Chapter 4

"Chaebol"-Led High Growth System in South Korea

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Introduction

Sustaining the high growth for 35years since the first economic plan, South Korea finally joined the OECD in 1996. During the developing period, it has been highly praised for the success of the export-oriented development strategy, but at the same time, it has been often slapped with the criticism for the powerful government intervation.[1] In recent years, when asked as to why South Korea has been able to maintain the international competitiveness despite government dominance, the answer has been standardized that while the government did intervene to provide various support, it has never spoiled the companies picked-up. However, this analysis may serve as an answer regarding the relative role of government in comparisons with Latin America and elsewhere, but does not necessarily answer the question posed by another fact in the South Korean economy; why the "chaebol" (Korean big business conglomerates) continue to encompass such large numbers of less competitive firms and remain financially weak[2] as a result of protection even today. In fact, the South Korean government did spoil the chaebols, but at the same time created institutional arrangements between the "chaebol" and its own agents, that is, the government-owned financial institutions. Would it be difficult to assume that the South Korean production system, as represented by the "chaebol", have maintained their competitiveness thanks to support by an aggregated instituational arrangements, that is, the economic system? Above all, in this article, the arrangements between the government and "chaebol" will be examined to discuss the implications of Korean's experience.

1 Designing the Economic System

1.1 Growth and Independence

The economic development of South Korea has been extremely distinctive in nature, in that it has been created on a strong commitment toward growth and economic independence, which were driven by an export-oriented and government-led strategy. First, it was the Park Chung Hee administration which seized the control over the government in 1962 by a coup d'état and launched the country's first economic plan. The government considered high growth to be crucial for beating North Korea (Democratic People's Republic of Korea) in the competition for economic development, and for establishing and reinforcing the legitimacy of the administration-which had come to the power without taking democratic procedure. The priority of economic policies has been, therefore, always consistently given to faster growth rather than balanced growth by checking inflation and the current account deficit. South Korea has been highly growth-oriented. After the first oil crisis, South Korea stared to evolve out of its labor-intensive industries by building heavy and chemical industries (HCI), and after the second oil crisis shifted from HCI to high-tech industries. In response to the external shocks to the system, efforts were concentrated on sophisticating the industrial structure relying basically on "big push" policies. The efforts for controlling the aggregate demand has often terminated in very short periods. Sustained high growth in this pattern has ensured better employment and steady increase in real wages, and improved working conditions, no matter while the democratization and labor movement have been politically suppressed and social policies such as social security and health insurance were de facto postponed until the late 1980s.

Secondly, the early economic development was stimulated by two major external factors: American aid and Japanese reparations. Naturally because of this reason, early Korean economy has had to depend heavily on the two giants: American and Japanese economies. In particular, it has suffered a continuous deficit in its trade with Japan from which it imported capital and intermediate goods. The Park administration, which overrode domestic opposition to restore diplomatic relations with Japan, has been constantly attacked by the opponents for "economic sub-ordination". This background has pressured the Park administration to emphasize "independency" as another goal, besides high growth. Ironically, if trying to be independent from Japan with its full-set type industrial structure, South Korea herself would have to follow Japan to imitate the industrial structure. The industrial structure was planned taking the lead from Japan, and to achieve the "independence", the industrial policies has focused the manufacturing sector while relatively ignoring the service industries. Direct investment bringing in the management control by foreign owners was all channeled to the special export processing zones, where foreign firms were obligated to export all products, being separated completely from the domestic market. Investment projects outside of the export processing zones were carefully screened, while preferring technology imports to direct investment, loans to technology imports.[3] Due to the slow disclosure of the "chaebol"-affiliated large firms governed by their founding families, the development of securities market has been stagnated. It was not until the 1990s that a real attempts were made to introduce global money by opening up the capital market.

1.2 Export Orientation and Government Initiative

Strong commitment toward high growth and independency has been sustained by two invention: the shift towards an export-oriented strategy and the sophistication of the government-led system. The export-oriented strategy was an innovative one first adopted by the Park administration, while the system of government control was rather inherited and path-dependent. However, the two factors rapidly complemented each other and formed a system conducive to high growth. The reason is first, at the time when economic development plans were implemented, primary import substitution had already completed with the saturation of the domestic market, and the foreign reserve position had considerably deteriorated. On the other hand, there were favorable market conditions externally (the U.S. a market as an absorber for the final products and Japan with its broad base of supporting industries and sources of technical information). South Korea had no choice but to adopt an export orientation. Since the Park administration had no reason to maintain consistency with the former administration, it was able to boldly switch the incentive paradigm from import substitution to an export orientation and was able to mobilize even some of the entrepreneurs who had emerged in the import substitution period into its export-oriented strategy. When the growth of labor-intensive exports slowed at the start of the 1970s, the government turned to the promotion of the heavy and chemical industries (HCI) through industrial policies. The ambitious plan covered the electronics industry—conceived of as the leading export industry to take the place of textiles—, petrochemicals including synthetic textile materials, synthetic rubber in demand for footwear, ferrous and nonferrous metals in demand for construction and simultaneously promoted shipbuilding sector, and all other material industries with an import substitution effect. These sets of projects, however, were also promoted on a scale enabling export competitiveness right from the start, and were not limited within a scale of import substitution. At the same time, the intermediate goods and capital goods required for export industries were freely imported to a substantial degree, even after the construction of HCI projects. Therefore, even in the 1970s as well, the incentive paradigm was never switched fully to import substitution. It should be safe to say that the export-oriented strategy has maintained consistently to the present.

On the other hand, the starting points of capital accumulation in Korea's private sector before the first economic plan had been 1) the land reforms, 2) the privatization of the colonial assets, and 3) the influx of aid from both Japan and the U.S. Since all these management were controlled by the government, the order by which the government rather than the market allocates the resources had already been established at the beginning of the 1960s. When the first economic plan was made, the blue qrint was prepared by handful elites of American educated professionals, who were basically liberals in their thoughts. However, the bureaucratic organizations and the financial organizations executing the plan and the educational system supplying the human resource for these organizations had inherited much from colonial Japanese legacy. The rapid spread of Japanese-style basic education, which stresses the role of learning over creativity, enabled the supply of large numbers of excellent quality workers, and at the same time bolstered the authority of the bureaucrats who were selected relatively equally from the time of primary school education by written examinations. This open selection process from the common background has contributed to reinforce the control by bureaucratic authority and discretion rather than legal framework.

On the other hand, the Park administration was also concerned that the "chaebol" must try to acquire the financial business as their core, which had been privatized once under the Syngman Rhee administration to grow into the "Zaibatsu" of prewar Japan, and therefore decided to renationalize the private banks. Since the central bank had already been under the strong influence of the Ministry of

Finance from the days of Japanese rule and the system had continued as it was, the government was able to govern the entire financial system effectively. As to take the heterodoxical export-oriented strategy against the conventional import substitution strategy, both the public and private sector corporated each other through human resource (bureaucratic organizations) and capital (financial organizations), trying to survive in the competitive, risky export market.

2 High Growth System and the "Chaebol"

2.1 Cycles in the Political Economy and the "Chaebol"

The export-oriented strategy proved to be a fortunate choice for South Korea during 1960s and 1970s when the world trade was growing rapidly. The government and business, as is shown in Fig. 4.1, repeatedly went through a polito-economic cycle of industrial promotion → collusion between the government and business → economic overheating and over-competition → change of administrations → breakoff of collusion and industrial readjustment (liquidating troubled firms) → business downturn → recession → new industrial promotion → intensive support for the large, prominent firms → reformation of collusion. And this repeated cycle created and developed the "chaebol" organization which is very much suited for economy of scale and scope to increase exports intensively.

In the 1950s, when industrialization started, foreign reserve, commodity aid, and other special government assistance = "special treatment" were allocated on a preferential basis to the specific companies with close ties to the government. Since the mid-1960s after the start of the Park administration, however, the system changed to one where assistance was accessed by anyone with an L/C on a non-discriminatory basis, and a broader base of entrepreneurs was successfully fostered.[4] In the 1970s, then the coverage of the "special treatment" of foreign loans and policy loans directed by the government again became narrowed and the relationship with the government turned to be a literally determinant for business performance. Since the flow of capital among affiliated "chaebol" companies could not be grasped by the tax authorities of course and could not even be determined by the financial institutions, some of the large corporations were able to make greater use of the "special treatments" by cross-holdings of shares among companies[5] to rapidly diversify their businesses and to grow into "chaebol". In 1976, the sales of the

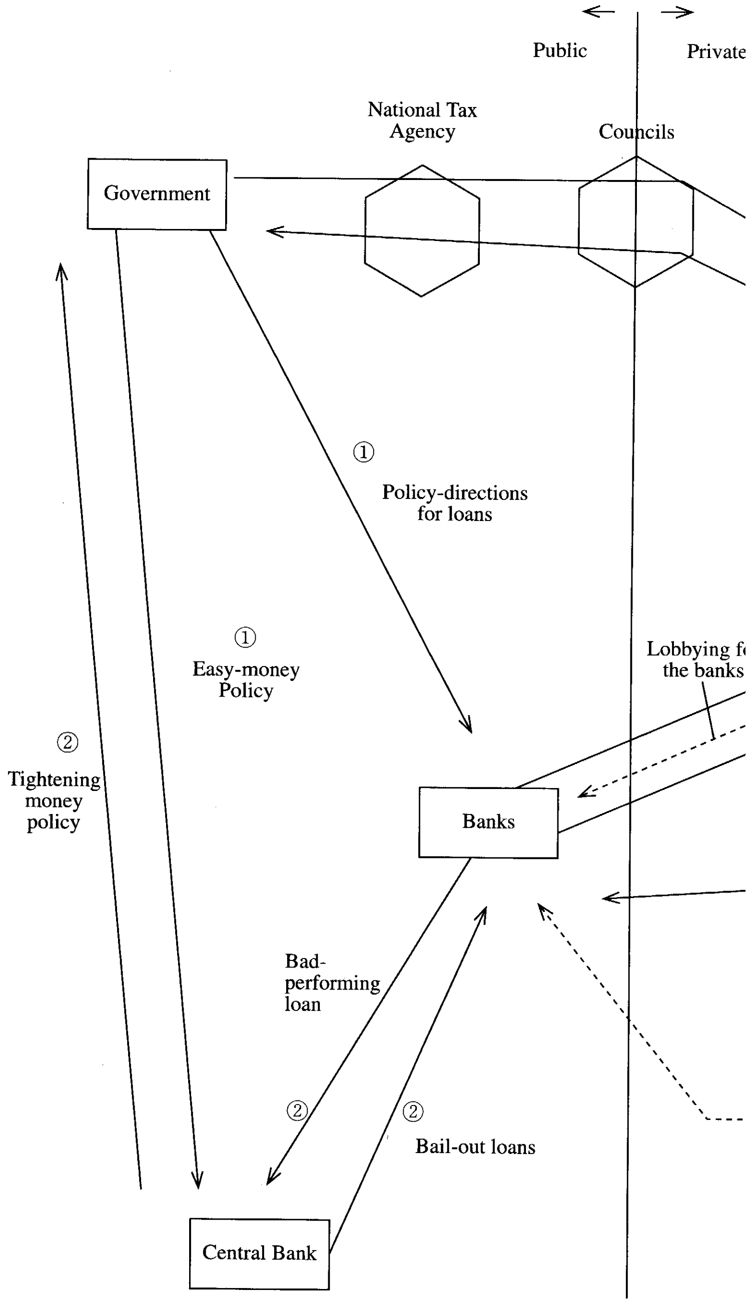
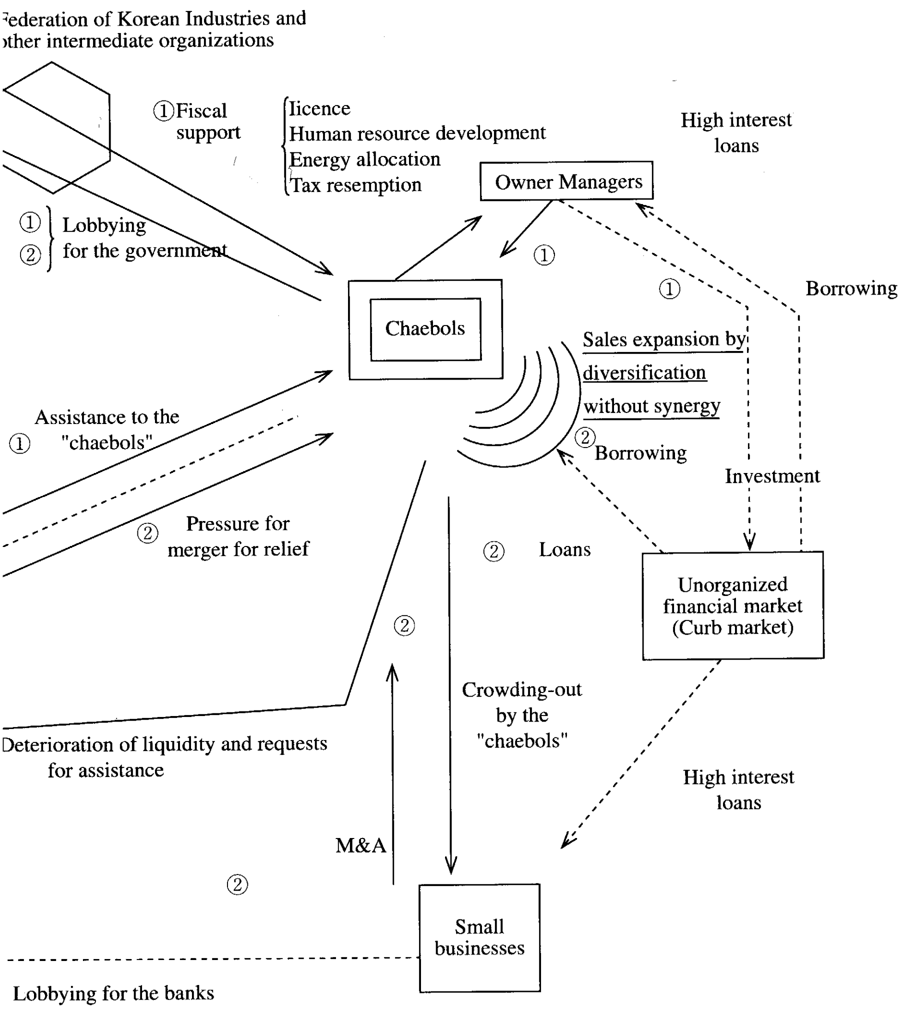


Fig. 4.1 Economic System in South Korea



Note: ① Cycle of business expansion
② Cycle of business slowdown
⟶ Legitimate transaction or lobbying
----→ Illegitimate transactions or lobbying

10 largest ''chaebol'' stood at 19.8 percent of the GNP but reached 67.4 percent in 1984. Their share of shipments in the manufacturing sector rose from 21.2 percent in 1977 to 30.2 percent in 1982. Once the ''chaebol'' organization started to grow, growth-oriented and export-oriented development strategies become largely dependent on the ''chaebol'' as major players - which tends to further expand the business size of the ''chaebol''. Conversely, small businesses as well as large, but independent corporations not belonging to any ''chaebol'' were rapidly driven from the domestic market.[6]

Precisely, the cycle of events at this time was as follows (see Fig. 4.1 again). First, when administrations change, the government in almost all cases reassesses the ''chaebol'' (condemning the domination of the ''special treatments'' in the past), and the economy starts to subside. However, when the economy slips into recession, unemployment, bankruptcies of small businesses (not the ''chaebols''), other social problems are aggravated, and the government has to search for means to stimulate the economy, ironically, the easiest way to refloat the economy, is to assist the ''chaebols'', for they are the very major players in the economic system. Further, the ''chaebol'' themselves had borrowed massive funds, so the sluggish growth in sales due to the decelerated economy directly threatens their operations so that they strongly lobby the government to switch into the expansion policy.

Once assistance then begins, the ''chaebols'' compete each otehr to acquire the ''special treatment'', and tend to increase the size of their investments. Competition overheats the economy, and, as a result, the financial institutions which had assisted these projects find themselves facing bad performing loans. Becoming conservative after this bad debts, the financial institutions start to refrain from lending funds to small businesses which have insufficient collateral and are therefore considered high in risk. The small businesses are thus often crowded out to unorganized financial market (curb market), and are forced to raise funds at higher interest rates than the ''chaebol''. These small businesses therefore lose their capital for technology investment and can no longer form the supporting industries at the level required by the ''chaebol''-affiliated export firms. If technological advantage is admitted, there is a risk of hostile acquisition by the ''chaebol'' with their massive financial power, so that the small businesses are lacking in the incentives to increase production or technology investment. When no longer able to overlook the burden on the financial sector as well as the squeezed small businesses, the government once again moves to clean up the ''chaebol'' and restructure industries, by promoting take-over of troubled firms, either the chaebol affiliated or independent, by providing financial support to the leading firms. Though the acquisitors inherit the debts, they also succeed the assets (often the real estate), so that in so far as the business returns to the regular high growth circle with inflation, these debts do not pose a serious problem. Rather, the increase in assets, namely collateral, improves the credibility of the acquisitors to borrow more from the financial institutions, while the increase in the scale of production reduces production costs to inerease competitiveness.

When a certain level of export is secured in South Korea in this way, the cumulative effect is to stimulate the related demand attracting investment, and therefore, bringing the economy into the high growth track, once again. That is, the ''chaebol'' has functioned in the production system as a designed mean, but also as a result from the system for the two orientations: growth and export.

The small businesses are industrial organizations quite the reverse of the dominant ''chaebol''. The creation of a relation between the ''chaebol'' and small businesses is largely obstructed by the burgeoning relationship between the financial institutions, which are agents of the government, and the ''chaebol''. The evolution of production systems takes place therefore as organized innovation within the ''chaebol'' trying to internalize the supporting industries. The slow pace of formation of production network and the weakness of the supporting industries has emerged as a serious issue since the 1980s when the leading industries shifted to assembly and processing type industries such as household electrical appliances, automobiles, and general machinery. However, in the end, the government was not able to abandon the growth pattern propelled by the ''chaebol''.

According to Kong (1994), who compared the relationship between the primary part suppliers and assemblers in the automobile industry—which needs wide range of parts—, South Korea learned from Japan and organized ''Keiretsu structure'' to foster long-term, consistent cooperative relations. However, while Toyota Motor has 300 primary part suppliers and a total of 12000 suppliers when including secondary and tertiary ones and therefore has extremely multilayered business relations, in South Korea, in 1993 for example, the largest company A (believed to be Hyundai Motor) had only 481 primary suppliers and, even including secondary suppliers, just 1120 in total, giving it fewer layers and thus a more horizontal supply system. Further, in South Korea, there is little capital cross-holding or exchanges of personnel between the assemblers and the primary parts suppliers. As a result, transactions continue to be market driven by short-term basis. Even the "cooperative groups" were originally speaking introduced from above by government advocacy and have not rooted in the Korean production system to have great impact.

2.2 Formation of High Growth System

The cozy relations between the government and "chaebols", while deepening along with the political and economic cycles, have formed an integrated part of "high growth" and "export expansion" system in the following respects:

2.2.1 Information Oligopoly

In South Korea, the political power concentrates heavily on the President. In particular, before the democratization in 1987, economic policies had been dominated by a small number of people called the "economic team", that is, Secretary to the President, Economic Affairs, Chief of staff to the President (above the Bluehouse), the Minister of the Economic Planning Board (EPB, present the Ministry of Finance and Economy) holding the power over economic planning as well as decisions over the budget (concurrently serving as deputy prime minister), the head of the Ministry of Finance, etc. Whenever there is a discrepancy between the Bluehouse side and the government such as between the economic plans prepared by the EPB and the separately announced heavy machinery and chemical industry declaration, the former has almost always overruled the latter.

On the other hand, up until the mid-1980s, most of the "chaebol" were still under the management of their original founders. Management was not separated from ownership, and information and decision-making powers concentrates on the owners, that is, the group chairmen and their assisting secretariats (planning and coordination offices). Only naturally, that generation of founders had close personal ties with the President, but even later, the elites all shared a common educational background—the higher level officials and economists involved in the decision making process, the secretariats and the staff of planning offices of the trading companies of the "chaebol", which was the command centers of overseas business, and the executives of the banks, public corporations, and industrial corporations. A tight network of people was therefore established between the public and private sectors at the top level. Further, in the high growth period, travel overseas was restricted due to reasons of conserving hard currency and public security concerns[7], despite of business opportunities substantially limited in the oversease markets, and it was relatively easy to control the latest foreign information.

This information oligopoly worked to promote exports in the following points: (1) enabling quick and flexible response to the changes in demand through a consensus reached by the public and private sectors, and (2) the achieving an economy of scale through consistent, intensive investment. Table 4.1 shows the dramatic changes of export structure in Korea. In this table we notice that in all the businesses, such as textiles, which continues to be competitive, and at an early stage the wig, plywood, footwear, ferrous metal and other metal products, and in recent years the electrical and electronics (household electrical appliances and semiconductors), chemical products, in which South Korea excels share the certain features as follow:

(1) mass production which technology is substantially embodied in the facilities themselves,

(2) greater chances for rapid price change through market fluctuations and introduction of new model of equipment,

(3) the importance of scale for production capacity and delivery over quality improvement,

(4) the possibilities for an material procurement within South Korea, and

(5) less need for after-sales service.

That is, decisive investment at a proper timing and efficient operation of production facilities can be viewed as having served as the advantage of the international competitiveness in Korea. While not in the manufacturing sector, overseas construction, which grew rapidly starting in the late 1970s, succeeded mainly for the similar reasons including collection of information, tactics in securing orders by excellent network between the public and private sectors, the ability to raise the required funds and capital, and the shortened project period.

The emergence of intermediate bodies such as Federation of Korean Industries, the counterpart to Japan's Keidanren, and industrial organizations such as Export Associations, and other semi-official bodies, led by the economic growth, has further developed this information network.

First, the exclusive information network benefited the "chaebols" naturally by reducing the new competitors for the "special treatment", and therefore by carrying out the ambitious investment for

Table 4.1 Changes in the Top 10 Export Items South Korea

(Unit: Million US$)

	1961		1970		1985		1990		1995	
	products	Value	products	Value	products	Value	products	Value	products	Value
1	Iron ore	5.3 (13.0)	Textiles	341 (40.8)	Textiles	5,041 (28.8)	Electronic products	17,870 (27.5)	Electronic products	44,389 (35.5)
2	Tungsten	5.1 (12.6)	Plywood	92 (11.0)	Electronic products	2,004 (11.4)	Textile products	8,860 (13.6)	Texrile products	18,383 (14.7)
3	Raw silk	2.7 (6.7)	Wigs	90 (10.8)	Ferrous metals	1,854 (10.6)	Footwear	4,307 (6.6)	Automobiles	8,430 (6.7)
4	Anthracite	2.4 (5.8)	Iron ore	49 (5.9)	Footwear	904 (5.2)	Ferrous metals	4,237 (6.5)	Chemicals	8,357 (6.7)
5	Cuttlefish	2.3 (5.5)	Electronic products	29 (3.5)	Ships	618 (3.5)	Ships	2,799 (4.3)	Ferrous metals	7,246 (5.8)
6	Other fish	1.9 (4.5)	Vegetables	19 (2.3)	Synthetic resins	531 (3.0)	Chemical products	2,348 (3.6)	General machinery	5,570 (4.5)
7	Graphite	1.7 (4.2)	Footwear	17 (2.1)	Metals	433 (2.5)	Automobiles	2,245 (3.5)	Ships	5,530 (4.5)
8	Plywood	1.4 (3.3)	Tobacco	13 (1.6)	Plywood	352 (2.0)	Feneral machinery	1,775 (2.7)	Petrochemical products	2,291 (1.8)
9	Grain	1.4 (3.3)	Ferrous metal products	13 (1.6)	Deepsea fish	352 (2.0)	Plastics	1,292 (2.0)	Plastics	2,198 (1.8)
10	Furs	1.2 (3.0)	Metal products	12 (1.4)	Electrical products	324 (1.9)	Petrochemical products	605 (0.9)	Footear	1,506 (1.2)
Subtotal		25.3 (62.0)		675 (81.0)		12,413 (70.9)		46,338 (71.3)		103,900 (83.1)
Total		40.9		835		17,505		65,016		125,058

Note: Figures in ( ) are the share against the total export
Source: Data compiled by Korea Traders Association by MTI classification

exports. Since it was occasionally the case that the government set specific targets for the private sector and demanded the cooperation of major companies for industrial adjustment and liquidating the troubled companies, private companies found the intermediate organizations of increasing importance as a place to lobby the government. On the other hand, the government also used the intermediate organizations as plum places for jobs for retiring officials and military officers and to obtain objective and precise information on the major firms and industries. Making the information channels between the public and private sectors in this manner, the intermediate organizations contributed to the swift, flexible, and accurate selection of industries targeted for promotion, by collection of relative objective statistics and projections from their neutral position.

2.2.2 Strong Financial Incentives

In parallel with the strong information oligopoly, the government maintained direct control over financing. The private banks which were all nationalized during the Park administration were privatized again in the 1980s under the Chun Do-Hwan administration, but the shares hold by the ''chaebol'' were limited strictly to under 5 percent. Even today the government exercises strong influence over these banks. In particular, up to the 1980s, the Korean financial system had had the major features as follows:

(1) the intensive use of policy loans,
(2) artificially low interest rates, and
(3) existence of an unorganized financial market as a real market.

The government tried to guide the ''chaebols'' to targeted industries by providing large financial rent to the large corporations which were already able to access regular finance. The National Investment Fund (NIF), which was a typical policy loans relied 40 percent of its funding in bank investment and the remainder from postal savings etc. Over 70 percent of the NIF was allocated for the heavy machinery and chemical projects. From 1972 to 1980, an average of 47.7 percent of domestic credit was used for policy loans, and in the same time period, the gap in the interest rates between policy lending and general bank loans exceeded 5 percent. Often, the interest rates would even dropped in to be negative. Further, anyone exporting could also obtain preferential export financing, so the financial incentive to companies was a major factor stimulating ambitious heavy machinery and chemical projects. Even if the ''chaebol'' rushed for the rent, as explained above, to crowd out the small businesses, the technology for capital intensive industries was embodied fully in the production facilities, and the supporting industries were able to rely much on that in Japan, so that there was no constraint for business expansion. However, each time bad performing companies were liquidated, or the investment projects are reconsidered, the banks were forced to increase policy lending which led to accumulate bad performing loans, and the banks had to rely lending from the central bank chronically, shrinking its reserve in vicious cycle. The financial sectors were repressed in the economic system.

There were two reasons why growth based on financial incentives could be sustained despite the distortions. One was that since the country relied on overseas savings for most of the capital, the projects were at least partly monitored by international institutions and foreign banks, and it was necessary to keep a certain credibility to withdraw additional loasns from the foreign banks including operation funds etc. Therefore, sufficient attention was paid by both the public and private sectors to using investment efficiently, in particular, to shortening the time for construction of production facilities, efficiently distributing raw materials, goods, and energy, and reducing inventory burdens. The symbol was the brilliant success in steel industry, which cut effectively the costs by strikingly reducing the construction terms, and the shipbuilding industry, which went after orders while building the docks simultaneously.

Second reason was that despite of the financial repression, even the unorganized financial market functioned in practice as an investment supporting system for the large corporations. Considerable risk was expected when Koreans started to build the heavy machinery or chemical industries in the competitive world market with less accumulation of technical know-how. However, companies which had given enough financial rent from the government were able to invest part of that into real estate to hedge against inflation or divert some of the funds to the unorganized financial market and earn high interest. The government was relatively generous about the "chaebol" when it comes to how they actually used the funds, but at least carefully managed the investment projects themselves through industrial policies and strict exchange controls, so that these funds did not fly in to "unproductive" industries or to overseas. Further, fiscal policy was kept consistently conservative in nature, so while there was relative leeway in fiscal affairs, the destruction of the financial market was prevented. Unorganized financing continued to serve as part of the de facto financial system up to the 1990s when the use of fictitious names in the financial system was prohibited legally.[8]

2.2.3 *Adoption of Industrial Policies*

It was the adoption of industrial policies that enabled the controlling mechanism of information and capital to be polished into an economic system for high growth. The industrial policies changed the incentive system of up to the 1960s in two points: One was that while export promotion incentives were given to all sorts of companies on a nondiscriminatory basis, the coverage of the industrial policy was limited to a specific group of companies. The other was that not only the government financial aid, but a package of other incentives including foreign investment laws, trade laws, and the tax resumption system were integrated for promoting the designated industries. As a result, the packaged incentives increased the intensity of "special treatments" enjoyed by the selected companies.

With the focus of the policies, the government (and the banks) obviously found the monitoring costs reduced, but at the same time since the competition for the "special treatments" had been fierce among the "chaebols" and much of that involved export projects, international competitiveness was judged not only by the government, but by the market. The government selected companies for the next round of "special treatments" based on export increase, factory operating rates, and other past performance and was able to compare and examine business results in great detail.

On the other hand, to acquire the incentives by a package, the "chaebol" also had to provide evidence of their achievements from various angles, which resulted in a striking rise in their ability for making strategic plans. It was indeed the organizational invention the chaebols in response for the industrial policies that started to set up "chairman's office", "planning and coordination offices", and the like, to be equipped with the human resources selected from best college graduates or professionals with various expertise acquired through later training. Even the ambitious leap into the heavy machinery and chemical industries, in the case of shipbuilding and the electronics industries, was a result of this exercise based on close and careful examination and analysis by the public and private sectors, especially trying to find out the division of labor with Japan.

Further, the "chaebol" competed so fiercely with each other to win the incentive packages, that little business relations developed among the "chaebols", and as a result, the "chaebols" sought for a strategy to internalize all the necessary transactions within the group by integrating the upstream to downstream. This behavior has caused endless competition and overlapping investment among the ''chaebols'' in petrochemicals, automobiles, and semiconductors in the 1990s along with the abolition of industrial policies to control them. In recent years, the negative aspects of this behavior have manifested themselves more strongly. However, in the high growth period South Korea was able to rely on Japan for most of its capital goods and intermediate goods fully, which were determining the competitiveness, and there was no incentive for subcontracting production of these goods and creating networks of firms in view of the various costs and risks in such transactions. With the relatively poor production infrastructure and techniques for inventory control at the time and the necessity for information management due to the fierce competition among the ''chaebols'', increasing one's transactions within companies outside the ''chaebol'' was conversely even dangerous. The ''chaebols'' were motivated to substitute imports in line with increasing demand, only in the case where they could internalize the production and the necessary transactions. The strength of the textile industry, where production stretching from synthetic materials and textile machinery to the final apparel were set up for each ''chaebol group'', is a typical example of this business pattern.

3 The ''Chaebol'' as Production Systems

Under the incentive paradigm for high growth and export expansion, the ''chaebol'', which is characterized by two features—concentration of ownership and management and rapid diversification without synergy effect—evolved into an organization well-fitted to the economic system. First of all, the capital accumulation of the ''chaebol'' has been mostly originated in the relations with the government, and the government's intervention has been always powerful in either terms, in the allocation of foreign reserve, aid, or banking loans for liquidation of troubled firms or in industrial policies. Since business activities were perfectly protected from the labor movement and the exchange rate fluctuations by the government, they seldom were faced with systematic risks rising from general economic fluctuations except for sporadic events like the oil crises—risks forcing reallocation of management resources. On the other hand, there has always been the typical unsystematic risk in relations with the administration, for there was no knowing when and in what form the political demand or claims would fell on them. The obvious thing was that the government strongly wanted to build a full set type industrial structure at a national level.

Since business performance was more influenced by ties with the government, rather than market judgement, diversification was the least risky strategy for the "chaebol", even without technical synergistic effects, showing a cooperative stance to the government to reduce the unsystematic risks.

The "special treatments" and an acquisition of the liquidated firms in any of the diversified fields expanded the size of the "chaebol" groups as a whole, for the capital flow within the group was unrestricted due to crossing-holdings of the equities and the intervention of the curb market. Following this pattern, the "cheabols" grew to be "too big to fail", and the diversification turned to be not only the least risky, but actually the very effective strategy for expanding and defending business.

Also, when the tie with the government is so crucial to the management, it should be natural that the people will grasp the management control, who will be able to participate the information oligopoly structure, sharing the network and negotiating with the government. Founders of the "chaebols" up to the Park administration have been highly praised for their management skills by the Presidents,[9] and it was unrealistic for the salaried managers to challenge them.

Further, even as the generations changed, compared with the days of the founders who had often started their business with nothing, the second generation owners had common educational backgrounds with the government elites and their own company staffs and further a broad ranged network develops through the "chaebol".

Second, the intensive rent from the financial sector was closely related with the promotion of capital intensive industries, of which the success lies in the conditions of facility introduction and the operation, as well as a slump in R&D activities. When South Korea was growing fast, the cost of introducing technology was inexpensive. And rather than bearing the risk of R&D activities, companies found it much safer to introduce the latest production facilities and start up operations in a short periods if time. As repeatedly stressed by Amsden (1989), the wellspring for the growth of the Korean economy has been in learning, not in technical innovation. Once modern, giant facilities were introduced, the economy of scale came into play and it was possible to increase "latent assets" through generous allocation of industrial sites in continuing inflation. Thereby, the materials industries, which were susceptible to market fluctuations, and the machinery industries, which were easily hurt by ups and downs in orders were all sustained in this mechanism. The fact that since the late 1970s, the government has been unsuccessful, despite the desperate efforts to get companies to release the land to hold down inflation, should be easily understood in this structure: the balance sheets of firms have been bolstered by the use of real estate to quite an extent.

With this system in effect, when not being able to draw upon "special treatments" and the company's performance deteriorated, the ability to save the firms either by disposing real estate or raising funds in the curb market hung on the credit standing of the founders and their families. This was another reason for little progress in separation of management from ownership. With financial rents so large and the ability to raise funds considered most important, what was sought about managers was the decision making power, which was identified as the fund raising ability in negotiation with the government, as well as adjusting the resource allocation among the affiliated firms. Rather, there was no rationale for bringing professionals with skills in technology or organizational management to the top management. The family management was actually effective in the economic system.

Third, the "chaebol" are massive organizations sustained by a complicated web of cross-holdings shares among the affiliated firms. Cleaning up a "chaebol" which has reached a certain size has tremendous effects on employment and financial sector as seen with the case of the Kukje Group in 1980s.[10] This is because even if a "chaebol" ends up encompassing non-competitive businesses resulted from reckless diversification, it is structurally impossible to evaluate just each affiliated firm separately by themselves and let them leave the market. Fearful of the impact, even when dismantling the Kukje Group, the government took the traditional approach of having the affiliated firms taken over by other "chaebols"—debts and asset including employees. Therefore, the dismantling of the Kukje Group in the end only served to further enlargement of the top "chaebol" which acted as the absorber. Since then, because of this painful experience, there has not been one single case of liquidation among the 10 largest "chaebols" for over 15 years. However, so long as this memory remains both in the government and among the chaebols, the inertia of strategic complementality remains to expand the size of the organization.

Further, it is assumed that if there is no risk of liquidation for the "chaebol" firms, a business with a certain scale of operations finds it better to do everything by itself rather than having outside contract, taking troubles to negotiate prices with the other firm and checking deliveries often delayed by labor conflicts. Therefore, both from the risk of liquidation and from maximization of "special treatment" within the group, it is more advantageous to promote horizontal diversification than to specialize into cereain business, dealing with the other "chaebols". This strategy has been adopted by almost all of the "chaebols". Due in part to the fact that the South Korean economy had not matured yet, there has always been a large room for growth of the domestic market, and due to the comparative advantages in foreign exchange and real wage carefully sustained for export, it has mattered whether there was any synergistic effect among the diversified sectors.

4 Assessment of Korean System and the Outlook

4.1 Assessment of Korean System

As alluded to up to now, the economic development of South Korea has heavily reflected various country-specific factors including a political tension with North Korea. In addition to these, the external environment at the time, was considerably different from the present, when the expansion of world trade was recording the peak and when the era of global money had not yet arrived, was considerably different from that faced by developing countries today. This model may therefore be difficult for other countries to apply as it is. However, while instructive by providing extreme examples, the experience of Korea shows that despite the financial repression due to massive use of policy loans, the concentration of economic powers by "chaebol", and the other problems already suffered by many developing countries, once the certain level of economic system is established, it enables external shocks to be borne well and a considerable degree of economic development to be achieved. This is attested to by two points.

First, while not a few developing countries find it difficult to sustain consistent policies, Korea's strategy has always been clear concentrating on production expansion and on the reduction of costs through exports, as well as flexible adjustment of the industrial structure. This consistency has contributed to yield various institutional arrangements. For example, since the era of heavy and chemical industries, the government has provided powerful rent and private investment has often been excessive. However, the "chaebol" structure, through its cross-holding of shares, has given rise to enough financial strength to survive until world demand recovers and, if the business opportunity is not allowed to slip by, the scale of the investment as well as the vintage of the facilities start to guarantee the competitiveness. The financial system, which together with the curb market and real estate investment has served to lighten the interest burden and the risk for "chaebols". The information networks of the general trading companies internalized in the chaebol organization[11] or other intermediate organizations linking the public and private sectors, and finally, the "chaebol" organization itself, with its high rate of in-group manufacture and concentration of decision-making power at the top, have developed and served for the flexibility of the economic system.

The second point is the strong awareness of the linkage with the industrialized economies—in South Korea's case primarily Japan. To sustain growth based on increased financial rent, investment must be efficiently realized. There is no room for promoting skill intensive supporting industries which take time but are difficult to prospects for Korea in a high-growth period. In these industries, the neighboring Japan is far in the lead and Korea has been able to maintain competitiveness by aggressively introducing its latest facilities and making thorough use of Japanese supporting industries, that is, creating production network with Japanese industries.

On the other hand, with the continuing high growth, educational levels have improved drastically, and the number of engineers has soared contributing greatly to more efficient plant operations. During the establishment of the heavy machinery and chemical industries, there was a sharp rise in university students majoring in metallurgy, while during the period of promotion of high tech industries, the number majoring in electronics soared. This flexible distribution of human resources laid the groundwork for the rapid absorption of technology along with the practical training given when the engineers were dispatched in large numbers to the plant manufacturers and related industries in Japan. In terms of Japan, South Korea's "orientation toward self-independence" has acted less as unrealistic nationalism but more in the direction promoting the realistic selection of industries with an emphasis on an international division of labor. Korea had been the only country in Asia other than Japan which attempted to make a supplier of heavy machinery and chemical products up until the 1980s, so South Korea's exports have been boosted by each successive round of Yen appreciation, and to lead greater productive capacity and improving competitiveness.

4.2 Outlook

Since 1990s, South Korea had eased its regulations, but with its membership in the OECD in 1996, it will be further pressed to open up its markets and liberalize its economy. The two main supports for the high growth system, suppression of labor movement and foreign exchange control has almost gone. The former, disappeared along with democratization, and the latter changed to allow greater fluctuation and saw gradually lessened intervention while maintaining a managed float. When the advantages in wages and exchange rates were guaranteed by the government, it was easy to secure a certain level of competitiveness only if the operation of production facilities embodying the latest technology is suitably progressed. This was why while the Korean economy repeatedly encountered difficult times, it has managed to sustain high growth by introducing new industries.

However, as the shortage of labor eliminates the advantage in wages and controls over foreign exchange are being eased, it is not possible to cope with the massive changes in domestic and overseas conditions under the traditional system. The fact that since the Roh administration, nature of the "chaebol", the centerpieces of the ancient regime, organization with rapid diversification has been called into question is a manifestation of this issue. In particular, the opening up of the financial and capital markets pledged to the OECD will have a major impact on the weakest sectors of the high growth system. The financial rent created among the government, banks, and "chaebol" will be pressured to be substituted dramatically by technical incentives, while the goals set by sales volume will shift toward profit survive.

The Korean economy has entered a downspin since 1996, and there was a concern over the macro balance after making OECD membership. Since high growth was sustained up to 1995, however, in fact there were still only a handful of claimants of a "serious turning point"[12] even in Korea. And those who took the slowdown in growth which began with the OECD to be structural were still not the majority. However, there are only five years left to prepare the OECD pledge of a plan for fuller liberalization. It will not be easy by any means to "incrementally" dismantle the old system, in particular the financial system, built up over the past 35 years. The slogan of the "chaebols", which thrived under the old system, is now calling for a "second founding". The Korean economy as a whole will be pressed toward a "second founding" of a system, autonomously controlled by market functions, and international standard.

Notes

1. Up until the 1980s, there was a large difference of opinion regarding the role performed by the government in economic development, even within South Korea. It ranges from groups denying the role based on the sub-ordination theories to self-praising affirmants primarily from the government sector, but appears to have closed somewhat after democratization. For example see Sakong Il (1994). While somewhat based on hindsight, Amsden (1989), (1995) stressed that even among the same authoritarian governments, the South Korean government, compared with the Latin American countries, has managed to enforce a discipline of efficiency on the companies (the "chaebol") and gives high marks to the role played by the government.

2. The South Korean government has repeatedly pressured the major "chaebols" to improving their balance sheet, in particular, with regard to heavy debts. The average debt ratio of the companies belonging to the four large "chaebols" in 1990, the year when the "chaebol" policy was overhauled, was 240.5 percent in the lowest group, Hyundai (ratio of owned capital 23.2%) and 579.6 percent in the highest group, Samsung (19.2%).

3. For example, the weight of foreign direct investment in the gross capital formation was, in Korea's case, just 1.0 percent since 1973, when foreign investment began to be solicited seriously, to 1994. This is far smaller than 23.2 percent of Malaysia (1981 to 1990), and also the 4.2 percent of Taiwan, which had industrialized earlier (1970 to 1994) than Korea.

4. For the approach of the "chaebols" to government incentives, see Fukagawa (1994).

5. For example, the "chaebol" were able to increase their businesses in the following way by cross-holdings of shares. The example of the following figure shows how capital of 10 billion won gives rise to a paper increase of 17 billion yen.

Parent company of group
| 10 billion won
Company A → 6 billion won → Company B
↓ ↑ ← 5 billion won ← |
2 billion won | 1 billion won
| 1 billion won ↓
↓ |
Company C ← 1 billion won ← Company D

	Nominal increase in capital		Paper increase in capital		Real increase in capital
Company A:	16	—	8	=	8
Company B:	7	—	6	=	1
Company C:	3	—	2	=	1
Company D:	1	—	1	=	0
Total	27	—	17	=	10

6. Taking as an example the case of 1994, of the top 100 listed companies in sales in Korea, three were public corporations. Of the remaining 97, 93, or all except for four independents not belonging to any "chaebol", belonged to certain "chaebols" in some way or another. Further, of the 93, as many as 52 were the affiliates of the top five "chaebols". This shows how large the top "chaebol" are (Fukagawa, 1996).

7. Passports had not freely been issued in South Korea until the late 1980s.

8. How large an economic effect the curb market used to have is shown by the measure to freeze private debt taken in 1972 (so-called "8.3 Measure"). Faced with the rapid deterioration in the financial standing of businesses due to over-investment, including of large corporations forming themselves into "chaebol", the government drastically lowered the interest rates on credit and froze the curb market.

9. Descriptions of personal dialogue with the President always appear in the memoirs of people like Lee Byong-Chul (Samsung Group) and Chung Ju Young (Hyundai Group), who have been questioned several times over their illicit assets. While their purpose was to make their profit, they also shared the goal of competitive industries serving for the state".

10. The Korean government implemented the 5 programs for liquidation of troubled firms since 1985. In the dismembering of the Kukje Group, which at the time was the seventh largest "chaebol", due to fears over the effect on employment, the government provided special loan and other government assistance to sell the affiliates of Kukje Group in pieces to "chaebols" with more leeway. It is a known fact that Daewoo, which took over the construction division, that is, Kyong Nam Enterprises, diverted the financial aid for the investment in a new line of business, automobiles, instead of using it for rebuilding the acquired company. However, it was never called to question by anyone.

11. Korea's general trading companies differ from those of Japan in that they have functioned for many years as the international department for the "chaebol"-affiliated firms. While transactions with unaffiliated firms, in particular, the turnover of goods of small businesses, has increased, as of 1996, these accounted for only 20 percent or so of total sales. The increase of sales of affiliated manufacturers sharing the same financial base has an effect on the trading company itself.

12. A typical example is the speech as follows: "The most important issue facing our economy in the medium and long term is that while past growth factors, for example, low wages, high productivity, high investment motivation, and easy introduction of technology, are gradually disappearing, but the new growth factors, such as sophisticated technology, rationalization of management, improvement of the industrial organization, and rational conversion of the role of government, are often not being established, and our efforts toward this end are insufficient as a whole" (statement of Cho Soon, the Minister of Economic Planning Boad (in 1992)).

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