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0521814359 - Financial Crisis and Transformation of Korean Business Groups: The Rise and Fall of Chaebols

Sea-Jin Chang

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## Financial Crisis and Transformation of Korean Business Groups

This book argues that the Korean financial crisis of 1997 was due to the inertia of both the business groups known as chaebols and the Korean government, which prevented adaptation to changing external environments. After the Korean government stopped central economic planning and pursued economic liberalization in the 1980s, the transition created a void under which neither the government nor markets could monitor chaebols' investment activities. Chaebols pursued ambitious expansions that often lacked a strong economic rationale. The intricate web of cross-shareholding, debt guarantees, and vertical integration resulted in extensive cross-subsidization and kept chaebols from shedding unprofitable businesses. The government's continued interventions in banks' lending practices created "moral hazards" for both chaebols and banks.

This treatment demonstrates how the structure of chaebols, which was once optimal for their rapid growth, later inhibited other adaptations and for all practical purposes became nearly dysfunctional. The book argues that restructuring of chaebols should focus on improving corporate governance systems. After such restructuring, the author predicts, chaebols will reemerge as stronger, more focused global players.

Sea-Jin Chang is Professor of Business Administration at Korea University. Previously, he was a faculty member at the Stern School of Business at New York University. He has also held visiting appointments at Stanford University and INSEAD, France. Prior to his doctoral study at the Wharton School of the University of Pennsylvania, he worked for large telecommunication companies in Korea and Japan.

Professor Chang's research focuses on understanding the process of creating operating synergies among diversified lines of business and building a strong local organization after foreign entry. His research has been published in journals such as *Review of Economics and Statistics*, *Journal of Industrial Economics*, *Journal of Management Studies*, and the *Academy of Management Journal*. He sits on the editorial boards of several leading journals in strategy and international business. He has also written several textbooks in strategy and international business.

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*To my teachers and colleagues*

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The Rise and Fall of Chaebols

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*Korea University*



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## Preface

The Asian Crisis in 1997 affected almost everyone in Korea. Thousands of companies went out of business, and many workers lost their jobs. Foreign investors fled the country, major banks became insolvent, and the government depleted its foreign reserves as the country went bankrupt. This crisis was financially and emotionally painful for me. I had returned to Korea in 1994. At that time, Korea's prospects looked bright. Korean firms continued to grow at a phenomenal rate and had expanded aggressively overseas. Every Korean I met was proud of his country, and businessmen were confident that Korea would soon catch up to Japan, which had served as a role model for Korea. As one of the faithful, I sold my stock in U.S. companies and invested the proceeds in Korean firms. Right after the crisis, however, my net worth in dollars had shrunk to one eighth of what it had been. My wife once teased me, asking how a business school professor could be such a lousy investor. Like many Koreans, I was determined to find out who had ruined my country and stolen my pride.

The widespread consensus was that chaebols were to blame for Korea's downfall. Chaebols, which are powerful groups of



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affiliated companies that helped catalyze Korea's economic development, have long been admired and criticized. On one hand, people admired them. Korea's top college graduates lined up to work for them. In downtown Seoul, where the insignias of Hyundai, Samsung, LG, Daewoo, and SK were displayed everywhere, the strength of Korea's economy was palpable. The chaebol chairmen who managed these empires seemed glamorous. On the other hand, chaebols were the subject of fear, disdain, and resentment. They were blamed for devouring Korea's resources and squeezing out smaller companies. Newspapers reported many incidents of chaebols making illegal contributions to politicians and receiving favors in return. Foreign governments often charged chaebols with dumping and other unfair business practices. Western businessmen believed chaebols were analogous to cancer cells that grew without purpose and thereby killed neighboring cells before consuming themselves.

As I researched chaebols, I learned that they were neither crazy nor irrational. Rather, chaebols had been efficient given their environment. By sharing financial and intangible resources such as brands, technology, and human resources among affiliates, their internal markets had created enormous synergies. Such resource sharing had been the source of Korean firms' competitive advantage and had enabled Korea's economy to grow quickly. Yet the Asian Crisis revealed chaebols' fatal weaknesses. The resource sharing among legally independent affiliates was possible only because chaebols were centralized, and their chairmen wielded immense power. There was no way to guard against the ill-conceived strategies of these chairmen, who pursued diversification that lacked any economic rationale, cross-subsidized unprofitable affiliates, and diverted profits to affiliates in which they and their families owned large equity stakes. All these activities wasted the synergies

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created through resource sharing. The intricate web of cross-shareholding, debt guarantees, and vertical integration further inhibited chaebols' efforts to restructure. During the transition from a state-controlled economy to a market-oriented economy in the years prior to the Asian Crisis, neither the Korean government nor the markets could monitor or guide chaebols' investment activities.

This book argues that wholesale criticisms of chaebols and radical prescriptions for chaebols, such as breaking them up, are wrong. It proposes instead that the Korean government needs to build institutional infrastructures, especially corporate governance systems, which will help markets function better. Other laws that protect minority shareholders' rights and strictly enforce the Fair Trade Act will make practices such as expropriation and cross-subsidization more difficult and will ensure that chaebols' investment decisions are sound. At the same time, increased international competition in their home markets will force chaebols to focus on their core businesses. By revamping its corporate governance system and trade policies, the Korean government can unleash the power of hardworking managers and workers, who were a key factor behind Korea's dramatic economic growth. I have no doubt that when chaebols are reformed, they will once again become strong global players.

As I researched and wrote about chaebols during the last five years, I realized how much I had learned – and continue to learn – from my teachers and colleagues. For this reason, I dedicate this book to them as a way of expressing my deep gratitude. Byung-Hyou Chong of the Seoul National University taught me industrial organization economics in college and encouraged me to pursue graduate work. Edward Bowman, Hubert Gatignon, Bruce Kogut, Dan Levinthal, and Harbir Singh of the Wharton School of the University of Pennsylvania were

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exemplary scholars who guided me through my doctoral studies. I am also indebted to my colleagues, who have been always a source of insight and encouragement. Tom Pugel and other colleagues at the Stern School of New York University created an intellectually stimulating environment. My colleagues at Korea University also provided me an environment in which I could concentrate on research. In particular, Linsu Kim helped me start this book project and Dean Jangro Lee of the Institute of Business Research provided me special funding for this research.

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