Emerging Market Spotlight

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The *Chaebols* in South Korea: Spearheading Economic Growth

South Korea has witnessed an incredible transformation in the three decades spanning from the 1960s to 1990s, evolving from an impoverished country to a developed high-income economy today. Often referred to as the "Miracle of the Han River", this remarkable turnaround was achieved through an aggressive, outward-oriented strategy, focusing on developing large-scale industrial conglomerates or *chaebols*.

Today, the chaebols have become multinational powerhouses with a global footprint. And with this, South Korea boasts of an economy that ranks 15th globally in nominal terms and 13th in terms of Purchasing Power Parity (PPP).

Fast Facts

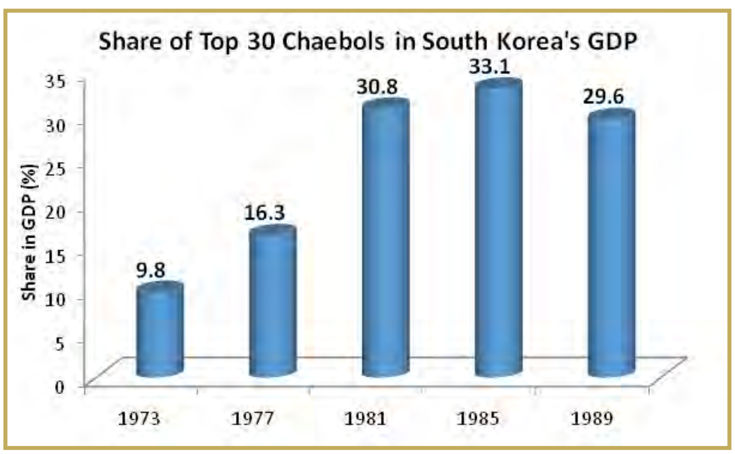
- *Chaebols* are large multinational family-controlled conglomerates in South Korea, which have enjoyed strong governmental support.
- The word *Chaebol* literally means "business association".
- Preside*nt Park Chung Hee* (1961-1979) widely propagated and publicized the *chaebol* model of state-corporate alliance.
- The *Chaebols* have invested heavily in the export-oriented manufacturing sector.
- Some well-recognized South Korean conglomerates boasting global brand names are Samsung, Hyundai and LG.
- The *chaebol* model of state-corporate alliance is based on the Japanese Zaibatsu system, which encouraged economic development through large business conglomerates from 1968 until the end of the World War II.

Paradigm shift in the South Korean economy

The first half of the 20th century was a tumultuous, war-ravaged period for the country, punctuated by a 35-year Japanese colonization of the country, which ended with Japan's defeat in World War II. Following, the three-year Korean War between North and South Korea ended with United Nations (UN) intervention that brokered peace in 1953. Understandably, this left South Korea with a poverty-stricken economy. But the 18-year reign of President Park Chung Hee (1961-79) was instrumental in ushering in an era of unprecedented development. He led a landmark transformation of the economy from a predominantly agrarian to an industrialized economy.

Emphasizing an export-led, outward-oriented model, the government wholeheartedly encouraged the growth of large conglomerates or the *chaebols*, developing a close and collusive relationship with them. These economic policies resulted in fast-paced economic growth, with GDP averaging 10% annual growth between 1962 and 1994. While the contribution of agriculture to the economy declined from 37% in 1965 to 3% in 2008, the industrial sector increased its contribution from 20% to 37%, and that of services from 43% to 60%. Of course, exports remained the cornerstone of this economic development, with their share in GDP accelerating from 8% in 1965 to a whopping 53% in 2008.

Powering *chaebols* to fuel explosive economic growth



Source: 'Chaebol Powered Industrial Transformation' by Ahn Choong-yong, Korea Institute of Public Administration and Korea Times, April 2010.

In the process of industrializing the economy, the South Korean government encouraged their domestic business groups in a big way. Most of the South Korean big businesses assumed a *chaebol* form, characterized by:

- A closed and concentrated, most often family-centered ownership structure.
- A highly diversified business structure.

By 1962, all commercial banks were nationalized, channeling financial resources to the *chaebols* under the directive of the government. The share of these conglomerates in total credit advanced by financial institutions was over 60% during the period from 1960-1991 *('The Post-Crisis Changes in the Financial System in Korea: Problems of Neoliberal Restructuring and Financial Opening after 1997', Kang-*

Kook Lee, TWN Global Economy Series, 2010). In return, these conglomerates were required to fulfill ambitious export obligations, which fueled rapid economic growth for these 30 years.

To stoke economic development, the government followed a two-pronged strategy of export promotion coupled with import substitution. The role of foreign direct investment (FDI) was restricted, but judiciously used as a means to harvest new technologies and managerial expertise. Conglomerates were liberally permitted to access foreign loans, promoted by the government to support fast-paced economic development, while in contrast outflows of domestic capital were effectively curbed *('The Post-Crisis Changes in the Financial System in Korea: Problems of Neoliberal Restructuring and Financial Opening after 1997', Kang-Kook Lee, TWN Global Economy Series, 2010).*

As a result of the South Korean government's unbridled and all-encompassing support, the *chaebols* experienced unprecedented expansion in size and scope. With the government virtually ensuring against their bankruptcy, the *chaebols* began to be perceived as 'too big to fail'. Their overbearing supremacy in the Korean economy was evident in their expanding presence in the economy. The top 30 *chaebols'* contribution to the country's GDP swelled from 9.8% in 1973 to 29.6% by 1989. Further, by 1997, the 30 largest *chaebols* accounted for virtually half of the total assets, debts, sales and net profits of the corporate sector in the economy (*Corporate Governance and Finance in East Asia, Vol. II, Asian Development Bank, 2001).*

Business Areas of Top Five Chaebols

Industry	**Hyundai**	**Samsung**	**LG**	**Daewoo**	**SK**
Automobile	*	*		*	
Aerospace	*	*		*	
Construction	*	*	*	*	*
Consumer Electronics		*	*	*	
Financial Services	*	*		*	
Machinery	*	*	*	*	
Oil Refinery	*		*		*
Petrochemical	*	*	*		*
Semiconductor	*	*	*		
Shipbuilding	*	*		*	
Telecom Equipment	*	*	*	*	
Telecom Service				*	*

The 1997 financial crisis jolts the *chaebol*-driven economy

In the prelude to the 1997 Asian financial crisis, the South Korean economy was perceived as remarkably sound compared to its other East Asian counterparts. During 1990-1995, while average economic growth was about 7%-8%, inflation remained below 5% and unemployment was stable at around 3%. The South Korean economy was fiscally comfortable, while its current account deficit, which peaked in 1996, was still below 5% of GDP, lower than most other East Asian economies.

However, trouble was brewing in South Korea's financial sector, threatening its macroeconomic fundamentals. While until the early 1990s the financial sector remained regulated under government control, the early 1990s witnessed extensive domestic financial as well as capital market liberalization. This was a prerequisite for the country's Organization of Economic Cooperation and Development (OECD) membership, which it later gained in 1996. This policy encouraged a rapid mushrooming of financial institutions, which increasingly engaged in mobilizing foreign-currency denominated loans for the *chaebol*-dominated corporate sector. While financial sector liberalization pushed up low interest rates, the government still ensured an easy availability of credit to the *chaebols*.

The fundamental flaw was that South Korea chose to liberalize its short-term capital flows ahead of its long-term flows. A large proportion of this short-term external debt was channeled to the expanding *chaebols*, which were increasingly relying on debt-financed rather than equity-financed growth. Backed by government guarantee and the overarching emphasis on size rather than profitability, the *chaebols* were straddled with perilous debt-equity ratios and dangerously high financial leverage. By the end of 1997, the average debt-equity ratio for the top 30 *chaebols* skyrocketed above 500%. While the economy's proportion of short-term external debt to total external debt had soared to 60% by 1996, the dependence of the *chaebols* on external financing as a proportion of their total financing had zoomed to 77.6% in 1996 *('The Post-Crisis Changes in the Financial System in Korea: Problems of Neoliberal Restructuring and Financial Opening after 1997', Kang-Kook Lee, TWN Global Economy Series, 2010).* Moreover, the massive capital inflows also led to an exchange rate appreciation, worsening the competitive position of the export-driven *chaebols*.

As the corporate sector became progressively highly leveraged, the financial sector in turn became extremely vulnerable, plagued with burgeoning non-performing assets. The highly leveraged position of most *chaebols* coupled with their loss in competitiveness, triggered a string of bankruptcies, beginning in 1997. Between 1997 and 1999, at least 11 *chaebols* out of the largest 30 went bankrupt. One of the most prominent bankruptcies at that time was that of Daewoo, which prior to the financial crisis of 1997 was the second largest *chaebol*. While at the time of the crisis the other *chaebols* cut back on debt and underwent restructuring, Daewoo took on additional debt while adding new firms, despite huge losses. After its bankruptcy in 1999, the group was spun-off into three distinct entities- Daewoo Corporation (now Daewoo Electronics), Daewoo Engineering and Construction and Daewoo International Corporation.

The IMF bailout and the reform era

The *chaebol* bankruptcies and the exposed vulnerabilities in the South Korean financial sector severely hampered investor confidence, sparking off massive capital outflows from the economy. As a result, the South Korean currency, the won, experienced a free fall, depreciating more than 50% against the dollar between November and December 1997. This had disastrous implications for the corporate as well as the financial sectors. With their external debt burden worsening, they were thrown into a crisis situation. As a last resort, South Korea approached the IMF for assistance and secured a $58 billion bailout package in December 1997.

The IMF rescue package, of course, came along with preconditions for economic reform and restructuring, which included:

- Macroeconomic adjustment, which incorporated monetary and fiscal tightening.
- Structural reform, which included corporate and financial restructuring, in addition to trade, capital market and foreign exchange liberalization.

But the austere fiscal and monetary policies had an adverse impact on the economy. Investor and consumer confidence tumbled, while the unemployment rate soared. Subsequently, the IMF reversed its stance and permitted an expansion of the fiscal deficit to prevent the economy from contracting severely. Interest rates were also gradually allowed to decline. Despite these measures, the South Korean economy witnessed a massive contraction of 7% in 1998. Yet, proactive economic reforms, focused on *chaebol* restructuring by President Kim Dae Jung, helped the economy bounce back the very next year. In 1999, the South Korean economy expanded 9%, and in 2000, it grew 8%.

Chaebols at the helm of corporate sector reform

Corporate restructuring consisted of the following measures to be implemented:

- Drastic reduction of corporate debt
- Improvement in transparency
- End of cross-debt guarantees by conglomerates
- *Chaebols* to concentrate on core businesses
- Greater managerial accountability to shareholders

As a positive impact of the corporate reform, the debt-equity ratio of the top 30 *chaebols* reduced from 500% in 1997 to 118% in 2005 *('The Post-Crisis Changes in the Financial System in Korea: Problems of Neoliberal Restructuring and Financial Opening after 1997', Kang-Kook Lee, TWN Global Economy Series, 2010).* Many *chaebols* were also encouraged to trim off their several non-related business diversifications. This would help them focus on their core businesses, and thereby increase efficiencies as well as global competitiveness. Yet, while the debt ratio decreased rapidly, the *chaebols'* profits did not recover as quickly. This was because their newfound cautious management approach, as well as the financial restructuring, had led to lower corporate investment.

The South Korean government resorted to a combination of approaches to come to the aid of the distressed *chaebols*, such as court-supervised insolvencies, out-of-court settlements, and the tapping of foreign capital. And then there were the "Big Deals", which involved mergers and acquisitions, and the restructuring of the subsidiaries of the top five *chaebols*. In October 1998, these top five *chaebols* announced that they would undergo restructuring in their seven business divisions of semiconductors, petrochemicals, oil refining, aviation, railway rolling stock, power generation and ship engines *('A Turnaround in South Korea', Amiya Kumar Bagchi, Frontline, Volume 16, 1999).*

Some prominent mergers driven by the "Big Deal" were:

- The acquisition of LG Semiconductors by Hyundai Electronics, which was later renamed Hynix Semiconductor.
- The purchase of Hanwha Energy's refining unit by Hyundai Oil Refinery.
- The acquisition of a 51% stake in Kia Motors by Hyundai Motors following Kia's bankruptcy. Currently, Hyundai Motors holds less than 40% stake.
- The purchase of a 70% stake in Samsung Motors by Renault. Today, Renault's stake stands at about 80%.

While corporate restructuring was effective to some extent in driving reforms in the *chaebols*, corporate governance reform remained limited. Insider control stemming from family strangleholds in *chaebol* firms continues to prevail.

Financial sector restructuring supports a rapid economic recovery

The comprehensive financial sector reforms involved the following measures:

- Closure of weak financial institutions.
- Cleansing financial institutions of non-performing loans.
- Recapitalization of viable financial institutions.
- Enforcement of stricter prudential regulation.

With these reforms, unviable financial institutions, many of which had come into existence in the early 1990s, were closed down. As a result, 550 financial institutions out of 2072 had gone out of business by 2001, and by 2008, 44% of all financial institutions had disappeared. Another significant positive development was the decline in non-performing loans, which fell from 13.6% of total commercial bank loans in 1999 to 3.3% in 2001 *('The Post-Crisis Changes in the Financial System in Korea: Problems of Neoliberal Restructuring and Financial Opening after 1997', Kang-Kook Lee, TWN Global Economy Series, 2010).*

The government also ushered in extensive and systematic capital account liberalization, completely opening up the domestic capital markets and short-term money markets to foreign investors, while completely abolishing the foreign ownership ceiling for South Korean companies by May 1998. The number of business categories open for foreign ownership was increased, while the rules for foreign borrowing of domestic firms as well as their international issuance of bonds were liberalized. The government also liberalized individuals' purchases of foreign currency and payments as well as residents' deposits in foreign financial institutions, while also freeing up non-residents' bond issuance as well as borrowings.

A snapshot of prominent *chaebol* companies

Company	Market Capitalization ($ Millions)	Stock Exchange Listing
Hyundai Motor	29,557	Korea Stock Exchange
Hyundai Mobis	21,940	Korea Stock Exchange
Hyundai Heavy Industries	21,829	Korea Stock Exchange
LG Electronics	12,191	Korea Stock Exchange
LG Chemicals	19,383	Korea Stock Exchange
Samsung Electronics	100,374	Korea Stock Exchange
Samsung Life Insurance	18,242	Korea Stock Exchange
S K Energy	11,799	Korea Stock Exchange
S K Telecom	12,145	Korea Stock Exchange

HYUNDAI GROUP

Hyundai Togun, the first company of the group, was established by founder Chung Ju-Yung in 1947. It was renamed Hyundai Construction in 1950 (now Hyundai Engineering and

Construction) and was extensively involved in post-war reconstruction in South Korea. Togun became South Korea's first construction company to win an overseas project in 1965. Successively diversifying into other fields, the firm established Hyundai Motors in 1967, as well as Hyundai Heavy Industries, which was engaged in shipyard construction. The company founded its global logistics arm Hyundai Merchant Marine in 1976. In 1983, Hyundai Electronics was established to support auto, ship and marine manufacturing. A decade later a semiconductor company was established as an outgrowth of Hyundai Electronics, and in 1999, this firm merged with LG Semiconductor Co. In 2001 the company was renamed Hynix Semiconductor. Some of the other companies established in the 1980s: Hyundai Elevator, Hyundai Research Institute, and Hyundai Logistics catering to the domestic logistics industry.

Hyundai invests about 10% of its total revenue in research and development, resulting in technological innovation and product enhancement. In addition to improvements in the automobile engine, some of the company's key breakthrough innovations are in the areas of the hydrogen and alcohol fueled cars, electric vehicles, magnetic levitation trains, LNG ships, and passenger helicopters.

After the Asian 1997 financial and economic crisis, the Hyundai Group spun-off many of its businesses including Hyundai Automotive Group, Hyundai Heavy Industries and Hyundai Department Stores. Hyundai Construction merged with Hyundai Engineering to form Hyundai Engineering & Construction in 1999, while Hyundai Electronics acquired LG Semiconductors in the same year and was renamed Hynix Semiconductor. Following the bankruptcy of Kia Motors in 1998, Hyundai also acquired a substantial stake in the beleaguered company. The existing affiliated companies of the Hyundai Group include: Hyundai Merchant Marine, Hyundai Securities, Hyundai Elevator, Hyundai Logiem, Hyundai Asan, Hyundai U & I, Hyundai Research Institute and Hyundai Investment Network.

SAMSUNG GROUP

The Samsung Group was founded in 1938 by Byung Chull Lee and was primarily engaged in the export of fish, vegetables and fruits to China. In 1951, Samsung Moolsan (Samsung Corporation today) was established, and three years later the textile company Cheil Industries, which is now no longer affiliated to Samsung, was founded. The group acquired Ankuk Fire & Marine Insurance in 1958 and Dongbang Life Insurance in 1963, renaming them as Samsung Fire & Marine Insurance and Samsung Life Insurance later. Samsung Electronics as well as Samsung-Sanyo Electronics were established in 1969, the latter merging with Samsung Electronics in 1977. Diversifying into heavy, chemical and petrochemical industries as well as into shipbuilding in the 1970s, Samsung established Heavy Industries, Samsung Petrochemical and Samsung Shipbuilding (merged with Samsung Heavy Industries in 1983).

Samsung developed a flourishing home electronics business, and apart from being a major domestic manufacturer, had a burgeoning export business as well. Another major move for the group was its acquisition of a 50% stake in Korea Semiconductor in 1974, making Samsung Electronics a leader in semiconductor manufacturing. With the founding of Samsung Precision (now Samsung Techwin) in 1977, the company also ventured into the hi-tech aerospace sector. The decade of the 1980s was significant as Samsung's core technology businesses witnessed unprecedented global growth. Samsung Data Systems (now Samsung SDS) was established in 1985, marking its entry in IT services, including systems integration and management, consulting, and networking. The merger of Samsung Electronics and Samsung Semiconductor & Telecommunications in 1988 was a strategic move to establish the company as a global leader in the electronics segment.

The early 1990s was marked by a substantial increase in competition for hi-tech businesses, with widespread mergers, buy-outs and restructuring. As a result, 14 Samsung affiliated companies became independent and the group also made some significant acquisitions. In the mid-1990s Samsung cemented its position as a manufacturer of world-class products, with 17 different offerings including semiconductors, computer monitors, LCD screens, and color picture tubes, all ranking in the top 5 according to global market share.

Having gone through a successful phase of restructuring already in the early 1990s, the Samsung Group weathered the 1997 Asian financial crisis better than most of its Korean counterparts. In order to maintain its competitiveness, the company sold 10 business units to overseas companies for $1.5 billion. Samsung Motors (established in 1994), which started selling cars in 1998 at the peak of the financial crisis, sold a 70% of its stake to Renault in 2000. Samsung Heavy Industries' construction equipment business was sold to Volvo, and its forklift business was sold to Clark. The company however continued its dominance in digital technologies and the electronics sectors. The group has 34 existing affiliated companies including Samsung Electro-Mechanics, Samsung SDI, Samsung Corning Precision Glass, Samsung SDS, Samsung Mobile Display, Samsung Techwin, Samsung Heavy Industries, Samsung Life Insurance, Samsung Securities, and Samsung Petrochemicals.

Earnings Growth				
	2007	2008	2009	2010
Hyundai Motor	10.25%	-13.94%	104.54%	142.76%(H1)
Hyundai Mobis	13.09%	40.34%	48.18%	69.47% (H1)
Hyundai Heavy Industries	126.74%	31.85%	-4.88%	131.67% (Q2)
LG Electronics	411.29%	-60.47%	324.43%	-33% (Q2)
Samsung Electronics	-6.2%	-25.53%	74.62%	83% (Q2)

Chaebol companies today: Impact of the global financial crisis

While the export-driven South Korean economy suffered under the aftermath of the global economic crisis of 2008, the government's immediate and pro-active response, including a stimulus package and budgetary support helped the economy skirt the recession. While the rest of the developed world struggled to cope with a recession, South Korea grew 2.2% in 2008, followed by 0.2% in 2009. Now with global economic recovery underway, the economy has reverted to buoyancy and is expected to expand 5.9% in 2010 according to the Bank of Korea. Compared to a 13.2% decline in 2009, exports from South Korea are expected to recover strongly, increasing 26.4% this year.

Significantly, while South Korean exports suffered during the global crisis, the country's biggest companies, Samsung Electronics and Hyundai Motors, still managed to grab market share from competitors in Japan, Europe and the U.S. They benefited from the depreciation of the Korean currency, the won, while successfully marketing their products like electronics and semi-conductors to the still growing emerging markets to make up for the loss of sales to the West (*'The Chaebol Conundrum', The Economist, March 31, 2010)*. Standing in testimony to this success, Samsung Electronics was the 39th most profitable company among the Fortune 500 global list for 2010.

Resilient and raring to go

Chaebol Companies in Fortune Global Rankings (2010)		
Company	**Global 500 Rank**	**Revenues ($ million)**
Samsung Electronics	32	108,927
LG	67	78,892
Hyundai Motor	78	71,678
S K Holdings	104	64,396
Samsung Life Insurance	316	25,805
Hanwha	358	23,521
Hyundai Heavy Industries	375	22,926

Remarkably, the South Korean *chaebols*, despite enduring a body blow during the 1997 Asian financial crisis, managed to adapt to the changing business environment and reinvent themselves. In addition to adopting prudent financial practices as well as corporate governance reforms, they continued to innovate and launch new products successfully, maintaining their global competitiveness. The test of their resilience was their ability to sail through the global economic crisis of 2008, while many other global multinationals were shaken. While these giant conglomerates remain heavily dependent on exports, they have ensured that their exports are well-diversified globally, a strategy that countered the global plunge in trade much better than the other economies *('Return of the Overlord', The Economist, March 31, 2010).* Once perceived to be too unwieldy for the contemporary business world, the *chaebols* have sprung back, proving that they are global corporations to be reckoned with, as well as the champions of the South Korean economy.

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