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Introduction

Among those countries that were seen, beginning in the early 1970s and lasting through the 1990s, as the "miracle economies" of Asia, perhaps none performed quite as miraculously as South Korea (or, more formally, the Republic of Korea). As recently as the mid-1960s, South Korea (henceforth simply "Korea" except when confusion with North Korea is possible) could be counted among the poorest of the world's nations. Indeed, in the years immediately following World War II, after Korea had been liberated from the repressive rule of Japan, the nation suffered a brutal war during which perhaps 10 percent of its population perished and per capita income, already low, fell further (see chapter 2). In the aftermath of this war, many analysts felt that Korea was a hopeless economic basket case whose people were destined to be perpetually dependent on foreign aid—and, even with that aid, consigned to live at the edge of poverty.[1] In 1962, in fact, real per capita GDP in Korea was less than that in Thailand, the Philippines, Malaysia, or even Ghana. The average person in Korea in 1962 could claim less than half the income of the average person in Malaysia, then the richest of these four other countries by this measure.

The analysts—and there were many of them—could not have been more wrong. Barely thirty years later, Korea had risen to become a candidate

1. See, e.g., United Nations (1952); in 1952, Korean relief programs were largely under the aegis of the United Nations, and military units sent to South Korea to fight the invasion from the North were nominally UN agents. However, both the relief and the military efforts were in fact almost exclusively conducted by the United States.

for membership in the Organization for Economic Cooperation and Development (OECD), the intergovernmental organization headquartered in a posh chateau in Paris once owned by the Rothschild family that is viewed by nonmember governments as a "club" that restricts membership to rich nations. Between the mid-1960s and mid-1990s, Korea, the nation whose economy once was seen as hopeless, experienced one of the most rapid compound rates of prolonged economic growth ever sustained by any nation. By 1988, real per capita GDP in Korea had more than quintupled, making the average Korean richer than the average Malaysian—even though Malaysia was also a high-performance economy whose per capita GDP had increased two and a half times since 1962. In 1988 Korea could in fact boast a per capita income more than two and a half times that of the Philippines and almost twice that of Thailand. Furthermore, rapid rates of growth would continue for almost another decade before Korea would experience a major setback in its economic fortunes.

Underlying the impressive economic growth of Korea since the 1960s have been important changes in the structure of output of the country's economy and, indeed, in its society. In the mid-1960s, when the "economic miracle" began to take hold, Korea's leadership deliberately chose to stress the manufacture of goods for export rather than primarily for domestic consumption. At that time, all that Korea could export were relatively simple goods embodying rather low-skill labor: footwear, apparel, and the like. However, beginning in the late 1960s and continuing through the 1970s, Korean firms, responding to policies undertaken by the government, began to enter new sectors in which it was thought the firms could build international competitiveness (and hence were by definition sectors in which Korea held latent comparative advantage). Most of these sectors could be characterized as "capital intensive"—that is, they required as a condition for entry large front-end capital expenditure. But in comparison to those industries that developed the fastest during the earlier decade of growth, these also required higher levels of technology, demanding, as economists like to put it, higher inputs of "human capital" (i.e., workers with higher levels of educational attainment, where "workers" include technical and managerial personnel). During the period 1971-79, in particular, Korean President Park Chung-hee put particular stress on the heavy and chemical industries, in an effort to build an industrial base designed to turn Korea into a military power. The 1970s in Korea thus is often termed the "HCI period."

This large-scale experiment in industrial policy doubtless should be rated an overall success, given the impressive rate at which per capita income grew in Korea. At the same time, however, major imbalances developed in the economy, cumulatively leading to serious difficulties that manifested themselves toward the end of that decade. These difficulties notwithstanding, during the 1980s and 1990s Korean firms continued to enter into new sectors; as a result, by the mid-1990s Korea was exporting a very wide range of products. These included highly technology- or human capital-intensive products such as semiconductors and electronics. Indeed, Korea became the leading producer of large-scale dynamic random access memory chips (DRAMs), one of the most technically sophisticated products of the modern age (albeit one that, as we shall see, had become a mass-produced commodity by the late 1990s). Korea ranked as well as one of the world's top exporters of automobiles, ships, machinery, steel, and many other goods.[2]

One consequence of the imbalances of the late 1970s was that economics experts inside the Korean government recognized that an industrial policy-driven strategy for development could take the country only so far; they saw that as the Korean economy advanced, the government should get out of the business of guiding the economy and instead allow market forces to hold sway. Thus, starting in the mid-1980s and continuing through the 1990s, many aspects of industrial policy were phased out in Korea. However, as I shall soon argue, some key aspects of industrial policy were retained—ones that indeed were to spell big trouble. Furthermore, during the period of activist industrial policy, many of the private institutions necessary for a market-driven economy to prosper were never developed as fully as they should have been. In particular, during the early days of industrial policy, the focus in Korea was on manufacturing industries, and thus the development of the financial sector lagged that of the industrial sector. This disparity continued even after the government moved toward a more market-driven policy. The earlier single-minded focus on industrial development, with no concurrent focus on financial development, was arguably a mistake. Economic research has consistently shown that a well-developed financial sector is absolutely essential if an economy is to maintain long-term growth (surveys of this research are provided by Levine 1997 and Levine and Zervos 1998). Thus, one major shortcoming of Korea as a miracle economy has been a relatively underdeveloped financial sector, whose consistent lagging behind the industrial sector helps to explain some of the economic difficulties Korea has experienced in recent years.

In late 1997, Korea became caught up in what now is termed the "Asian financial crisis." To put this into some perspective, in 1996 and early 1997 some Korean economists were concerned that a significant economic downturn was imminent, perhaps at worst a nosedive to 4 percent positive growth—about the same rate of growth as the US economy was experiencing at that same time. But while Americans were toasting the robustness of their economy and attributing it to the miracle of the information age, Koreans worried that 4 percent growth would constitute a "growth recession." As it happened, however, performance did not simply

2. Detailed descriptions and analyses of Korea's export performance from the middle 1960s to the early 1990s are provided by SaKong (1993) and Cho S. (1994).

fall to a level comparable to that of the United States; instead, the bottom fell out of the Korean economy. Growth in 1998 was *negative* 8 percent, a full-blown recession by any standard. Had this contraction continued for very long, 1998 would have been recorded as the beginning of an out-and-out depression.

But then, almost as rapidly as the economy had plunged into severe recession, in the early months of 1999 the situation began to reverse itself. Recovery was swift, and from the middle of 1999 to well into 2000 the Korean economy grew at a 10 percent rate.

Even during this rapid recovery, however, not everything was proceeding smoothly. In particular, in mid-1999 one of Korea's largest groups of business firms (or, to use the Korean term for these groups, *chaebol*), the Daewoo group, failed. Also, as 1999 faded into 2000, it became increasingly clear that the largest of the chaebol, the Hyundai group, was teetering on the edge of bankruptcy. Moreover, this group was beset by barely disguised internal conflict as several of the sons of the group's founder, Chung Ju-yung, maneuvered for control as the health of their elderly father began to fail. As will be discussed in more detail in chapter 4, after Chung Ju-yung's death in April 2001 the Hyundai group was split into three entities, each controlled by one of the sons, and several of these successor groups continued to experience financial difficulty.[3]

The chaebol had in fact been the main engines of the economic growth of Korea from the HCI period up through the 1997 crisis, and the weaknesses revealed in these groups came as a shock to many Koreans. "Chaebol" is actually something of a junk term, used to designate any of the large nonfinancial groups of firms that are headquartered in Korea. These include specialized groups such as Lotte, which is (mostly) a retailing and hotel chain but also holds some industrial affiliates, and Pohang Iron and Steel Company (POSCO), created as a state-owned firm but now privatized, which largely specializes in primary steel production and indeed ranks as the world's second-largest and most efficient steel producer. However, when Koreans talk about the chaebol, they generally are referring to a rather small number of very large and highly diversified groups of firms that have come to dominate most of the industrial sectors that make up the core of the Korean economy.[4] Some of these groups have

3. In this text, Korean names follow the Korean convention: i.e., the family name precedes the "first name," except for those individuals who are widely known internationally by names written in the Western fashion (e.g., Syngman Rhee). Also, as a rule given names (which generally consist of two parts) are hyphenated: thus, "Park Chung-hee," not "Chunghee Park" or "Park Chung Hee." Finally, because transliteration from Korean has not been standardized, I have tried to use the spelling favored by the person him- or herself when this is known: thus, "Chung Ju-yung," as it appears in Hyundai's annual reports, and not "Chung Ju-young" or "Chung Ju-yun," as the same name has appeared in newspapers.

4. For a discussion of various aspects of the chaebol issue, see Yoo S. (1995).

names that by 1997 had become recognized throughout the world, while others were relatively unknown outside of Korea.

The five biggest chaebol at the onset of the 1997 financial crisis were Hyundai, Samsung, Daewoo, LG (formerly Lucky Goldstar), and SK (formerly Sun Kyung). At that time each, had it issued consolidated financial statements, would likely have been included among the world's two hundred or so largest business enterprises ranked by total sales (but not by total profits). Combined sales of individual firms listed on the Korean Stock Exchange constituting each of the three largest groups (Hyundai, Samsung, and Daewoo)[5] were then all over $50 billion, according to published income statements. (Because some of these sales were to other members of the same group, these figures reflect some element of double-counting that cannot be determined from the published data.) To a very large extent, the story of the miracle of Korea is the story of the rise of these five groups and a handful of similar but smaller groups.

Conversely, the story of the Korean crisis of 1997 and of the still not fully resolved problems lying deep within the Korean economy that came to light as a result of the crisis is also largely the story of these same groups. The harsh fact is that even today, many of the affiliates of these groups are experiencing difficulties, to varying degrees and for varying reasons. Only two groups, Pohang and Samsung, are in good financial condition overall. Most of the groups share the same symptoms: some combination of lack of profitability, excessive debt, and overstaffing.

This does not mean that all affiliates of these groups—even those groups that are troubled—are themselves in difficulty. In fact, one characteristic of most of the chaebol is that as diversified groups of firms, they typically hold operations that are by most measures very healthy and profitable; indeed, some are considered to be "world-class" firms, such as Samsung Electrical Company and SK Telecommunications. But each group except Pohang also holds affiliates that are in quite bad shape. The overall health of each of the groups thus is largely a function of which dominate, the healthy member firms or the unhealthy ones.

A major issue for the groups, and for the Korean government (as we shall see, the chaebol and the government in Korea have been, since the beginning of the miracle, deeply intertwined), is whether unhealthy firms and operations within the chaebol can be nursed back to health. Arguably, one strong feature of the chaebol form of organization has been that profits from healthy firms could be used to revive the feeble. The risk is that such a course of action could be ineffective and indeed put the healthy companies at risk. Alternatively, the unhealthy firms could simply be forced to stand on their own, though in many cases they would

5. Although the Daewoo group was bankrupt and a ward of the state, most of the firms in it were still in business in 2000. This situation will be discussed in greater detail in the pages that follow.

then fail completely. As noted above, this is the course that the Hyundai group has followed, although its response has been determined more by fate and the passing of its founder than by deliberate plan.

One problem that Korea faces and has to date largely failed to resolve is that the restructuring of unhealthy firms would in many instances lead to large numbers of jobs being lost. Indeed, the avoidance of job loss is arguably the main reason why a large number of unhealthy firms have been allowed to remain in business without restructuring and thus to consume resources that might otherwise be available for other (and almost surely, in the long run, better) uses. Thus, significant labor shedding might still be required in Korea. This thorny problem is one of the main issues addressed in this book.

The histories of the chaebol are usually rather short, as most began to become important institutions only in the 1970s. Although one of them, Samsung, has a pedigree extending before World War II, the others were founded after the war: of the top five, the ancestral firm of Samsung dates to 1938 (but the current mother firm only to 1951), LG and Hyundai both to 1947, SK to 1953, and Daewoo to 1967. As a result, the founders of many of the groups are still alive or have died quite recently; in some cases they are even still actively involved in management. The founders and their families are typically the largest (and controlling) shareholders of the groups. The short histories of the chaebol are in contrast to the history of Korea itself, which spans at least 2,400 years if one counts precursor states that unified to form what was to become modern Korea.

For the most part, these groups were relatively small, family-owned enterprises until the 1970s growth driven by industrial policy. To be sure, as the next chapter details, at least two, Samsung and Hyundai, were quite large by local standards even before 1970, but they remained small by world standards. Their growth into the behemoths that they are today came about largely under the nurture of the government and began at about the same time as the commencement of the HCI drive.

Indeed, the meteoric rise of the chaebol as institutions leads many Koreans to question their legitimacy. To understand this complex issue, one needs to know something about the recent history of economic development and the role of the chaebol in this development in Korea, background that will be supplied in the pages that follow. In brief, some Koreans are suspicious of the chaebol because their growth was financed largely via debt: funds were borrowed from abroad or from banks that intermediated savings generated by private households in Korea. Early on, foreign debt predominated, but as time passed and savings in Korea rose, domestic loans overtook foreign loans as the main source of funding. There is nothing unusual in this intermediation per se; but during the period of Korea's most extraordinary development, lasting from the late 1960s until about the end of the 1980s, the recipients of funds were not determined by market forces. Especially after 1972, intermediation

Table 1.1 The 10 largest chaebol in Korea, 1983

Chaebol	Total assets, 1971 (billions of won)[a]	Total assets, 1983 (billions of won)[a]	Average annual growth of assets, 1971-83 (percent)
Hyundai	158	4,469	32.1
Samsung	416	3,372	19.1
Daewoo	35	3,340	46.3
LG (formerly Lucky Goldstar)	437	2,715	16.4
Ssangyong	310	1.712	15.3
SK (formerly Sun Kyung)	40	1,478	35.1
Hanjin	84	1,340	26.0
Korea Explosives	256	1,173	13.5
Daelim	65	943	25.1
Kukje	153	896	15.8

a. Valued in constant 1980 won.

Source: Kim E. (1996, table 1).

was instead largely by government fiat. Favored enterprises received credit at subsidized rates and numerous other forms of preferential treatment, including all-important government permission to borrow from abroad. When, in the 1970s, overseas borrowings rose markedly, the government often guaranteed the loans extended by foreign banks to private Korean enterprises, and such guarantees were granted on a preferential basis.

The result was the phenomenal growth of certain firms: table 1.1, taken from Kim Eun-mee (1996), demonstrates exactly how fast they grew. Although all of these top ten groups grew very quickly, some clearly did better than others. The very fastest growing groups were Hyundai, Daewoo, SK, Hanjin, and Daelim. Analysts believe that they all had special ties of one sort or another to President Park (see chapter 2). Samsung by contrast was largely seen as out of favor with Park throughout the 1960s and early 1970s. However, beginning in 1976, Samsung began expanding rapidly in the HCI sectors favored by Park, in part by taking over ventures founded by other firms that were failing.

Thus, the many Koreans who doubt the legitimacy of the chaebol credit their success to cronyism or worse. But this interpretation is by no means universally held in Korea. Defenders of the chaebol argue that competence and willingness to take risks were the hallmarks of the owners and managers of these groups during their periods of rapid growth. And whereas in most countries with rampant cronyism the locally favored enterprises tend to be noncompetitive in world markets, at least some operations of the chaebol have emerged as world-class firms in very competition-driven sectors. Thus, when a customer in any advanced country walks into a store selling products that embody advanced technology, such as computers, DVD players, cellular telephones, and the like, he or she sees products made by the chaebol, often under the name of the group—and not, typically, products made by firms based in other developing nations. As Alice Amsden explains in her classic work on Korea:

> Reciprocity (between business firms and the government) in Korea was in no way free of corruption. No business in Korea could survive the last forty years if it challenged the government politically. None could make it big if it did not support the government financially. Yet for all the venality the evidence…suggests that beginning in the 1960s the government's favorite pets—the big business firms that came to account for so large a share of GNP—were outstanding performers from the production and operations perspective. (Amsden 1989, 146)

In the pages that follow, we examine the rise of the chaebol, and find that the facts do not rule out either of the above stories. On the one hand, much evidence points to the chaebol as products of a rather corrupt system that, one way or another, supported ventures that would not have prospered without favoritism in the form of significant injections of explicit and implicit subsidies. One problem faced today by the Korean government, headed by a president who definitely was not himself part of past cronyism and indeed was for many years among the most prominent critics of the system in Korea, is what to do about enterprises that almost surely would collapse without government aid continuing in some form.

On the other hand, as already noted, there is also much evidence that the chaebol are entrepreneurial ventures that battled against fierce odds to establish themselves as world-class competitors in advanced industrial sectors. Whatever might be the truth about the chaebol, it is unquestionably very complex.

To understand how these groups came to be world-class competitors after starting as virtual nonentities in what had been a very poor nation, it is necessary to explore Korea's rise from almost hopeless poverty to the relative wealth of an advanced nation in barely more than one generation. This larger context is also key to understanding why many of these same groups have fallen into serious trouble. Thus, in chapters 2 and 3, we examine the economic history of Korea in order to determine how the chaebol came to be as they are. Chapter 4 then examines the years that preceded the 1997 crisis, beginning with the last half of the presidency of Roh Tae-woo (which lasted from 1987 to 1992); it attempts to pinpoint exactly what was going wrong in the chaebol and what efforts the Korean government made (and did not make) to deal with a situation that clearly, by late 1996, had a large potential to go wrong.

One of the main themes that emerges is that for a variety of reasons, when rates of return on capital began to fall (as was natural for capital accumulated during the transformation of an economy from less-developed status to that befitting an advanced industrialized nation), neither the Korean government nor, more important, Korean firms adjusted as necessary. Instead, Korean firms continued to seek growth opportunities via new capital investment even when returns on this investment were low. Furthermore, this expansion was financed, as before, largely in the form of debt. Such failure to adjust for changing circumstance largely explains why Korea experienced a meltdown in 1997: a combination of high leverage (use of debt financing) and low returns created widespread financial weakness throughout the Korean economy, which ultimately erupted into crisis. Chapter 5 examines the crisis itself and its aftermath, including efforts to resolve the problems that it revealed—problems that were compounded by the deep recession that followed. The main conclusion is that some of the weaknesses of the chaebol—in particular, the vulnerabilities created by the structure of these groups and their dominance in the economy—persist despite efforts at pervasive reform. Chapter 6 concludes by recommending where Korea should go from here.