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8 Dual Sources of the South Korean Economic Crisis: Institutional and Organisational Failures and the Structural Transformation of the Economy

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THE POLITICO-ECONOMIC INSTITUTIONS AND CORPORATE ORGANISATIONS OF SOUTH KOREA: FROM CORE COMPETENCIES TO CORE RIGIDITIES

This chapter analyses the sources of the South Korean economic crisis and the current economic reforms. Many business scholars and practitioners have tried to figure out the causes of the economic crisis that swept through most Asian countries in 1997. Among the seriously damaged Asian countries, the case of South Korea, which used to be the world's eleventh largest trading country, has drawn special attention from students of Asian economic systems. Until the financial crisis in 1997 the South Korean economy had enjoyed miraculous growth. In the early 1960s South Korea was one of the world's poorest nations, but by the mid 1990s it had become a major competitor in many core industries, such as semiconductors, cars, ship-building, steel and electronics. The South Korean economic system was so highly praised that it was closely studied and ardently copied by many developing countries. South Korea was even acclaimed as 'the next giant' that would follow in the footsteps of Japan as a significant force in the world economy (Amsden, 1989). As late as the mid 1990s few anticipated the sudden collapse of the economy. So what went wrong?

There are various possible causes of the South Korean economic crisis, but this study focuses on structural problems at the institutional and organisational levels. It is argued that while South Korea's politico-economic institutions and corporate organisations were the core instruments of the rapid growth during the earlier stages of economic development, they later became the main causes of the economic crisis. It has been suggested elsewhere that when there is an environmental change, an organisation's core competence can become ineffective and turn into a core rigidity that obstructs the organisation's adaptive change (Leonard-Barton, 1995). This chapter will show how the institutional and organisational factors that had served as the core competencies of the South Korean economy later became the core rigidities that hindered adaptation to the changing environment and eventually caused the economic crisis of 1997.

Particular emphasis is placed on the interaction between South Korea's politico-economic institutions and the large business organisations called *chaebol* as the main cause of both the rapid growth and the 1997 crisis. The interaction between institutional environments and organisational actors is a central research area in institutional organisation theory (Meyer and Rowan, 1977; DiMaggio and Powell, 1983). Institutions are taken-for-granted rules and contexts for action (DiMaggio and Powell, 1983). Since economic actors try to maximise their interests within the constraints of taken-for-granted institutional factors such as laws, regulations, practices and norms, politico-economic institutions significantly affect the performance of an economic system (North, 1990).

As well as serving as external constraints, institutions define the structures of incentives and opportunities that organisational actors can take advantage of (Williamson, 1975; North, 1990; Milgrom and Roberts, 1992). Therefore, while effective institutions can facilitate a high performance by economic actors by providing appropriate incentives and opportunities and reducing transaction costs, ineffective ones seriously hold down the level of performance of economic actors by imposing unnecessary constraints, incurring high transaction costs and displaying internal inconsistencies and vulnerability. Neither the rapid growth nor the recent crisis of the Korean economy can be properly explained without a clear understanding of the interactions between institutional dynamics and organisational dynamics.

The second section of this chapter discusses the politico-economic institutions that orchestrated the rapid economic growth during the 1960s and 1970s, while the third section looks at the organisational characteristics of the *chaebol*, which served as the main corporate engines behind that growth. An understanding of the institutional and organisational dynamics during the growth period is crucially important because these same dynamics later became the fundamental cause of the economic crisis. In the fourth section the institutional and organisational failures that caused the economic crisis in 1997 are systematically analysed. It will be argued that both the politico-economic institutions and the *chaebol* failed to adapt to the environmental changes in the mid 1980s. Instead the *chaebol* continued their old ways of doing businesses due to organisational inertia, whereas the government displayed institutional confusion by implementing ill-prepared, uncontrolled and inconsistent institutional changes. Further damage was inflicted on the economy by the misalignment between the politico-economic institutions and the *chaebol*. The fifth section discusses the structural transformation of the South Korean economy since the crisis. Finally, the concluding section examines the outcomes of and the problems with the government's economic reforms.

THE POLITICO-ECONOMIC INSTITUTIONS OF SOUTH KOREA DURING THE HIGH-GROWTH PERIOD

The miraculous economic growth of South Korea has been widely studied by business scholars and practitioners. There are numerous statistics that testify to this growth. For instance, exports increased from mere US $3.5 million in 1946 to $136 billion in 1996 (*Korean Economic Review*, 23 October, 1998). GNP per capita rose from about $100 in the early 1960s to more than $10 000 in the mid 1990s. In 1995 Korea was the world's eleventh largest trading country, the fifth largest producer of cars, the second largest ship-builder and the largest producer of semiconductors (Song, 1997). The two main engines behind this unprecedentedly rapid economic growth were Korea's unique politico-economic institutions and the *chaebol*.

The Birth of Developmental Dictatorship

The economic growth of South Korea often referred to as 'the miracle of the Han river', started after Park Chung Hee seized control of the country in 1961 and assumed the presidency. At the time of the military coup there was virtually no modern industry in South Korea. The development of modern industries had been deliberately suppressed and natural resources had been stripped by the Japanese occupation forces throughout the colonial period (1910–45). Further damage had been inflicted on the national economy by Korean War, which had completely destroyed the industrial facilities during the period 1950–53. During the volatile period between the end of Japanese occupation in 1945 and the military coup in 1961, the government, led by President Rhee Seung Man, had been unable to lead the country towards modernisation and industrialisation. Instead the corrupt and incompetent administration had been concerned only with the maintenance of political power and had consequently been overhauled by the student revolution in 1960. Then came the military coup led by General Park Chung Hee in 1961.

Unlike most dictators with a military background, Park was highly successful in the area of economic development. Based on a powerful coalition between authoritarian politicians and technocrats, Park systematically implemented economic development measures and effectively mobilised the limited national resources throughout his 19-year rule. Rapid economic growth, however, was inevitably accompanied by the complete loss of political democracy. Park ruthlessly persecuted all those who opposed his policies or challenged his power. As a result Park's presidency, which ended with his assassination in 1979, was characterised by numerous antigovernment rallies and the imposition of marshall law. That is why the Park era is often referred to as the period of 'developmental dictatorship' (Shin, 1994).

Building Institutions for Rapid Economic Growth

In order to industrialise the economy, Park set up powerful politico-economic institutions to ensure tight government control over economic organisations such as companies, banks and government agencies. To this end he relied mainly on the following three government bodies: the Ministry of Commerce and Industry, the Ministry of Finance and the Economic Planning Board. The Ministry of Commerce and Industry was responsible for guiding corporate activities such as entry into a particular industry. If the government did not want a certain company to do business in a particular industry, it had the legal right to prevent it from entering. With the Bank of Korea under its jurisdiction, the Ministry of Finance was responsible for fiscal and monetary policies. Since it controlled all the South Korean banks, no company could obtain a bank loan if this was against the government's wishes. Therefore the government had the discretionary power to ruin or support companies and actively exercised this power to align corporate activities with its economic policies. In other words the government played the role of a pseudo market that sorted out fit and unfit companies.

The following agendas lay at the heart of Park government's economic policies: the nurturing of export-oriented industries, the buliding up of heavy industry, the provision of cost advantages to South Korean companies based on the control of labour, the protection of domestic markets from foreign competition, and the concentrated allocation of limited national resources to a small number of *chaebol*. Exports were at the very centre of Park's economic agenda. He aided and rewarded companies that brought in dollars

by exporting goods to foreign markets (Kim, 1997), and he provided generous financing and export subsidies to companies with the potential to make money in overseas markets. Park's obsession with exports is well illustrated by the fact that he did not miss a single monthly export promotion meeting during his 19-year rule. The export-oriented economic policy was an inevitable choice for the rapid economic development of South Korea, which had a small domestic market, and Park's policy contributed significantly to the early internationalisation of South Korean firms.

Unlike in most other developing countries, the development programme was centred on heavy industries such as steel, cars, ship-building, petrochemicals and electronics. Park poured a vast amount of resources into heavy industries that many economists predicted would never become a significant competitive force in international markets, for example the Pohang Integrated Steel Company (POSCO), founded in 1968. Although there was literally not a single person in South Korea who had seen a blast furnace at the time of its construction, POSCO went on to become the world's largest and most efficient steel mill in the 1990s (Innace and Dress, 1992).

In order to provide South Korean companies with cost advantages in overseas markets the Park administration ensured an abundance of cheap labour by ruthlessly suppressing labour movements and preventing labour unrest. Although the quality of domestic labour was one of the world's highest (South Korea had a very high literacy rate), most workers were paid only minimum wages (Shin, 1994). Labour activists were stigmatised as communists and were arrested. As a result companies enjoyed the benefits of cheap, high-quality labour with little serious labour unrest during the Park era.

The domestic markets were strongly protected by the government, and since there was little preexisting industry, first-movers were able to gain a virtual monopoly or oligopoly status in these markets. The only constraint was the government's veto over market entry. Since the government explicitly favoured export-oriented companies, those first-movers had to demonstrate their willingness and ability to export to overseas markets. Thus many companies exported their products at lower than cost price, the losses being compensated by high prices in the domestic markets, where they enjoyed near monopoly status. In other words consumers were actually subsidising these export-oriented companies. Due to the success of this under-pricing practice, coupled with the fact that labour was cheap and technological capabilities immature, competing at the lower end of international market remained the primary strategy of South Korean firms' for a considerable time.

Since there were very limited financial resources for economic development, the government ensured that they were allocated efficiently by distributing them to a small number of large corporations that showed the potential to become viable competitors in the international market. These corporations enjoyed various favours, such as special financing, subsidies for the importation of capital goods and the exportation of products, and monopoly status in the domestic markets. Thus began the era of the *chaebol*, large conglomerates with highly diversified business activities. As long as they conformed to the government's guidelines the *chaebol* were strongly supported by the government, at the cost of small and medium-sized firms, the rural sector, workers and domestic consumers. The politico-economic institutions set up by Park performed splendidly and contributed to the unprecedentedly rapid economic growth of South Korea by systematically orchestrating the activities of all corporate and financial organisations.

THE ROLE OF THE *CHAEBOL* AS THE CORPORATE ENGINE OF ECONOMIC DEVELOPMENT

The Governance Structures of the *Chaebol*

As mentioned above, the government relied heavily on the *chaebol* as the main corporate engine of its economic development project. Due largely to the *chaebol*'s superb performance, the South Korean export industry grew from scratch into a major world force in semiconductors, ship-building, steel and cars in less than twenty years. In order to understand why the *chaebol* were so effective we need to look briefly at their organisational dynamics (the organisational characteristics of the *chaebol* are analysed in detail in Shin and Kwon, 1999).

A *chaebol* is a group of large companies operating in diverse and mostly unrelated industries, usually under the ownership and control of a single family. Until the 1997 crisis the economic landscape of Korea was dominated by a small number of *chaebol*. For instance the 30 largest *chaebol* accounted for more than 70 per cent of GNP from the mid 1970s (Shin, 1994). The head of a *chaebol* family held the title of chairman (*Hoejang*), which was an informal position without legal basis. The chairman had almost unlimited power within the group, and without consulting anybody he could found new companies, disband existing ones, enter new business areas and appoint or fire the CEOs of member companies, regardless of business feasibility. Most *chaebol* chairmen had their own office and personal staff, usually referred to as the office of planning and coordination (OPC).

The OPC was the most powerful unit within the *chaebol* and tightly controlled all the activities of the member companies. The owner–chairman's

plans and wishes were translated into concrete business plans and implemented by the OPC. The original function of the OPC was to assist the chairman's decision making by acting as a think-tank and collecting and analysing data on the member companies. Later its functions expanded to include most major strategic decisions and much of managerial decision making.

Unlike in large firms in the West, there was no governance mechanism to monitor or sanction the managerial behaviour of the chairman and the OPC. The board of directors in a *chaebol* company was composed only of internal executives so these executives were responsible for monitoring and evaluating their own credibility and accountability. Moreover, since there was neither a legally guaranteed right for minority shareholders to call a general meeting of shareholders nor an organised agent to whom minority shareholders could delegate their votes, the annual shareholders' meeting did little more than ritualistically approve the chairman's and OPC's decisions.

The member companies of a *chaebol* group were tightly controlled and managed in a highly centralised manner by the chairman and the OPC as if they were a single organisation. In order to examine empirically the degree of centralisation of *chaebol* groups, the author and a colleague (Shin and Kwon, 1999) measured the distribution of decision-making power between the headquarters (that is, the chairman and the OPC) and the member companies according to a scale that ranged from 1 (decisions are made solely by the headquarters), to 7 (decisions are made solely by the member company). In between were various degrees of joint decision making.

The results showed that the headquarters made most of the strategic decisions and a significant proportion of the managerial decisions for the member companies. More specifically, the headquarters made the following types of decision almost free of input from the member companies: the formation of joint ventures and mergers and acquisitions by member companies (1.37 on the seven-point scale), the appointment and replacement of top managers of the member companies (1.40 on the scale) and the expansion of business areas (1.60 on the scale). With regard to managerial decisions the ratings were as follows: changes in the organisational structure of the member companies (2.45), determining financing methods (2.76), budgetary decisions of the member companies (2.97), determining target areas and R&D investment (2.97), strategic planning within existing business areas (3.25) and the hiring and firing of employees (3.27). Thus the survey clearly indicated that the member companies were governed by headquarters in a highly centralised manner, so centralised in fact that even decisions on resource exchanges between member companies were made solely by the owner–chairman and the OPC and the member companies were seldom involved in the decision-making process.

The explanation of the degree of power enjoyed by the owner–chairman and his office lies in the ownership structure of *chaebol*. Lim's (1997) pioneering work sheds some light on this. The corporate control of a *chaebol* by the owner–chairman was maintained through two types of internal shareholding: direct shareholding by the owner and his family and corporate shareholding among the group's member companies. The owner and his family held shares in a few key companies, which in turn held shares in other member companies. The member companies not only held each others' shares but also guaranteed each others' loans and debts, which enabled them to obtain the external financial resources needed for their relentless expansion. As a result the average debt–capital ratio among the 30 largest *chaebol* exceeded 500 per cent in the mid 1990s (Lim, 1997; Kim, 1998).

The Corporate Strategy of the *Chaebol*: Expansion through Diversification

The corporate strategy of the *chaebol* is well illustrated by their in derogatory nickname: 'octopus companies.' From their birth in the 1960s, until the mid 1990s, when the economic crisis started to emerge, the *chaebol* consistently pursued a diversification strategy. According to the strategic management literature, diversification is pursued for various reasons, such as obtaining new sources of profits, reducing risk, achieving economies of scale and scope, securing the supply of new production factors, gaining new competencies and using existing competencies in new ways (Ansoff, 1965; Rumelt, 1974; Porter, 1985; Barney, 1997; Collis and Montgomery, 1997). If effectively implemented, diversification can contribute significantly to firm performance (Weston and Mansinghka, 1971; Levitt, 1975).

Most of the *chaebol* engaged in unrelated diversification, that is, they relentlessly expanded their size by continually entering new industries with little technological commonality. For example major *chaebol* such as Samsung, Hyundai and Daewoo entered a wide range of unrelated industries such as electronics, computer hardware and software, telecommunications, petrochemicals, cars, ship-building, construction, hotels and tourism, trading, department stores and so on.

Conversely, the dominant strategic trend among the world's leading companies during the same period was increasing specialisation in a few closely related business areas for which they had core competencies and withdrawal from peripheral business activities (Shleifer and Vishny, 1994). It has been repeatedly shown that, of the two types of diversification strategy, related diversification is generally superior to unrelated

diversification in terms of firm performance (Rumelt, 1974; Palepu, 1985; Varadarajan, 1986; Robins and Wiserma, 1995). Most of the competitive advantages that a diversification strategy can provide, such as synergy generation, economies of scale and scope and the full exploitation of existing competencies, apply only to related diversification. Despite this the *chaebol* consistently pursued an extremely unrelated diversification strategy.

There are a number of competing explanations for the *chaebol*'s choice of strategy. In the strategic management literature it is argued that the core benefit of unrelated diversification is risk reduction under environmental uncertainty (Galbraith *et al.*, 1986; Amit and Livnat, 1988). Thus, one could argue that the main reason for the *chaebol*'s choice of strategy was the existence of a high degree of environmental uncertainty and risk. In other words, specialising in a few business areas was too risky as the *chaebol* did not possess strong technological capabilities in any area and the business environment surrounding them was extremely volatile and unpredictable. However this line of reasoning bears the danger of becoming a self-fulfilling prophecy. If a company chooses to diversify into a wide range of unrelated business areas because it lacks accumulated technological competence in any particular business, that decision will prevent the future accumulation of specialised competence. As a consequence, widely diversified firms will stay that way forever.

Lim (1997) offers an alternative explanation from a corporate finance perspective. He argues that unrelated diversification was adopted by the *chaebol* not because of business risk, but because of financial risk – that unrelated diversification was an efficient means of managing the risk portfolio of the owner's personal assets. According to this explanation, by investing his assets in a wide range of unrelated businesses the owner of a *chaebol* was less likely to lose a significant proportion of his assets than would be the case if he invested in a few specialised areas (ibid.).

However it is argued here that the extreme degree of unrelated diversification engaged in by the *chaebol* can be fully understood only by also taking into consideration the idiosyncratic environment of South Korea during the high growth period. Thus it is maintained that the motives for unrelated diversification in South Korea were quite different from those of US corporations in the 1960s (Shleifer and Vishny, 1994). During the high growth period the South Korean economy was in what might be called an 'industrial vacuum.' Modern industry simply did not exist in most business areas. Thus even if it had little technological competence a firms could make a profit merely by being the first to enter an industry. All that was needed was the ability to mobilise financial resources and some degree of managerial capability. Since the *chaebol* were the only organisational actors to have these two attributes at the time, they were able to enjoy a virtual monopoly in a wide range of industries. However it should be stressed that the *chaebol* had to rely increasingly on external financing as their internal resources were limited.

Environmental Conditions and the Competitive Advantages of the *Chaebol*

Why were the *chaebol* such an effective corporate engine in the rapid economic growth of South Korea? What exactly were the sources of their competitive advantage? Most studies fail to explain specifically why and how the *chaebol* were able to become so internationally competitive in such a short time, for example they seldom go further than emphasising government subsidies or the entrepreneurial ability of *chaebol* founders such as Lee Byung-Chull of Samsung and Chung Ju-Young of Hyundai (Amsden, 1989; Steers *et al.*, 1989; Steers, 1998). In contrast it is maintained here that the fundamental explanation of the *chaebol's* strong performance lies mainly in their organisational dynamics. In other words, the *chaebol* were able to achieve such an outstanding performance and rapid growth because their particular organisational characteristics fitted nicely into the environment that prevailed during the high growth period.

It is generally agreed that the heyday of the *chaebol* was roughly the 20-year period between the mid 1960s and the mid 1980s. In line with the Park government's guidelines, embodied in a series of five year economic development plans, the *chaebol* transformed South Korea from an agricultural society into a modern industrial economy by indiscriminately entering all types of industry during the 20-year period. However it is very important to understand the environmental conditions that supported this rapid expansion and outstanding performance.

Many of the environmental conditions were discussed earlier in this chapter, but to recap, the developmental government of President Park Chung Hee strongly supported the *chaebol* as the main organisational weapon for its national economic development project. Because of the limited national resources the government provided cheap financial resources only to a small number of large *chaebol* in order to create an industrial infrastructure as fast as possible. Furthermore, so that the *chaebol* would have cost advantages in international markets the government ensured an abundance of cheap, high-quality labour by suppressing labour movements. The domestic markets were strongly protected from foreign competition so the *chaebol* enjoyed near monopoly status. Most of all, there was a huge industrial vacuum in most business areas that the *chaebol* could easily fill without much competition. As a result of the interaction between these

environmental conditions and the organisational advantages of the *chaebol*, they were able to expand rapidly by entering whatever business areas were available. However it was *chaebol*'s organisational abilities that enabled them to utilise these environmental conditions effectively. The following three organisational factors should be particularly stressed: resource mobilisation, economy of scope, and safety-net effects.

First, the *chaebol* were highly effective in gathering together the resources needed to enter new businesses. As explained earlier, a *chaebol* was able to draw in a significant amount of resources from its member companies based on its highly centralised governance mechanism cross-subsidisation, cross-shareholding and internal trading. Moreover the *chaebol* had advantages over non-*chaebol* companies in the acquisition of external resources based on mutual payment guarantees between member companies (Kim, 1998). In the absence of such internal and external resource-pooling systems, a non-*chaebol* company either had to rely on its own resources, which were often limited, or obtain external resources, which usually took a long time to negotiate and contract.

Second, unlike non-*chaebol* companies, the *chaebol* enjoyed economies of scope through the sharing of competencies and resources among member companies. In addition to risk reduction, economy of scope is considered to be a main advantage of diversified companies (Chandler, 1962, 1977; Collis and Montgomery, 1997). By sharing competencies and resources across different businesses, diversified firms could reduce their total costs. There are numerous examples of the advantages that arise from economies of scope. For example when the Samsung *chaebol* set up a new member company, it normally used the facilities and human resources of existing member companies until the new company became self-sufficient. Another salient example is integrated trading companies, which most *chaebol* established in the 1970s as international trading agencies for all member companies.

Third, probably the *chaebol*'s greatest competitive advantage compared with non-*chaebol* companies was the safety-net effect, whereby a *chaebol* member company could overcome a temporary crisis by obtaining help from the other members of the group. For example, if a member company faced a temporary competitive threat and was unable to deal with it by itself because inexperience or lack of maturity prevented it from competing independently, its sister companies dealt collaboratively with the problem by providing financial resources and other aid to the stumbling company. Of course this type of resource provision was not voluntarily offered by the sister companies, but dictated by the group headquartes. Had it not been for the existence of such safety nets the *chaebol* would not have been able to enter risky new markets or stay in business in highly competitive markets. For instance, when faced with growing competition from the *chaebol* in the 64K DRAM and 256K DRAM memory chip markets in the mid 1980s, the then dominant Japanese semiconductor manufacturers staged a fierce price war, dumping their models at less than a half of the South Korean producers' costs in order to get rid of the new competitors at an early stage. However the strategy failed to have the desired effect. While many US producers, all of which were independent companies, were forced out of the market, the South Korean companies were able to ride out the price war because of the financial cushion provided by their sister companies, under the direction, of course, of the powerful headquarters (Kim, 1997).

THE FALL OF SOUTH KOREAN POLITICO-ECONOMIC INSTITUTIONS AND CORPORATE ORGANISATIONS

Environmental Changes in the Mid 1980s and the Unfolding of the Economic Crisis

In early 1997 the South Korean economy started to show signs of being in serious trouble. It was reported that the economy had incurred a $20 billion trade deficit the previous year. A number of major *chaebol*, such as Hanbo, Sam-Mi, Jinro, Haitai and Kia, went bankrupt in 1997, and the crisis began to accelerate from the autumn of that year. The credit rating of Korea by S&P was downgraded by six steps from AA– in early October 1997 to B+ (unsuitable for investment) in December (*Korean Economic Review*, 14 February 1999). The won exchange rate, which used to hover around 800 won per US dollar, fell to 1300 won per dollar in November. The government quickly depleted most of its foreign currency reserve in order to defend the value of the won, but in vain. The foreign currency reserve decreased from $33 billion to $7.2 billion that month. The South Korean Stock Exchange index, which had passed the 1000 point mark, plummeted to 450, the lowest in ten years. Foreign creditors started to recall their loans, but South Korean companies and financial firms did not have sufficient liquid resources to pay them back. The South Korean economy was on the verge of collapse by the end of November 1997.

On 27 November, the government applied for $55 billion emergency loan from the IMF – the largest bailout in the IMF's history – but even after this deal was signed the crisis continued. The exchange rate fell even further to as low as 1964 won per US dollar in early 1998. Two months into the crisis about 7000 small and medium-sized firms went bankrupt (*Korean Economic Review*, 23 December, 1998). The Korean Stock Exchange index sank to 280 in early 1998 and the unemployment rate, which stood at about 2 per cent before the crisis, exceeded 8 per cent in late 1998. In the 1998 fiscal year the annual economic growth rate was minus 6 per cent and GNP per capita, which had exceeded $10 000 in 1995, fell to $6500. More than 75 per cent of the population admitted that their wealth had substantially decreased after the crisis (ibid., 13 October, 1998). Of the 30 largest *chaebol*, 11 were virtually bankrupt.

What went wrong with these highly effective institutions and organisations? What caused the downfall of the Korean economy in 1997, which was referred to as the greatest national disaster since the Korean War? By and large there are three competing explanations of the crisis. Some blame the *chaebol* for their endless expansion, based on external financial resources, while others point to the incompetence of the government in dealing with the crisis. Still others – from a more radical camp – consider that the economic crises in Korea and other Asian countries were an inevitable consequence of worldwide neoliberalism, which had consistently forced unprepared developing countries to open their financial and trade markets. It is submitted here that it was the combined effect of all three factors that caused the crisis. In other words the crisis can be properly understood by focusing on the interaction among the *chaebol*, the politico-economic institutions and the changing environment. Of course neoliberalism should be counted as an important environmental factor. Here it is argued that the economic crisis was a result of South Korea's failure to make adaptive changes to its politico-economic institutions and corporate organisations in order to deal with the new environmental factors. What were the environmental changes that made these once-powerful institutions and organisations stumble so seriously?

The critical period seems to have been the mid 1980s, when the economy was simultaneously faced with the following environmental changes: the opening of domestic financial and product markets as a result of pressure from other countries; the democratisation of South Korea and the consequent sharp increase in labour costs; challenges from less developed countries such as China and other Southeast Asian countries, which were armed with much cheaper labour and other production factors; the organisational maturation and rapid globalisation of the *chaebol*; the industrial shift towards products with high added value such as semiconductors and computers; and the worldwide trend towards corporate restructuring and intensified competition. All these changes took South Korea by surprise and imposed a whole new competitive environment on the economy that was qualitatively different from the previous environments, in which

South Korea's politico-economic institutions and corporate organisations had been able to perform competently.

An antigovernment movement swept the entire nation and gave birth to a new, democratically elected government in 1987. Unlike the previous governments of Park and Chun, both of whom had seized power by military coup, the new government of Roh Tae Woo was not able to suppress labour movements or hold labour costs at the minimum level. As a result the average wage level in South Korean firms increased sharply during the late 1980s.

Great damage to the traditional cost advantages of South Korean firms was inflicted by the entry of China and other Southeast Asian countries – such as Indonesia, Malaysia, Thailand and Vietnam – to the international business scene in the late 1980s. Blessed with much lower labour costs, these countries started to encroach into low-end markets that were traditional strongholds of South Korean firms. Thus, whether they liked it or not, South Korean firms had to make the transition to mid and high-end markets.

However the competitive dynamics in the mid and high-end markets were very different from those in low-end markets. In low-end markets competition was based mainly on low prices rather than state-of-the-art technological innovations or high quality, therefore firms did not have to develop technological capabilities and could rely on technologies that had been developed by more advanced firms quite some time ago. Also, as these firms were not located at the technological frontier, the environment tended to change relatively slowly and the firms did not develop the organisational flexibility required for rapid environmental adaptation. Instead, managerial attention focused on tight and centralised control of all corporate activities in the interests of cost efficiency (Perrow, 1967, 1986).

On top of all this, in the 1980s the global business environment underwent a turbulent paradigm shift. What is often referred to as 'the new competition', based on the continuous improvement of quality and technological innovation, rapidly spread and became widely institutionalised in the mid 1980s (Best, 1990). Under the new paradigm, competitive advantage based on a single product or technological innovation became unsustainable. Instead firms were faced with 'hyper-competition', in which the only way to achieve a sustainable performance was continually to generate new competitive advantages (D'Aveni, 1994). The worldwide trend towards restructuring, reengineering, outsourcing and downsizing that began in the mid 1980s can be interpreted as an adaptive response to this change in the competitive environment. Thus South Korean firms not only had to move to new markets, they also had to deal with a paradigmatic change in these unfamiliar markets.

Another critical change in the mid 1980s was the opening of the South Korean financial and product markets, primarily in response to increasing pressure from foreign countries. The setting up of the World Trade Organisation made it even more difficult for the South Korean government to protect its domestic markets. Thus firms that used to enjoy near monopoly status in domestic markets had to compete against foreign firms even in their home base. This also meant that they could no longer charge low prices in international markets by overpricing the goods they sold in domestic markets. However a much greater threat to the South Korean economy was posed by the opening of the financial markets to foreign investors, which can be seen as a double-edged sword. On the bright side, South Korean firms now had access to much more diverse and efficient sources of finance. But at the same time the economy became highly vulnerable to fluctuations in the international environment and the behaviour of foreign investors.

It should be pointed out here that the environmental changes in the mid 1980s were not cumulative but discontinuous, and each environment was sharply distinct from the preceding one (Tushman and Anderson, 1986; Tushman *et al.*, 1986). In other words, they were not the result of the improvement, adjustment or intensification of existing competitive dynamics.

Hence, the environmental changes in the mid 1980s forced South Korea to compete in whole new areas and in completely different ways. Moreover these changes were competence-destroying in the sense that they destroyed the effectiveness and utility of the institutions and organisations that had been the core competencies of the South Korean economy during the high growth period (Utterback, 1994). In order to compete effectively in the new environment the economy needed to create new competencies by making significant adaptive changes. However, as we shall discuss later, the economic actors of South Korea did not change their course, which I believe was the central reason for the 1997 crisis.

Organisational Inertia and the Failure of the *Chaebol*

The main problem with the *chaebol* during the transition period in the mid 1980s was their organisational inertia. Despite the environmental changes they did not change their corporate strategies and governance structure, rather they enhanced them. For instance, although it is generally perceived that the unrelated diversification gradually decreased with the maturation of the *chaebol*, it in fact accelerated during the decade running up to the 1997 economic crisis in terms of both the number of member companies and the number of product groups (Shin, 1998). The average number of business areas in terms of two-digit SIC codes among the 30 largest *chaebol* increased from 16.0 to 18.8 during the period 1987–96, and among the five largest *chaebol* they reached 29.6 in 1996, a year before the economic crisis emerged (Hahn, 1997).

Another interesting finding is that the degree of centralisation in the *chaebol* also increased during that decade. Contrary to the general perception that their highly centralised structure became increasingly decentralised with organisational maturation, a 10-year panel study found the reverse to be true (Shin *et al.*, 1999).

The present author believes that this organisational inertia among the *chaebol* was significantly responsible for the economic crisis. First, their unrelated diversification strategy inevitably involved the dispersal of limited resources, which in turn prevented the accumulation of advanced technological and organisational competencies. As discussed earlier, the lack of accumulated competencies did not pose a serious competitive problem in low-end markets where the *chaebol* could compete on cost advantages. However, in the new environment, in which the main criteria in the competitive game were technological innovation and high quality, the *chaebol* were unable to compete against foreign firms that were highly specialised in a few interrelated business areas.

Instead of abandoning their unrelated diversification strategy the *chaebol* attempted to solve the problem by obtaining further external resources. Since domestic financial resources were limited the *chaebol* lobbied the government to open up the financial markets so that they could freely borrow cheap capital from foreign investors. This wish was granted and the financial markets were opened in 1994. Thereafter the *chaebol* not only borrowed heavily within South Korea, but their foreign branches borrowed even more aggressively abroad. While foreign borrowing by *chaebol* headquarters was monitored by the government, the direct finance obtained by their foreign branches was not and this form of borrowing increased rapidly. Thus when foreign investors withdrew in the run-up to the crisis, most *chaebol* were faced with a serious liquidity problem.

A serious side effect of the *chaebol*'s excessive diversification and chronic overinvestment was the devastation of the South Korean financial sector. Since the member companies of a *chaebol* offered cross-payment guarantees for one another and they were more reliable borrowers than small and medium-sized firms, South Korean banks willingly provided them with loans. Other reasons why the banks were still lending a large amount of money to stumbling *chaebol* in the mid 1990s were their sunk costs and government pressures. By the mid 1990s the *chaebol* had accumulated such huge bank debts that if they went bankrupt the banks would go bankrupt with them. In order to avoid this they had to lend even more to the already debt-ridden *chaebol*.

Another factor was the government's wish not to cause an economic panic by letting huge *chaebol* go bankrupt, which might have a devastating effect on South Korea's credibility in international markets and influence the results of the forthcoming presidential election. Hence, the government exerted pressure on the banks to provide more loans to troubled *chaebol*. When a number of major *chaebol*, for example Hanbo, Kia, Haitai, Jinro and New Core, finally went bankrupt in 1997, most Korean banks fell into serious trouble too and a number of major banks, such as Cheil Bank and Seoul Bank, were virtually bankrupted.

Second, the highly centralised governance structure of the *chaebol* did not fit the new competitive environment either. During the earlier stages of their corporate evolution, when they were competing in low-end markets based on cost advantages, central control over the member companies was necessary to the efficient utilisation of limited resources. However, in the rapidly changing and unpredictable competitive environment, organisational flexibility became crucial. That is, subsystems needed greater autonomy so that they could make quick local adaptations (Weick, 1976; Orton and Weick, 1990). In this regard the *chaebol*'s highly centralised governance structure became a liability (Shin *et al.*, 1999).

Besides, when a firm contains diverse functions and business activities within its boundaries the costs of planning and coordination can easily exceed the benefits from economies of scope (Williamson, 1985; Perrow, 1986). Thus, according to the strategic management literature (Chandler, 1962, 1977; Collis and Montgomery, 1997; Barney, 1997), as the extent of a firm's unrelated diversification increases, the degree of decentralisation should also increase. This is a logical conclusion because it is impossible for a small number of top managers at company headquarters to possess adequate information on and competencies in a wide range of unrelated business areas. However, contrary to this common-sense managerial axiom, the *chaebol* strengthened their centralised governance mechanisms, the inevitable results of which included slow decision making, low adaptive capability and high bureaucratic costs.

Institutional Confusion: Deregulation and the Opening of Capital Markets

To understand the logic behind the accusation that the incompetence of the government was to blame for the economic crisis, we have to look at the political changes that took place after the assassination of President Park in October 1979. Immediately after Park's death another military strongman, Chun Doo Hwan, seized power through a military coup and the subsequent massacre of hundreds of civilians in the southern city of Kwang-Ju in 1980. Even more authoritarian than his predecessor, Chun violently repressed all antigovernment forces, including opposition parties and labour and student movements.

The continued suppression of labour movements meant that South Korean firms continued to enjoy their competitive advantage based on low labour costs during Chun's seven-year rule (1980–87). During this period, government control over the *chaebol* strengthened and Chun even forced the *chaebol* to donate companies to the government or swap member companies between them. If a *chaebol* was unwilling to comply with the government's requests, the latter did not hesitate to use brutal coercive power. For example the Kukje Group, then the sixth largest *chaebol*, was completely dissolved and put of business because of its uneasy relationship with Chun government.

Although Chun maintained basically the same politico-economic institutions established by Park, the developmental aspects of Park's economic policy faded to a considerable degree during Chun's rule, due primarily to the maturation and growth of the *chaebol*, which by that time had gained their own momentum. Thus the main thrust of the government's policy was not to support the *chaebol*, but to control and guide them. In addition, as the Chun government had a serious legitimacy problem within Korea, it tried hard to gain foreign support by implementing economic policies favoured by the USA, such as partial market opening. As a result, while labour costs remained low, other sources of the *chaebol*'s cost advantages, such as the protection of domestic markets, significantly weakened. Nonetheless, the economy enjoyed another big boom in 1985 thanks to the so-called 'three lows phenomenon' – the simultaneous arrival of low oil prices, low interest rates and a low US dollar, which enabled South Korean firms to export a huge volume of products to international markets (Song, 1997).

Because of ongoing and vehement antigovernment action by students, workers, politicians and ordinary civilians, the weakened government of President Chun had to reintroduce democratic elections in 1987. Violent labour disputes were sweeping the nation at that time and the government was unable to quash the workers' demand for fair wages and better labour conditions. In particular the fierce strikes at the Hyundai factories in the summer of 1987 clearly showed that the *chaebol* and the government could no longer suppress labour activists just by harassing them. Wages subsequently rose rapidly in most industries, and so even cheap labour was removed as a source of competitive advantage. The governing style of President Roh Tae Woo, who was elected in the 1987 presidential election, was very different from that of his predecessors. In terms of economic policies, the Roh era is best characterised by the uncontrolled deregulation of economic activities and the unprepared opening of financial and product markets.

Unlike Park and Chun, Roh seldom intervened in the business activities of the *chaebol*. For instance in 1990 he removed the controls on land use in green belts, the development of which the previous governments had strictly prohibited. In 1992 he implemented an import liberalisation plan and opened the Korean stock market to foreigners. Roh's successor, Kim Young Sam, who was inaugurated in early 1993, extended the policies of deregulation and market opening by declaring *Sekyehwa* (globalisation) in November 1994, geared to the establishment of a completely open market economy compatible with the Anglo-American economic model. The government not only completely opened the domestic capital market to foreign investors, but also fully deregulated loan financing by South Korean corporations and financial companies in foreign capital markets. With the opening of the product and financial markets, South Korean firms that formerly competed for exports quickly began to compete for imports and rushed to attract as much foreign capital as possible. In particular the *chaebol*, which were still strongly expansion-oriented, rushed for cheap foreign loans in both domestic and overseas capital markets. As a consequence the domestic product markets became completely exposed to foreign competition and the economy became heavily dependent on foreign capital.

* * *

With the arrival of Roh government in 1988, then, the era of authoritarian and developmental government virtually ended. It is contended here that the policies of rapid deregulation and market opening by Presidents Roh and Kim resulted in institutional confusion which eventually became a source of the 1997 economic crisis. There are two reasons why these policies unintentionally caused institutional confusion. First, as discussed above, the *chaebol* retained both their policy of diversification and their highly centralised governance structure until the outbreak of the economic crisis in late 1997. When the government lifted the restrictions on capital markets the *chaebol* rushed to acquire for foreign capital for their expansion projects, most of which were commercially unfeasible. Consequently, as the size of the *chaebol* grew between the mid 1980s and mid 1990s, their profitability paradoxically fell.

According to an empirical study of the economic value added (EVA: net operating profit after taxes minus the cost of capital) of 570 non-financial firms listed on the Korean Stock Exchange between 1992 and 1996

(Kim *et al.*, 1998), only 27 per cent had a positive EVA. In other words, almost three quarters of the listed Korean companies generated insufficient operating profits to cover their external capital costs, which means that most South Korean firms were destroying value rather than creating it (Kim, 1998). In an advanced open market such destructive behaviour is controlled internally by corporate governance mechanisms such as boards of directors or externally by market discipline. Unfortunately in South Korea neither of these existed to prevent the uncontrolled expansion of the *chaebol*.

As explained earlier, all *chaebol* board members were inside executives and there were no institutional means for minority shareholders to express their concerns. Therefore the managerial processes in *chaebol* were completely without transparency and accountability, and very little crucial information was disclosed to outsiders. Although the chairman had almost unlimited power within the group he was not legally responsible for his decisions. A market for corporate control, such as mergers, acquisitions and hostile takeovers, did not exist. Thus with government regulations lifted, the *chaebol*'s highly risky pursuit of expansion based on borrowed foreign capital was unstoppable until the 1997 economic crisis. It is argued here that one of the causes of the Korean economic crisis was the hasty implementation of deregulation and capital market opening when no institutional mechanisms existed to countervail the high risks inherent in a deregulated and open economy.

The second type of institutional confusion was caused by the vast array of inconsistencies among economic policies. An institution is structured as a complex network of interrelated components, such as laws, policies, rules, norms and patterns, consistency among which is crucially important for the generation of good performance (DiMaggio and Powell, 1983; Zucker, 1983; North, 1990). The economic policies of Roh and Kim were riddled with inconsistencies, which generated a state of institutional confusion. For instance both exerted pressure on formally deregulated South Korean banks to provide huge loans to a number of troubled *chaebol*. As a result many banks were suffering serious credit problems at the outbreak of the economic crisis.

The most salient examples of this are Cheil Bank and Seoul Bank, both of which went bankrupt as a consequence of the loans they were forced to provide to problematic *chaebol*, such as the now defunct Hanbo Group. Because of his illegal involvement in bank loans for Hanbo Steel, Kim Hyun Chul, son of President Kim, was sentenced to imprisonment in early 1997, which crippled the credibility and political power of the Kim administration. With the presidential election scheduled for December 1997, the arrest of his son not only made Kim a lame-duck president, but also fatally

affected his ability to handle the economic crisis that started in September that year.

A more serious inconsistency in the government's economic policies lay in the relationship between its capital market policy and its exchange rate policy. While the government implemented various policies to liberalise the capital markets, such as opening financial markets to foreign investors and relaxing controls on currency flow, it continued to exert tight control over the exchange rate. This type of inconsistency also existed in other developing countries that have suffered an economic crisis, such as Mexico and Thailand. This odd mix of mutually contradictory policies can work fine if the government-imposed currency value is similar to its market value. However, if there is a significant gap between the two values, speculative currency flows, such as short-term capital and hedge funds, may precipitate a currency crash (Kim, 1998).

Despite the falling profitability of South Korean firms in the 1990s the government chose not to devalue the won, the accumulated effects of which eventually caused the crash of the won in the 1997 crisis. Even in the midst of the crisis the government refused to devalue the won, partly because of the negative effect this might have on its chances in the presidential election, scheduled for December. Instead the government wasted $25 billion of its foreign exchange reserve in November in a vain attempt to defend the value of won. This futile act virtually depleted the foreign exchange reserve, and as a consequence the won was devalued by more than 50 per cent, which in turn doubled the foreign debts of South Korean organisations, which were still competing to borrow whatever foreign capital was available. Now the confused government had no other option but to go for the largest bailout in the history of IMF.

THE STRUCTURAL TRANSFORMATION OF THE SOUTH KOREAN ECONOMY SINCE THE CRISIS

After the inauguration of President Kim Dae Jung in February 1998 the new government immediately started work on the structural transformation of the economy. At his inauguration Kim declared that he would create the necessary politico-economic institutions for a truly free market system by allowing autonomous decision making in economic organisations, minimising government intervention and deregulating most business activities. The central tenet of the various reform policies was the undoing of the institutional and organisational problems discussed in this chapter. The reform agenda included the restructuring of the financial sector, letting the value of the currency be determined by the market, restructuring government agencies related to economic affairs, the prohibition of cross-subsidisation and mutual payment guarantees between *chaebol* member companies, the dissolution of the *chaebol*'s offices of planning and coordination, the forced reduction of the *chaebol*'s debt–captial ratio to 200 per cent of capital, a reduction in the extent of *chaebol* business areas and the establishment of a tripartite coalition between labour, management and the government.

The Reform of the Financial Sector

Since one of the direct causes of the economic crisis was the crippled financial sector, which had been unable properly to monitor and control the *chaebol*'s excessive diversification and chronic overinvestment, it naturally became one of the first targets of the new government's reform programme. The government duly broke the old unwritten rule about the inviolability of banks by forcing troubled banks either to offer themselves for sale to foreign investors, to merge with each other or to go bankrupt. Moreover all the banks were required to increase their BIS ratio to 8 per cent by the end of 1999.

Subsequently five relatively small banks – Donghwa, Dongnam, Daedong, Kyungki and Chungcheong – had to declare themselves bankrupt. Of the seven largest banks, only two – Jutaek Bank and Kookmin Bank – were considered to be financially healthy; the two most problematic banks – Seoul Bank and Cheil Bank – were sold to foreign banks; and Hanil Bank and Sangup Bank were merged to become Hanbit Bank. The Foreign Exchange Bank was able to stay alone by attracting an equity investment of 350 billion won from the Komertz Bank of Germany. Mergers between smaller banks or between smaller ones and larger ones were also strongly encouraged. For instance three major deals were signed between Hana and Boram, Choheung, Chungbuk and Kangwon, and Kookmin and the Long-Term Credit Bank.

The second financial sector, which had not been controlled directly by the Bank of Korea until the crisis, was also heavily restructured by the government. The government closed down 16 integrated financial services firms (*Chong-Kum-Sa*), 10 lease companies, eight security companies, 22 insurance companies and two investment banking firms. In the process the government had to spend 31 trillion won on the restructuring of banks and 12 trillion won on the restructuring of the second financial sector.

The central organisational apparatus of the financial sector reforms was the Financial Supervisory Board (FSB), which was installed on 1 April 1998 as a government agency with virtually unlimited power over the financial sector. The FSB was created by integrating the following previously separate government agencies: the Bank Supervisory Institute, the Security Supervisory Institute, the Insurance Supervisory Institute and the Credit Management Fund (*Chosun Ilbo*, 1 April 1999). The FSB was bestowed with a wide range of powers over all types of financial organisation. For instance, it was given the power to replace the top managers of banks. The FSB is the government's main organisational weapon to enforce the highly problematic deals between the *chaebol*, which will be discussed shortly. Since most of the banks to which the *chaebol* owe a large amount of outstanding debt are heavily dependent on government subsidies for their restructuring, they are willing to exert pressure on the *chaebol* at the FSB's request. For this reason, some observers of the South Korean economy have strongly criticised the FSB as representing the resurrection of the government-controlled financial sector of the developmental period (ibid.).

The Restructuring of the *Chaebol*'s Financial Structure

Immediately after taking office in February 1998 the new government introduced various *chaebol* reform policies, which focus on improving the *chaebol*'s financial structure, transforming their governance structure and restructuring their business areas. The most fundamental of these is the financial restructuring of the *chaebol*, because, if thoroughly implemented as planned, it will dissolve the foundation of the *chaebol* structure described earlier.

First, the government ordered the *chaebol* to reduce their debt–capital ratio from over 500 per cent of their capital to less than 200 per cent. This was to be achieved by the end of 1999 by selling some of their member companies and assets or attracting foreign investment (*Korean Economic Review*, 16 December 1999). Otherwise their outstanding debts would be recalled immediately by the banks at the government's request. As a consequence, further expansion based on external financial resources has become impossible. The sale of even profitable companies to foreign investors has been strongly encouraged by the government. In order to make South Korean companies attractive to foreign investors the government and banks have offered various incentives, such as debt reduction and tax exemption. Foreign investors have indeed rushed to buy them at bargain prices, and many once-profitable companies, such as Daehan Jungsuk, the world's largest tungsten producer, and Hansol Paper have been sold in this way.

Second, the government prohibited both cross-investment and mutual payment guarantees between *chaebol* member companies, and all existing mutual payment guarantees must be cleared by the end of March 2000 (ibid., 8 April 1999). Therefore the *chaebol* not only lost their ability to mobilise internal resources, they also lost a means of attracting external resources. Hence the complex web of ownership networks within *chaebol* groups will soon disappear.

Third, internal trading between the member companies was prohibited by the government, which gave the Korean Fair Trade Commission full authority to monitor trading between member companies of the same *chaebol* and to take heavy punitive measures in the event of infringement. On 26 March 1998, the LG Group announced that transactions between its member companies would henceforth be made only if the companies concerned considered it beneficial to both parties. This strongly testifies to the former prevalence of internal trading, the sole purpose of which had been to subsidise other member companies (ibid., 27 March 1998).

Fourth, in order to make monitoring by external investors and regulatory agencies easier, the government ordered the *chaebol* to present consolidated financial statements for all the companies in their corporate control for the fiscal year 1999. While this would make their corporate finances much more transparent, the cost of producing consolidated financial statements for dozens of member companies would be enormous.

The Transformation of the *Chaebol*'s Governance Structure

The dismantling of the unique governance structure of the *chaebol* explained earlier in this chapter, was also one of the early aims of the government's reform policies. *Chaebol* owners were required to assume formal CEO status with full legal responsibilities. Thus unlike in the past, the owner–chairman of a *chaebol* group can now be held legally accountable for all his managerial decisions. Then the *chaebol* were required to appoint board members from outside the group and end the situation where all-insider boards consisting of top executives of *chaebol* companies monitored and audited their own managerial behaviours.

The government also introduced the legal right for minority shareholders possessing more than 1 per cent of a company's stocks to call a general meeting of stockholders. Coupled with this legal amendment was strong pressure from the so-called 'minority shareholder activists'. Starting with the 1997 general meeting of the stockholders of Cheil Bank to debate its problematic loans to the now defunct Hanbo Steel, minority shareholder activists fiercely confronted top executives of major *chaebol* on a wide

range of managerial decisions. Minority shareholder activism has received a mixed response. Those in favour argue that it not only protects the rights of minority shareholders, but also contributes to the improvement of firm performance by preventing owners and executives from pursuing their individual interests rather than the firm's interests (Chamyo Yondai, 1999). Those against argue that it may discourage reasonable risk-taking by executives, which is crucial for the achievement of above-normal returns (*Yonsei Business Review*, 15 April 1999). Regardless of the pros and cons, minority shareholder activism has become a force for *chaebol* owners and executives to reckon with. For instance, at the general meeting of shareholders of Samsung Electronics in February 1999, Samsung executives agreed to most of the requests of minority shareholder activists and decided to institute an interim dividend system and a regulatory mechanism for internal trading, and to grant shareholders the right to recommend outside board members.

The most controversial one of the *chaebol* reform measures was the government's demand for the immediate dissolution of the offices of planning and coordination (OPC). As discussed earlier in this chapter, the OPC was the core body that sustained the owner–chairman's highly centralised control of the diverse member companies. For instance, the OPC arranged and coordinated internal trading and cross-subsidisation among member companies, which the government deemed to be the *chaebol*'s main structural problem. However, the *chaebol* argued that the government was overlooking the crucial functions of the OPC in the effective coordination of member companies, such as rapid decision making, synergy generation and the creation of new business opportunities (*Chosun Ilbo*, 8 February 1998; *Joong-Ang Ilbo*, 9 February 1998).

The *chaebol* also argued that they needed their OPCs to implement the restructuring measures that the government was demanding. The dismantling of their OPCs was problematic for the *chaebol*, particularly since the holding structure was not legally allowed in Korea. There have been many debates on the desirability of the holding structure, but most law makers are opposed to the idea of allowing the *chaebol* to establish holding companies, and through these to exercise formal control over their member companies. Many observers of the South Korean economy, including law makers, were worried that legalisation of the holding structure would justify and enhance the *chaebol*'s advantages based on internal trading, mutual payment guarantees and cross-subsidisation. However, the *chaebol* maintained that, given the unique ownership structure of *chaebol*, it would be practically impossible to manage the diverse member companies without some kind of centralised coordination mechanism. Hence they insisted that if their OPCs were to be terminated in line with the government's policy, then the creation of holding companies should be legally allowed.

Eventually all the *chaebol* surrendered to the government's pressure to dismantle their OPCs by the end of March 1998. Based on the logic that the effective management of diverse companies would be impossible without a coordination unit, the *chaebol* looked for suitable alternatives to the OPC, such as establishing an association structure among member companies or delegating OPC functions to a core company in which the owner–chairman would take up the position of CEO (*Chosun Ilbo*, 8 February 1998). For instance the LG group announced that, along with its OPC, it would dismantle all its group-level decision-making units, such as the strategic planning committee and the human resource committee, and institute a lower-level, interfirm cooperation mechanism, primarily for information exchanges between member companies. The board of directors of each member company would have autonomous decision-making authority, and each company would have complete autonomy in CEO selection and strategic decision making (*Korean Economic Reveiw*, 27 March 1998). However it remains to be seen whether the closure of the OPCs will really transform the *chaebol* into a cooperative interfirm structure based on truly autonomous decision making.

Big Deals and the Restructuring of the *Chaebol*'s Business Areas

The most problematic of the new government's economic reform measures was the so-called 'big deal policy', which involved massive swaps of companies and business lines between *chaebol* groups. In order to force the *chaebol* to concentrate on a few specialised business areas, the government identified a number of industries that were covered by too many *chaebol*, including such core industries as cars, semiconductors, electronics, petrochemicals and aerospace. For instance, the government demanded that swaps be made between Samsung Motors and Daewoo Electronics and that LG Semiconductors should be taken over by Hyundai Semiconductors.

The 'big deal' policy was heavily criticised by the *chaebol*, economists and even some government officials (Kim, 1998). For example Bae Soon-Hun, the minister of information and telecommunications, had to resign after he expressed his disagreement with the swaps between Daewoo Electronics and Samsung Motors. The forced merger between LG Semiconductors and Hyundai Semiconductors was fiercely resisted by the LG Group, which was required to sell its equities to Hyundai. LG protested that the value of LG Semiconductors was actually greater than that of

Hyundai Semiconductors (*Korean Economic Review*, 25 December 1998). It was also pointed out that this takeover of LG Semiconductors by Hyundai Semiconductors was inconsistent with the government's big deal guidelines, which clearly prescribed that relatedness among business areas was a core criterion. The LG Group reluctantly agreed to hand over its semiconductor business only after the government threatened to take strong punitive measures, such as the early recall of its bank loans and the prohibition of future loans (ibid., 29 December 1998).

The rationale behind the government's big deal policy was that the *chaebol* could not be trusted to reduce their overdiversified business areas and excess capacities, which had posed a heavy burden on the competitiveness of the South Korean economy. However some considered that the government's role in the economic reforms should be confined to the establishment and enforcement of a truly free market system, and hence the restructuring of the *chaebol*'s business areas should be left to the discipline of market mechanisms (Kim, 1998). Some even voiced the criticism that the big deal policy was based on government-centred economic reasoning that was basically the same as the economic logic of the developmental period (ibid., 14 October 1998).

CONCLUSION: OUTCOMES AND DILEMMAS OF THE ECONOMIC REFORMS

Throughout this chapter, it has been argued that South Korea's politico-economic institutions and corporate organisations have had both positive and negative effects on the economy. While these institutions and organisations served as the main engines of rapid economic growth until the mid 1980s, they were also responsible for the economic crisis of 1997. It is submitted that the politico-economic institutions and corporate organisations served the South Korean economy as a core competence in the 1960s and 1970s but became a core rigidity that hindered the economy's adaptation to the changing environment in the late 1980s and 1990s. In other words the economy fell into the same competence trap that had caused the sudden failure of once-outstanding organisations during discontinuous environmental changes in which the utility of their competencies abruptly disappeared (Utterback, 1994; Leonard-Barton, 1995).

Since the economic crisis South Korea has made various attempts at structural transformation, geared to realigning of its politico-economic institutions and corporate organisations with the new competitive environment. However the results have so far been mediocre, at best. On the plus side the credit rating of the South Korean economy by S & P, Moody's and Pitch IBCA was upgraded to 'suitable for investments' at the end of 1998 (*Korean Economic Review*, 14 February 1999). Also, the average debt–capital ratio of the 30 largest *chaebol* fell from 518.9 per cent at the end of 1997 to 379.8 per cent on 1 April 1999 (KFTC, 1999). However, by the end of 1998, the debts of the five largest *chaebol* had increased by about 13 trillion won compared with the end of 1997 (one US dollar was roughly equivalent to 1200 South Korean won at the end of 1998). In particular the debt of the Daewoo Group had increased by 17 trillion won and that of Hyundai Group by 10 trillion won, whereas Samsung, LG and SK had significantly reduced their debts during this period. Dissatisfied with the *chaebol*'s debt–reduction performance, President Kim announced that the government requirement that the *chaebol* reduce their debt–capital ratio to 200 per cent by the end of 1999 would not be renegotiated (*Korean Economic Review*, 6 April, 1999).

The profitability of the *chaebol* has not significantly improved either. Although the average sales of the 30 largest *chaebol* increased by 7.1 per cent in 1998, their net losses had increased by 16 trillion won compared with 1997 and amounted to 19 trillion won (KFTC, 1999). According to another report on the profitability of 584 listed companies, the average return on equity was minus 20.4 per cent in 1998 (*Joong-Ang Ilbo*, 6 April, 1999). These statistics testify that the *chaebol* have not completely discarded their old way of doing business, that is, expansion at the cost of profitability. The reform of their governance structure has not been satisfactory either. Although their OPCs were officially dismantled, virtual OPCs have been maintained for the coordination of member companies by delegating this function to one of their core companies. Furthermore the owner–chairmen are still exerting a powerful influence over their member companies.

The area of greatest government dissatisfaction concerns the big deal policy. Although the *chaebol* reluctantly agreed to conform to the government's guidelines, by March 1999 not a single deal had been signed. For instance the Samsung Group was still hesitating about taking over debt-ridden Daewoo Electronics, while the Daewoo Group was still trying to beat down the takeover price of Samsung Motors. In the negotiations between the LG and Hyundai Groups agreement could not reached about the proper price for LG Semiconductors. In order to put pressure on the deadlocked negotiations, President Kim declared that the government might apply 'Workout' – forced restructuring preceded by the removal of corporate control from the owners – to large *chaebol* that failed to keep their promises about these deals (*Chosun Ilbo*, 15 April 1999; *Dong-A Ilbo*, 15 April, 1999). This resulted in the LG and Hyundai Groups agreeing on the price of LG Semiconductors on 23 April, 1999 (*Chosun Ilbo*, 23 April 1999).

Careful consideration of the 1998–9 reform processes reveals two types of fundamental dilemma: the government's role in structural transformation, and the tradeoff between the resolution of the existing structural problems and the construction of new competencies. With regard to the first dilemma, the government has had to intervene actively in the economic activities of the *chaebol* and banks in order to facilitate the transformation of the South Korean economy from a government-centred system to a free market system. Some argue that the government should lead the process of economic restructuring, or at least during the transition period, whereas others insist that the government is turning back the clock to the government-centred economy of President Park (*Chosun Ilbo*, 1 April, 1999).

The second and more important dilemma is the tradeoff between the resolution of the existing institutional and organisational problems and the construction of new competencies. Going back to the earlier point about the shift of Korean institutions and organisations from core competence to core rigidity, what the Korean economy most urgently needs is the building of new competencies. However the measures implemented since the economic crisis seem to have concentrated on the removal of core rigidities rather than the building of new core competencies. Many observers question whether the South Korean economy will be able to compete in the future without the developmental government and the unique advantages of the *chaebol* structure (*Korean Economic Review*, 18 December 1998). Although it is widely agreed that the worst of the economic crisis is over (ibid., 23 February 1999), it has yet to be seen whether South Korea can rise again in the world economy by building new competencies. In other words the recovery of the South Korean economy will depend on whether Korea can effectively build post-developmental politico-economic institutions and post-*chaebol* corporate organisations that can offer as new competitive advantages and core competencies in a borderless world market characterised by hypercompetition (D'Aveni, 1994).

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9 The Malaysian Model: Governance, Economic Management and the Future of the Development State

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INTRODUCTION

Before the Asian economic crisis, Malaysia was regarded by many as a remarkable success story (World Bank, 1993). After gaining independence in 1957 it transformed itself from a primary commodity-producing nation into an economy driven more by the production and exportation of manufactured goods. This was done in the context of a complex, multiethnic population representing 'a microcosm of Asia, with the three largest communities in its heterogeneous population – Malays, Chinese, and Indians – representing samples of Asia's three most populous countries – Indonesia, China and India' (Leete, 1996, p. 1). The annual growth rate of Malaysia's gross domestic product (GDP) averaged more than 8 per cent over the period 1988–97. This high growth rate was achieved in a relatively benign inflation environment. Much of this economic progress was credited to the unique Malaysian development model, which is often associated with Mahathir Mohamad, the current prime minister of Malaysia. This model is a variant of the highly touted East Asian development model, which forms a common thread in the various chapters of this book.

However the Asian economic crisis of 1997 exposed some of the weaknesses in the political economy of Malaysia. This in turn dented the image of the development model. Thus the main objectives of this chapter are (1) to examine the pattern of economic development of Malaysia, especially under the administration of Prime Minister Mahathir Mohammed; (2) to review the principal features of the economic crisis and its consequences; and (3) to evaluate the response of the Malaysian government to the crisis.

The rest of the chapter is divided as follows. In the next section, a brief background of the history and politics of Malaysia is presented. In the third section we shall examine the main patterns of the economic development of