the future. Alfred Chandler argued that with the development of enterprises in size and scope, family capitalism would be transformed into managerial capitalism run by professional managers. Does this hypothesis hold true for the Korean chaebol? To answer this question, one must explore the significance of the changes within the chaebol system.

The first thing to note is that half of the 30 largest pre-crisis chaebol went bankrupt or entered workout programs by the end of 2000, and a number of other chaebol also disposed of some of their subsidiaries. As a consequence, leaders of those chaebol saw their controlling power either diluted or wiped out altogether. Some of them are now under the control of creditor banks and their business operations are carried out by professional managers. More importantly, numerous chaebol affiliates, such as Daewoo Motors, have been sold for foreign capital, and this involves an erosion of the chaebol system, since most foreign firms that have entered Korea take the form of modern managerial businesses instead of family businesses.

Secondly, it appears that managerial experts have been increasing their influence within the chaebol. In the aftermath of the financial crisis, there was criticism against incompetent chaebol heads, and it was the managerial experts who dealt with the arduous restructuring process, even though the final decisions were made by the chaebol heads. Furthermore, while dynastic succession within the chaebol is continuing to some extent in Korea, these new heirs usually have less and less control over their companies. This decrease in power occurred because they did not gain as much knowledge and experience of group management as their predecessors, which became more evident as their groups grew in size and scope. Evidence of this is Samsung Group's second-generation leader and SK's new leader. The former, who has failed in automotive and movie businesses, no longer makes

routine management decisions and his role as Samsung's head has become little more than symbolic (*Newsweek* 2003.11.24). The latter, who suddenly succeeded his father at a young age, does not know much about his group's business and appears to share the controlling power with professional managers. And yet, the situation appears to vary among the chaebol and there is no detailed analysis regarding these changes.

Thirdly, corporate governance reform imposed some restrictions on chaebol management practices. Attempts to expropriate non-controlling minority shareholders are much more likely to be heavily publicized than before. Non-government organizations such as the People's Solidarity for Participatory Democracy have filed derivative suits and complaints against the illegal activities committed by the chaebol management. The increased threat of litigation is forcing both corporate managers and audit firms to exercise greater caution in making their decisions. Foreign institutional shareholders also began to protest against family business practices, seeking to appoint independent outside directors or demanding the resignation of top management officials charged with fraud.

Despite all these changes, however, the family business structure remains the dominant form of large firms in Korea. One of the reasons for this dominance is that Korean family businesses have maintained the ability to institute changes and the willingness to adapt their original business ideas to new market circumstances.¹⁶ As previously discussed in section II, the chaebol have developed managerial hierarchies and coordinating group headquarters as they have grown in size and scope. Through these organizational innovations, the chaebol have mobilized managerial experts to support the group leaders and fully utilized intra-group information, technology, capital, and man-power during underdeveloped market conditions. In order to keep their rights of control intact, they are more likely to borrow from banks than to issue equity for investment. Intricate intra-group ownership relations along with customer deposits in financial affiliates have served the purpose of strengthening the chaebol heads' controlling power. Furthermore, the family business system is effective in establishing long-term relationships with corrupt bureaucrats and politicians.

Secondly, family businesses persist in Korea due to insufficient reform. The Korean government has pursued chaebol reform since the 1997 crisis, but it had many

¹⁶ There are numerous studies regarding the reasons why family business persists in the era of managerial enterprise. Refer to the bibliography included in A. Collis (2003).

limitations. Faced with the chaebol's opposition, the government stepped on both the accelerator and the brake when it came to chaebol reform. For example, the government abolished the ceiling on total equity investment by the chaebol and removed the restrictions on the voting rights of a chaebol-affiliated institutional investor over a company belonging to the same chaebol, thereby making hostile M&A's almost impossible. Imperfections in the inheritance and the gift tax systems have enabled the chaebol heirs to gain control of a group without impairing their rights of control. Reforms on transparency and accountability also went only halfway. Market pressures on family businesses are still weak because there is insufficient competition in the domestic market. Foreign firms in Korea will exert some influence in this regard in the long-term, but since they have mainly acquired ailing Korean firms such as Daewoo Motors, their domestic competitiveness is yet to be seen.

Thirdly, and related to the second reason, the huge private benefits of control, which are agency costs from the perspective of other shareholders, hinder the development of professional management in Korea. Until now, the chaebol leaders have accumulated their wealth through private benefits of control rather than through dividends. Typical examples are kickbacks from suppliers, stock price manipulation regarding the dealings of chaebol heads' stocks, and transfer pricing among chaebol affiliates that is favorable to a particular affiliate whose shares are wholly owned by chaebol heads. Chaebol leaders also spend corporate money on their personal affairs and enjoy their position in social relationships. Unless all these private benefits of control are reduced by a great extent through corporate governance reform, chaebol heads will naturally be reluctant to delegate responsibility to professional managers.

In aggregate, the chaebol are in the process of changing their old practices, while they basically continue with a family business management system. It is also getting more and more difficult to draw a line between a family business and a managerial enterprise. For example, Samsung Group appears to have come close to being a managerial enterprise under A. Chandler's definition, where controlling families can say no and can replace senior managers with other career managers, but are rarely in a position to propose positive alternative solutions (Chandler 1977, 10). It goes without saying that there is a long way to go before the Korean economy eliminates the chaebol system. However, as Korean firms grow in size and scope, management capabilities will gain greater importance than the emotional bonds of the

controlling families. Meanwhile, the probability of heirs being competent generation after generation will be very low. Therefore, long-lasting success will only be ensured by the willingness of the controlling families to loosen the links between family and firm. The extent of the power delegated to managerial experts will depend on developments in the institutional, legal, and cultural environments. Reduction in agency costs will be the most important accelerating factor of this transformation. It is again worthy to note that family businesses are not homogeneous and that there are great variances among them during this transformation.

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