

# Korea's Comeback: The Thirst for Funds Drives Change

A Paper from the Project on Development,  
Trade, and International Finance

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Hilton L. Root

A Council on Foreign Relations Paper

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## FOREWORD

In the wake of the 1997–98 financial crises in emerging economies, many prominent thinkers focused their energies on what went wrong, how it could have been prevented, and what reform measures are required for the future. While some concentrated specifically on financial markets within the economies in question, others examined the larger system-wide implications. The Council on Foreign Relations Project on Development, Trade, and International Finance convened a Working Group in an attempt to look at the problem from both levels, to investigate the problems in the world economy that led to the crises, and to propose policy options calculated to prevent future large-scale disturbances.

Specifically, the goal of the Working Group, which began in 1999, was to promote discussion of different perspectives about the necessity for change in the world economic system, and to look at concrete forms that change might take. These included, but were not limited to, discussions about reforming the international financial architecture to facilitate a transition from export-led growth to internally or regionally demand-driven development strategies that offer the populations of the developing world an improved standard of living.

One of the Working Group's several undertakings was to commission papers from the participants on a broad range of subjects related to the international financial architecture. The authors come from a variety of backgrounds, and their papers reflect a diversity of perspectives. However, we believe that all of them provide useful insights into international financial architecture, and that they represent collectively factors that should be considered by U.S. and international economic policy makers.

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# Korea's Comeback: The Thirst for Funds Drives Change

*Hilton L. Root*

## INTRODUCTION

One year ago, Korea was in trouble. Its banking system, inadequately supervised, collapsed. Industry, lacking financial discipline, expanded unproductively with its “too big to fail” private firms crowding out smaller rivals. Labor market rigidity weakened the competitive position of Korean industry. The financial crisis that resulted gave rise to hopes that significant reform would address all three dimensions of Korea’s vulnerability.

The crisis provided a window of opportunity to seek a coordinated solution, given that the overall condition of the economy was everyone’s concern. However, Korea’s quick recovery may have eliminated that opportunity as each interest group focused on its own well-being, resulting in social and political fragmentation. The regional focus of the 2000 parliamentary elections reflected this fragmentation. No consensus emerged on a reform agenda needed to dramatically restructure the economy.

With the government lacking support to continue comprehensive reform, new vulnerabilities began to appear. Before the crisis, the government implicitly insured depositors’ bank loans to the large conglomerates. These guarantees left the banks with little incentive to develop credit analysis and loan monitoring skills necessary for prudent lending. Now, the government’s increased ownership of the nation’s capital assets may further weaken market discipline. Again, the insured agents, both firms and bankers, will not take proper care to manage risks.

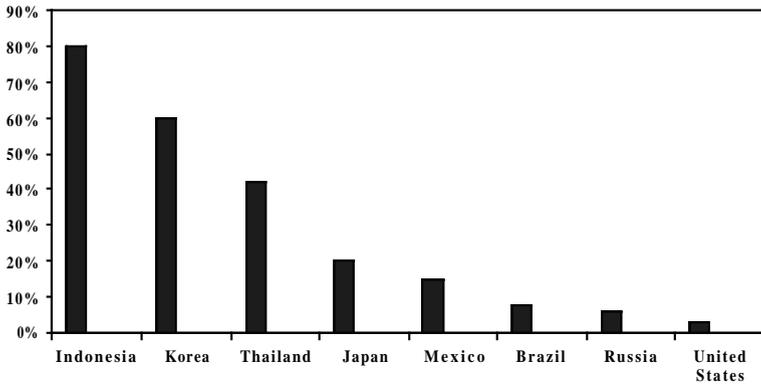
Despite the stalled political reform process, market forces may yet change Korea precisely because the banks are unlikely to resume the central role they once played as the principal source of investment capital. Companies will have to turn to capital market alternatives—bond, equity markets, and Internet banking—for sources of new funding. As they seek new forms of financing, firms will be compelled to change management practices, concentrate on shareholder value, and adopt disclosure standards that are more rigorous than what is demanded by Korean law. The collapse of the banks will have another beneficial effect: weakening the cozy links between firms and politicians who once provided privileged access to cheap credit in exchange for contributions.

Thus, the collapse of the banking system may inadvertently accomplish what the politicians have been unable to do. Market-based financing will provide new sources of entrepreneurial capital and open the society by placing power in the hands of firms that are better adapted to a changing global market place.

Using normal accounting procedures, it would seem that the economy of South Korea is well on its way toward recovery and in record time. It often takes an average of three years after a banking crisis for an emerging market economy to return to pre-crisis economic growth (see Figure 1). Consider how favorable Korea looks using the type of data investors normally consult to forecast economic potential, illustrated in Table 1.

Korea's recovery seems exceptionally robust by these macro measurements. After three years of crisis, GDP growth in 1999 was 10.7 percent, reserves exceed \$70 billion, inflation is in check, and the won is stable. Foreign direct investment in Korean companies was estimated at \$15 billion for 1999, up from \$2.6 billion in 1996. Do these strong macro indicators reflect strengthened micro institutions or do these impressive results imply that the micro foundations were never in the kind of jeopardy the pessimists suggested? Part of the recovery is due to a positive external environment led by strong U.S. growth. It is also possible that normal accounting masks the underlying weaknesses that led to the crisis. Looking

**Figure 1: Bank Crises: Estimated Total Losses/Costs Relative to GDP**



Source: James R. Barth, Daniel E. Nolle, Hilton L. Root and Glenn Yago, 2000.

**Table 1: Principal National Account Indicators**  
(Unit: percent)

	1997	1998	1999
1. National Income (Nominal Term)			
GDP (Trillion Won)	453.3	444.4	483.8
GDP (U.S. \$ Billions)	4,766	3,177	4,067
2. GDP Growth Rate (Real Term)	5.0	-6.7	10.7
3. Growth Rate by Type of Economic Activity			
Agriculture, Forestry and Fishery	4.6	6.6	4.7
Manufacturing	-6.6	-7.4	21.8
Construction	5.4	-8.6	-10.1
4. Growth Rate by Type of Expenditure			
Final Consumption Expenditure	3.2	-9.8	8.5
Gross Fixed Capital Formation	-2.2	-21.2	4.1
Exports	21.4	13.2	16.3
Imports	3.2	-22.4	28.9

Source: Korea, Ministry of Finance and Economy, March 2000.

back at the sources of the crisis, perhaps we can assess whether changes underway are sufficient to reduce vulnerability to the recurrence of a crisis and improve resource allocation.

## FINANCIAL SYSTEM REFORM

**Problem:** Existing financial institutions did not effectively match capital with profitable investment opportunities.

**Causes:** Before the crisis, Korean banks never acquired an adequate supervisory framework. Government supervision of banks' overseas borrowing was weak. At the same time, lenders believed the government was committed to maintaining its currency and had the means to do so. Long-standing exchange-rate pegs encouraged financial institutions to borrow abroad, convert the borrowed funds into domestic currency, and then lend domestically. International investors did not think they had to worry because their investments were brokered by local banks that were presumed to have government backing (see Table 2). Meanwhile, Korean intermediaries had little motive to develop the necessary skills in credit analysis, believing their loans were backed by the government.

**Table 2: Payment Guarantees by the Government**  
(in billions of won, as of the end of year)

	1997	1998	1999*
Total debt guarantees	13,039	71,953	83,020
(% share of GDP)	(2.9%)	(16.0%)	(17.1%)
Loan guarantees	1,975	31,298	16,050
Bond guarantees	10,864	40,541	65,050
Foreign official loan guarantees	200	114	1,920

Note: \* projected

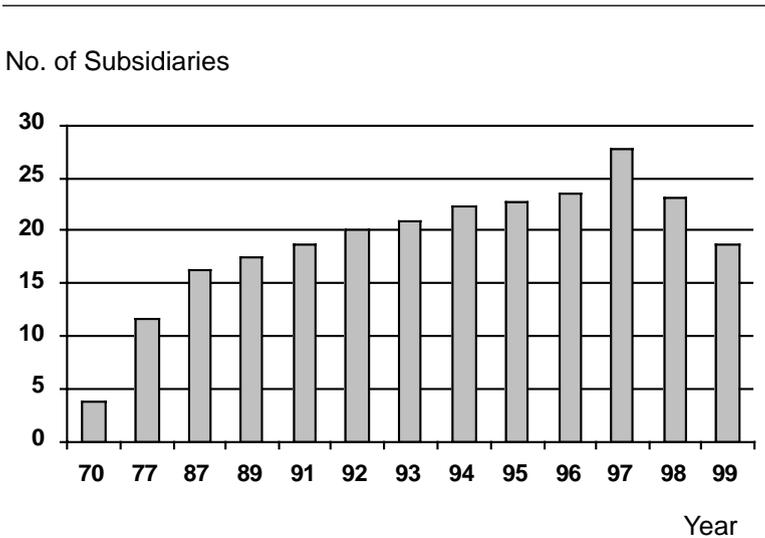
Source: *Joong-Ang Economist*, October 26, 1999, cited in Jongryn Mo, *The Political Economy of Financial and Corporate Restructuring in Korea* (CIS Policy Analysis, February 15, 2000).

Additionally, the government insured the financing requirements of the conglomerates and implicitly underwrote their risks. Since the banks did not choose projects or make decisions about which firms should expand, they did little monitoring. They had no

incentive to independently assess the plans they were financing and, as a result, did not acquire the skills necessary for effective loan assessment.

Without appropriate accounting, would-be bank regulators could not regulate the banks, which in turn could not regulate the borrowers. The government was not even able to count the number of subsidiaries belonging to each *chaebol* group (see Figure 2). Without fundamental information, credit was allocated on the basis of personal relationships or collateral. The largest borrowers got the rosier assessments, since it was understood that they could always borrow more to pay off existing debts. So long as the economy grew, the potential of the *chaebols* was considered unlimited (see Table 3).

**Figure 2: Average Number of Subsidiaries for the Top 30 Chaebols**



Source: Seong-min Yoo, Evolution of Government-Business Interface in Korea: Progress to Date and Reform Agenda Ahead, working paper. Seoul: Korean Development Institute, November 1997.

**Table 3: Comparative Average Debt-Equity Ratios of Korean chaebols with the Manufacturing Sector in Other Countries (percentages)**

Year	Korean Manufacturing	Korean 30 chaebols <sup>1</sup>	United States	Japan	Taiwan, PRC
1991	307	403	147	209	98
1992	319	426	168	202	93
1993	295	398	175	202	88
1994	303	403	167	196	87
1995	287	388	160	196	86
1996	317	450	154	187	..

Sources: Korea Fair Trade Commission; Financial Statements Analysis, Bank of Korea; U.S. Census Bureau; Quarterly Financial Report for Manufacturing, Mining, and Trade Corporations; and The Quarterly Report of Enterprises; Ministry of Finance, Japan Quoted from Republic of Korea; Selected Issues, Jeanne Gobat, 1998, IMF Staff Country Report  
<sup>1</sup>Nonfinancial subsidiaries of 30 largest chaebols

**Recommended Solutions:** Of course, the first matter of business is to clean up nonperforming loans. However, real reform requires a transfer of the skills and information necessary for running the financial system, from the government to market-based institutions. Thus, domestic banks will be forced to take full responsibility for the loans they authorize.

Progress in the financial sector is a prerequisite for restructuring the enterprise sector. The erosion of profit margins, low return on equity, and low return on capital all reflect a lack of financial discipline. Banks must be able to allocate credit on the basis of an objective assessment of a borrower's cash flow prospects.

Korea has been chided for failing to establish accounting standards, which are considered a precondition for effective bank regulation. Active credit analysis, however, will thrive when loans are resold, which means that alternatives to banks must be developed. Greater independence for the central bank's inspection of the financial sector will ensure that these alternatives are managed according to appropriate standards.

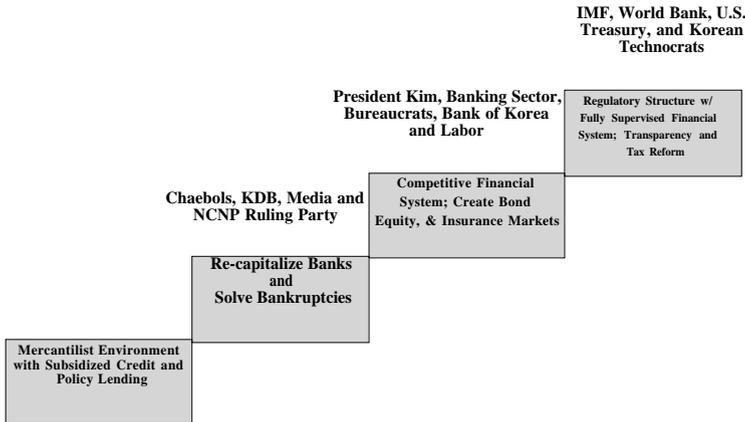
Solving the current loan problems is only a first step; decentralizing financial decisions is essential. However, during the crisis, discussions on financial reform became polarized. The

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International Monetary Fund and World Bank advocated international capital and deep reform; the chaebols saw the problem simply as a liquidity issue, while President Kim Dae Jung adopted an intermediate step of moderate institutional reform (see Figure 3). The parties have not been willing to compromise, and President Kim has not had adequate political support to break the stalemate. The opponents of reform have one very powerful weapon to impede the momentum of change. They have characterized the reform process as a fire sale in which prized national assets are being sold to foreign investors at bargain prices.

Not surprisingly, the major banks in Korea have used their monopoly over information to control the loan market. An active assessment of loan performance may threaten their ability to continue controlling the loan supply. Recapitalizing the banking sector as it existed—the very organizations that have no incentive to actively monitor the performance of loans to large vested interests—would allow large financial institutions to continue to dominate the credit market.

**Figure 3: Korean Financial System Reform Taking the Policy Steps in the Reform Process**



**Post-Crisis Developments:** Where is Korea now? Addressing the financial sector, the government faced two challenges in the aftermath of the crisis. With the initial task of cleaning up nonperforming loans, the government injected 64 trillion won to acquire nonperforming loans, recapitalize viable financial institutions, and support deposit insurance. In the process, a number of financial companies were closed or merged with healthier ones. However, the ratio of nonperforming to performing loans in the system is still unhealthy. Many nonperforming banks still exist.

In 1998, the government set up a vehicle for acquiring nonperforming loans: the Korea Asset Management Corporation (KAMCO) (see Table 4). Authorities moved relatively aggressively to strengthen their banking systems through injections of public funds (\$23.3 billion with few conditions attached), nationalizations, removal of bad debts, and mergers (see Table 5). The milestones in the restructuring process included liquidation of five commercial banks whose Bank for International Settlements capital adequacy ratio was under 8 percent. In addition, the government merged nine banks into four and is selling two banks to foreign investors. Banks have cut staff by 34 percent. Depositors make deposits

**Table 4: Asset Resolution Strategies**

Set up centralized asset management lition in company to which banking system's nonperforming loans are transferred	KAMCO has accumulated \$37 bil- assets
Centralized asset management companies purchase assets at subsidized prices	Initially assets were purchased above market-clearing prices with recourse. Since February 1998 purchases have been attempted at market prices
Nature of agency: restructuring or disposition?	Not clearly defined. Mostly engaged in disposing of assets
Type of assets transferred	No particular strategy
Assets transferred	26% of nonperforming loans, equal to 10% of GDP
Assets disposed of as share of total assets transferred	4.7%

Source: Stijn Claessens, Simeon Djankov, and Daniela Klingebiel, *Financial Restructuring in East Asia: Halfway There?* (Washington, D.C.: World Bank, September 1999).

**Table 5: Financial Distress Resolutions and Bank Recapitalization Strategies**

<b>Initial government response</b>	
Substantial liquidity support	\$23.3 billion (5% of GDP)
<b>Financial distress resolutions</b>	
Bank shutdowns	None
Shutdowns of other financial institutions	More than 117
Mergers of financial institutions	11 of 26 absorbed by other banks
Nationalizations	4
<b>Bank recapitalization strategies</b>	
Public funds for recapitalization	Government injected \$8 billion into 9 commercial banks; 5 out of 6 major banks now 90% controlled by the state
Majority foreign ownership of banks	Allowed, 2 completed and 1 near finalization
Weak financial institutions still in system	Many weak non-bank financial institutions remain

*Note:* Local currency figures converted at mid-September 1999 exchange rates.

*Sources:* Roy Ramos, *Financial Restructuring Scorecard* (Hong Kong: Goldman Sachs, 1999); World Bank data. Cited in Claessens, Djankov, and Klingebiel, *Financial Restructuring in East Asia: Halfway There?*

more prudently as the myth that banks cannot fail has been eliminated. They are being more selective with regard to which banks they deposit with and they are investing funds in alternative instruments. To monitor the KAMCO, the government created the Financial Supervisory Commission. This raises the question of how independent a regulatory agency that regulates a government-owned banking sector can be when no external constituency exists to demand such independence.

Korea has improved its exit framework. An independent supervisory agency now supervises different types of deposit-taking institutions on a consistent and consolidated basis. Guarantees on banking system liabilities have been phased out. A deposit insurance scheme with elements of prompt corrective action has been adopted.

Compared to other crisis countries in East Asia, capital levels appear most solid in Korea as a result of the government's injections of capital. But many challenges remain. Banks would still be undercapitalized if they were to provision adequately. Taking into account current levels of capital, loan-loss provisioning and the non-

performing loans that remain, spreads in Korea would be fairly close to historical levels. Asset management companies have not yet disposed of many assets and global experience indicates that these companies tend to be weak at corporate restructuring.

As a way of putting the issues into context, consider that when communism ended, newly private banks were saddled with significant nonperforming loans to state owned enterprises. In Hungary in the early 1990s, a large percentage of GDP was devoted to bank recapitalization; however, foreign ownership of a large portion of the banking sector was necessary to forge a competitive financial system. By contrast, in the Czech Republic, most nonperforming loans were consolidated into a state-owned institution that still has not been able to dispose of its nonperforming assets. Nonperforming loans are rolled over and real restructuring is postponed<sup>1</sup>. Is Korea headed for the same fate as the Czech Republic? Although the government now owns many banks that were recapitalized, few management changes have occurred.

As stated previously, real reform requires a transfer of authority from the government to market-based institutions, which forces banks to take full responsibility for the loans they authorize. As noted, banks had little incentive to develop the necessary credit analysis and loan monitoring skills because the government implicitly insured depositors and backed bank loans made to *chaebols*. In other words, the financial sector was a classic case of moral hazard where the insured agents did not take proper care in the managing their risks. Ultimately, it may be the adequacy or quality of monitoring and discipline intended to reduce moral hazard that matters most, not the total amount of insurance.

In theory, the extent of moral hazard can be measured by the amount of insurance extended to financial institutions. In practice, however, the problem in Korea was complicated by the presence of informal or implicit guarantees. To preserve confidence in the banking system and prevent a run on deposits, the government

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<sup>1</sup>Thomas W. Hall, *Economic Policy and Financial Sector Reform in Emerging Markets: The Case of Central and Eastern Europe*. Ph.D. dissertation (Los Angeles: University of Southern California, 1999).

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had to provide a blanket guarantee covering all bank deposits as well as certain other liabilities of financial institutions. In January 1998, the government also guaranteed payment of domestic bank foreign liabilities in the amount of \$24 billion as part of a debt restructuring agreement with foreign creditors. Furthermore, in the summer of 1999, the government was forced to guarantee the principal of corporate securities funds issued by investment trust companies (see Table 2). During the three years of financial restructuring, the government became the largest shareholder in the financial sector, acquiring major shares in ten commercial banks, eight insurance companies, and two investment trust companies.

While foreigners now play a larger role, entry into the financial sector has been limited to two foreign banks. Considerable uncertainty about the future still exists because an overall strategy on banks, clarifying issues such as whether *chaebols* can own banks, has yet to be established. Korea's government controls assets worth more than 100 percent of GDP. In sum, three years after the onset of the crisis, financial restructuring is incomplete, much new capital is needed, and for most financial institutions, new private owners are needed. The government's increased ownership stake in banks and other financial institutions is the greatest disappointment of the reform process.

### *The Non-Banking Sector*

The government has been less successful in addressing problems in the non-banking sector (except for closing merchant banks). Of the 2,069 non-bank financial institutions, many of which are in weak financial condition, only 242 had stopped operations as of August 1999. The top five *chaebol*-affiliated investment trust companies have continued to extend financing to their loss-making affiliates, mainly in the form of bonds with high interest rates sold to the general public as people moved out of low-yielding deposits. The small investors in these funds rarely have adequate information or protection.

More adequate provisioning for nonperforming loans may reveal further capital shortfalls. Although Korean companies have

experienced large improvements in cash, data for the first half of 1999 indicate that 27 percent of Korea's publicly listed firms cannot fully cover interest payments from operational cash flows. Of the \$34 billion in new funds raised by Korean corporations in 1999, more than half have gone to the top five *chaebols*. Of that capital, 7 percent was in the form of new equity, 32 percent were bank loans, and 61 percent were corporate bonds.

An undercapitalized financial sector can inspire banks to finance risky but potentially high-return projects in attempts to restore capital. Fiscal stimulus programs have already led to large deficits—more than 5 percent of GDP—and rising public debt. If all financial restructuring costs fall on the public sector, public debt levels will rise sharply from 37 percent to 48 percent. If interest rates remain at current levels, interest payments are expected to account for 6–14 percent of fiscal revenues.

#### *Summary of Financial Sector Reform*

The international community has pinned its hopes on required regulatory disclosure, but rules and regulations will not be a substitute for genuine competition among firms. Only if direct political interference and the danger of capricious taxation are eliminated will companies seeking credit want to disclose profits accurately. Then the skills of credit analysis will migrate to their higher-value users: the companies that buy and sell loans. The existence of a deep secondary market will motivate active loan assessment.

Transparency, improved corporate accountability, and governance that can facilitate proper risk pricing via the transmission of market signals will emerge—as will rating agencies and credit analysis—when institutional investors and issuers freely seek each other. Regulatory review, creditors' rights, and covenant structures are all products of economic competition that come into being as the government steps out of the direct management of credit allocation. Breaking up an oligopoly of a few large lenders will more effectively develop credit analysis than regulating disclosure into existence. Bringing foreign banks into the Korean market will be an important step in this direction.

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While Korea has made significant progress during the past two years in restructuring its financial sector, corporate governance is still compromised by links between non-bank financial institutions and the corporate sector. In fact, since 1997, non-bank financial institutions have become much more important in Korea, with investment trust companies expanding considerably. Close links could reduce incentives for banks to restructure corporations and perpetuate the continued accommodation by banks of their clients' credit needs without independent monitoring and oversight.

The government needs to adjust its approach to bank and corporate restructuring, and go beyond the focus on reducing financial systems' capital shortfalls to dealing with other systemic issues. It must expand the sticks and carrots for corporate governance, for example, by linking additional fiscal resources for banks to promote corporate restructuring under a loss-sharing agreement.

But the discipline to reduce moral hazard is still wanting. No timetable exists to privatize government-held shares of financial institutions. It is even possible that in the years ahead, instead of phasing out its dominant presence in the financial market, future uncertainties may induce more government involvement.

## BUSINESS REFORM

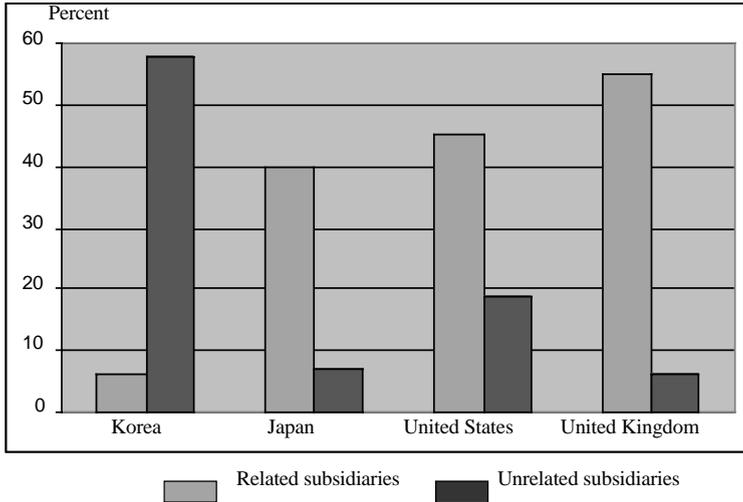
**Problem:** The weakness of financial-market supervision promoted unhealthy industrial development. Because the government stepped in to prevent large firms from going under, they became “too large to fail,” further consolidating their grip on credit. This paved the way for their almost unlimited expansion into unrelated businesses.

**Causes:** First, the government conferred preferential status to industries by relieving them from competitive pressures. Then it allowed the firms to expand into areas in which they had no competitive advantage through the practice of cross-guarantees within *chaebols*. Internal cross-financing made it possible for *chaebols* to grow in seeming defiance of market forces. Although expansion started with government support of preferred sectors, firms soon moved into unrelated sectors, using finance derived from the core specialty. This risky strategy would have been unthinkable had it not been for expectations on the part of both banks and firms that the government was ultimately available to bail them out.

This ownership pattern makes it difficult for potential outside investors to assess the balance sheet risks of these entities. Transfer pricing within a conglomerate allows one subsidiary to subsidize another, thereby allowing unprofitable subsidiaries to operate. It also prevents small and medium-sized enterprises (SMEs) from operating in areas where *chaebols* are not efficient. In fact, many conglomerates were dragged down by their affiliates. For example, Kia Motors, despite having world-class production facilities, was dragged down by its failing sister companies: Specialty Steel, Asia Motors, and Kaisan. These shortcomings were hidden within the conglomerate structure (see Figures 2 and 4).

The balance between large and small businesses became disproportionately weighted toward the large firms to the point where they could dump their problems into the laps of smaller enterprises. *Chaebols* were known to force the acceptance of promissory

Figure 4: Related vs. Unrelated Subsidiary Holdings within Conglomerates



Source: Seong-min Yoo, *Korean Business Conglomerates: Misconceptions, Realities and Policies*. Korea's Economy 1995. Washington: Korea Economic Institute of America, 1995.

notes with unfavorable terms on smaller firms. They could pressure those firms to cut prices on products they sold to their big brothers. Eventually, many were driven out of their specialized niches.

**Solutions:** *Chaebol* reform should include restricting the practice of cross-guaranteeing loans and cross-shareholding in order to trim their lines of business to core specialties. The rights of small shareholders need protection. The boards of directors and auditors should be given meaningful, independent roles. Management should be disciplined by an active market for mergers and acquisitions. Financial institutions must play an active role as investors. In the long run, the government must shed its habit of allocating resources by decree and instead set up fair competition laws to break the collusion of business and politics. Once individual Koreans own shares and demand a return on their investments, business accounting practices will fall into line with international accounting

standards. However, developing efficient equity and bond markets would require diversification of *chaebol* ownership and the establishment of minority shareholder rights.

*Chaebol* reform addresses the very foundation of Korea's corporatist society. President Kim says that the future of Korea is tied to the development of SMEs and has attempted to reduce *chaebol* overcapacity through legislation. But is he ready to take the final step toward real reform, requiring *chaebol* owners to accept diversified ownership structures with management-sharing concessions, voting rights, and corporate transparency?

**Figure 5: Forean Business Reform Moving on the Policy Steps of Business Reform**

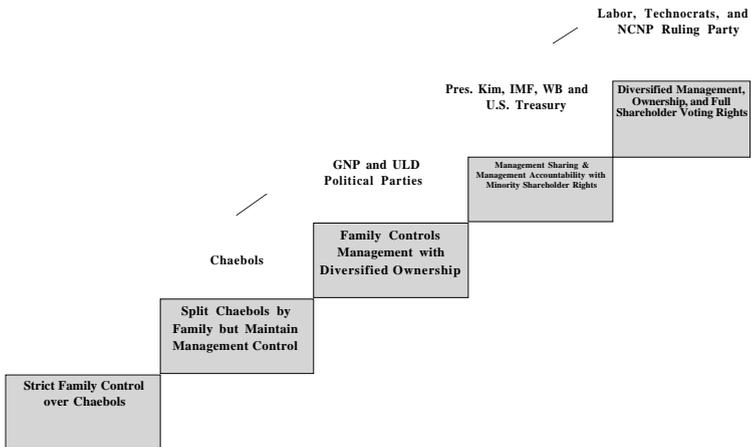


Figure 5 illustrates the compromise that would result if the *chaebols* moved up one step in the reform process while labor, Korean technocrats, and the NCNP moved down one step. However, throughout the crisis, political support for *chaebol* reform has been low and has decreased as the *chaebols* accepted only minimal reforms.

Effective equity markets will not form until *chaebols* are broken up into units whereby economic performance can be more directly observed. The pre-crisis *chaebol* components could not be

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assessed according to the criteria set for a normal economic rate of return and shareholder value.

The government's strategy to reform the chaebols began with what it called the "Big Deal," essentially meaning asset swaps. Koreans view the government-*chaebol* agreement on voluntary restructuring (the "Big Deal") as a significant step toward industrial consolidation. It is premised on the belief that consolidation around core competencies will eliminate the danger to otherwise healthy companies of being brought down by their nonperforming assets. However, this simply allows the conglomerates to dump the public assets that are unsalvageable and keep the jewels for themselves. In other words, *chaebols* can consolidate value for themselves at the public's expense. Moreover, the Big Deal does not replace the need for effective market discipline that comes when capital markets reward effective corporate strategies with investor capital. The Big Deal replaced the market with government. This might have made sense when the private sector was weak and lacked experience, but what sense does it make when the private sector is more knowledgeable than the government?

***Post-Crisis Developments:*** Kim Dae Jung's government announced three principles of corporate reform in January 1998: to improve corporate governance by increasing the accountability of controlling shareholders and management; to enhance the transparency of management by eliminating cross-payment guarantees between and among *chaebol* subsidiary companies; and to improve the capital structure of firms and focus the conglomerates on core activities. In essence, he hoped to reduce debt-to-equity ratios to 200 percent by the year 2000 by requiring the *chaebols* to raise new equities, to sell excess assets, and to spin off unrelated affiliates, reduce lines of business and shed excess capacity (see Table 6). Three more principles were added in August 1999: limiting the chaebols' control of non-banking financial institutions; reducing insider trading and cross-subsidiary equity investments; and tightening regulations on inheritance and other types of wealth transfers among family members of *chaebol* owner-managers. Progress in corporate restructuring has been made but the

outcome is decidedly mixed: the corporate restructuring program has centered on the restructuring of corporate debt. Measures to reduce corporate debt overhang are essential for the short term, but the governance structures of Korea's *chaebols* are a barrier to the company's commitment to shareholders.

The ultimate test of corporate reform is whether or not firms compete according to market principles; i.e., are they subject to market discipline? One indicator is whether the government allows insolvent firms to fail or continues to bail them out. So far, many failed entities are still operating.

Of the various components of Kim Dae Jung's economic program, the least successful has been the reform of the large *chaebols*. Although Samsung has done much to bring its debt-to-equity ratios down, SK and LG have muddled along (see Table 6). Daewoo resisted restructuring and took on additional debt during the crisis. Hyundai increased its debt-to-equity ratio but opened the "Buy-Korea" fund that increased its equity.

The table below, based upon statistics reported by the Korean government, most likely underestimates the true relationship between debt and equity. Lower debt-equity ratios include asset re-evaluations that are questionable; actual debt ratios are not available for reasons discussed below. Combined financial statements that prevent firms from making double entries or hiding assets will not be required until 2000 and even then it is unclear whether the government will be able to enforce this requirement.

**Table 6: Top 5 Chaebols: Liabilities/Equity**

Group	1997	6/30/99-12/31/99
Hyundai	572%	341%-148.1%
Daewoo	470%	588%-N. A.
Samsung	366%	193%-114.7%
LG	508%	247%-169.3%
SK	466%	227%-116.4%

Source: Excludes effects of asset re-evaluations. Financial Supervisory Services (Korea)

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Beyond the top five, the *chaebols* ranked from six to thirty remain in deep distress, with a negative income of 6 trillion won. Before the crisis, eighteen of the top thirty *chaebols* with assets of \$86.2 billion, employing 255,000 workers, were on the verge of bankruptcy. Their debt-to-equity ratio rose from 493 percent to 784 percent during the crisis.

Many affiliates of the second-tier *chaebols* have entered into workouts under the supervision of the Korean Financial Supervisory Commission. These workouts have centered on financial restructuring, with emphasis on debt rescheduling and reductions of debt-to-equity ratios. The reductions are achieved by raising new equity, debt-to-equity swaps, and selling assets—with the proceeds being used to retire debt. Workouts are not for groups as entities but for affiliated firms within the group. These workout programs keep many nonviable *chaebols* on a life-support system of instead of letting them go bankrupt.

By September 1999, some forty-one affiliates of sixteen *chaebols* and some thirty-eight stand-alone large and medium companies (seventy-nine companies in total) negotiated memoranda of understanding (MOUs) with their creditors, rescheduling debt of 35 trillion won. Some 81 percent of debt restructuring and 34 percent of self-help measures were implemented by September 1999 (see Table 7). These workouts were done quickly amid deep concern over systemic failure. Many companies will likely have difficulty meeting their projected performance.

In the best cases to date, these workouts have produced substantial improvements in immediate financial prospects, but they have not extended to the restructuring of corporate operations. An estimated one-quarter to one-third of the restructuring would need to be renegotiated to achieve this. Many others will need to be rolled over at the end of the rescheduling period. In general, it appears that the second-tier *chaebols* are having difficulty meeting their projected performance under the MOUs, while the stand-alone medium and large companies appear to be largely in compliance. Of the second-tier *chaebols* that did not enter the workout program, many are in unsatisfactory financial condition.

Table 7: Summary of Corporate Restructuring Workouts

Measure	Agreed Amounts (in billions of won)	Actual Implementation (as of 9/30/99)
<b><i>Self-Help:</i></b>		
Real estate sales	3,956	23%
Affiliate sales	1,047	7%
Other asset sales	995	46%
Foreign capital	1,650	58%
Rights issues	433	53%
Cost reductions/capital contributions	1,262	44%
	9,343	34%
<b><i>Debt Restructuring:</i></b>		
Rate reduction & deferral	23,302	96%
Deferral	4,857	93%
Conversion to equity or CBs	4,329	78%
Other*	2,412	105%
	34,900	94%
<b>Total</b>	43,133	81%

Note: \* Includes repayment and write-offs

Source: CRCC and Financial Supervisory Services (Korea) Cited in Ira Lieberman and William P. Mako, *Korea's Structural Reform*. Korea's Economy 2000, vol. 16. Korea Economic Institute of America, Washington, D.C., 2000.

The critical weakness of the workout process is the low number of affiliate sales. In effect, the same corporate structures still exist despite the workouts. Labor reductions and wage compressions are often the driving force behind the improvement in operational cash flows. Korea's largest corporations have shed more than a quarter of their workers.

The small business sector has stabilized after two years of widespread business failures. The economic recovery has helped small business restructuring and this sector is leading new growth and employment creation.

***Future Development:*** As corporate restructuring continues, more nonperforming loans will arise and more capital will be needed to recapitalize the banks. Workouts have produced seventy-nine agreements—more than in any of the other crisis countries—though implementation is still far from having been accomplished. To date, three of the top five *chaebols* have implemented their capital

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structural improvement plans. However, new accounting and disclosure regulations are needed. Moreover, the international operations of *chaebols* remain a dark secret.

Only Samsung provides information sufficient for an independent analyst to assess the group's financial status. Even the information it provides the public falls short of U.S. Securities and Exchange Commission requirements. In general, the Korean Stock Exchange requires less information than required by the SEC, and its requirements apply to individually listed firms, not their affiliates. In the United States, the SEC provides information not only about the listed companies themselves but also their controlled affiliates. In Korea, this loophole is an important caveat since many *chaebols* consist of unlisted firms that form a substantial portion of the whole. Greater information transparency might have been a more meaningful contribution to *chaebol* reform than the "Big Deal." However, the constituency for greater *chaebol* transparency is weak. The federation of Korean industries spoke out against Kim Dae Jung when he required the major *chaebols* to provide consolidated financial statements by the year 2000.

Corporate restructuring is a complex process that will require many years. Although the financial restructuring of enterprises has progressed in a relatively successful manner, it cannot serve as a substitute for essential governance reforms: the appointment of independent directors, protection of minority shareholders' rights, and full disclosure under international guidelines.

It is still the government and not the markets that determine the ultimate fate of Korea's firms. The "Big Deal" allows the administration to act in a discretionary manner toward the *chaebols* and the government still controls the banking system. The final step toward real reform has not been made. That would require *chaebol* owners to accept diversified ownership structures with management-sharing concessions, voting rights, and corporate transparency. In fact, many observers fear that influential segments of the bureaucracy do not want to go this far toward a market based system but prefer instead to maintain administrative control.

The brightest spot in the recovery is the considerable progress made in eliminating barriers to foreign entry, though a number of restrictions remain (see Table 8).

**Table 8: Changes in Foreign Direct Investment Restrictions by Sector**

Finance	Manufacturing	Retail	Utilities
From 15% to 100%	From 20% to 100%	From 20% to 100%	From 0% to 49%

Source: World Bank data. Cited in Claessens, Djankov, and Klingebiel, *Financial Restructuring in East Asia: Halfway There?*

However, considerable progress needs to be made in corporate governance (see Table 9).

**Table 9: Equity Rights, Creditors Rights, and Judicial Efficiency, mid-1999**

Indicator	Republic of Korea
<i>Equity Rights</i>	
One-share, one-vote	1
Proxy by mail	0
Shares not blocked	+1
Cumulative voting	0
Equity rights score (sum)	2
Improvement over 1996	+1
<i>Creditor Rights</i>	
Restrictions on reorganizations	1
No automatic stay on assets	0
Secured creditors first paid	1
Management does not stay on in reorganizations	1
Creditor rights score (sum)	3
Improvement over 1996	None
<i>Judicial Efficiency</i>	
Timetable to render judgment	+1
Existence of a specialized bankruptcy code	1
Judicial efficiency score (sum)	2
Improvement over 1996	+1

Note: 1 denotes that equity and creditor rights laws exist, that there are time limits to render judgment, and that specialized bankruptcy courts exist.

+1 indicates an improvement over the law in place before the crisis, that is, in 1996.

Sources: Claessens, Djankov, and Klingebiel, *Financial Restructuring in East Asia: Halfway There?*; Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "Law and Finance," *Journal of Political Economy*, vol. 106 (1998), pp. 1113-55.

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Since the crisis, formal minority shareholder rights have improved in Korea. As can be seen from the above table, enforcement of these rights, as reflected in measures of the efficiency of the judicial systems, remains weak. Minority rights are often violated, and valuations of firms controlled by inside shareholders are far below those of comparable firms, suggesting large-scale expropriation by the principals.<sup>2</sup> In Korea, large-scale financial transfers continue among firms within groups, the most recent example being the channeling of SK Telecom profits to loss-making affiliates rather than to shareholders. In two key areas—the independence of regulators and the strength of judicial systems—Korea has just begun a long process of transition to a rule-based economy. Outside directors are often unsatisfied with their roles.

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<sup>2</sup>Stijn Claessens, Simeon Djankov, and Larry Lang, “Who Controls East Asian Corporations?” Policy Research Working Paper 2054 (Washington, D.C.: World Bank, 1999).

## LABOR REFORM

**Problem:** Historically, labor-market rigidity has weakened the competitive position of Korean industry. Companies cannot adjust to business cycles and are forced to accept the high costs of maintaining labor during recessions, which makes economic cycles more extreme than they need to be. This labor-market rigidity makes Korean assets unattractive to foreign investors.

**Causes:** Directed and financed by cheap government credit, the *chaebols* subsidized social stability during economic downturns by keeping their employees and thousands of subsuppliers working. In return, the government furnished the conglomerates with a compliant labor force. This job-security arrangement, coupled with an economy that has historically had low levels of unemployment, prevented the development of a flexible labor market.

**Solution:** Clear and credible rules governing layoffs are crucial to bolstering foreign direct investment, particularly among bankrupt companies where redundancies are likely to be the highest. To gain support for improved labor-market flexibility, the government needs to introduce a national safety net that includes those not presently covered and extends benefits for those who are cut off after a short period.

Properly structured equity arrangements provide management with direct incentives to run companies more efficiently. Regulations allowing Korean companies to use equity ownership, particularly employee stock ownership plans (ESOPs) and stock options, offer management alternatives to cash as a means of motivating employees. Moreover, investors prefer companies with high management/ownership ratios. Increased equity incentives will also help unlock Korea's highly developed human capital.

The Korean government recently took the first policy step toward labor reform by allowing temporary layoffs of permanent employees among firms that have obtained government approval (see Figure 6). Given that Korea has no national unemployment



political concessions to soften radical labor demands and appease moderates. Nevertheless, Korea is unlikely to revert to the “lifetime employment” of the past.

Several reform opportunities existed that were not exploited. If the conservative parties (GNP and ULD) were to politicize the labor issue in the media by claiming that the president was hostage to labor interests, they might be able to pressure labor to allow some permanent layoffs. Even so, substantive changes are not likely.

Labor is unwilling to make any significant concessions. Only temporary layoffs can occur, and these only with government approval. However, labor is willing to trade employment security for management and decision-making participation. Consequently, *chaebol* reform is closely connected to labor reform. Labor reform is potentially politically volatile. The government is thus unwilling to attempt it unless it can also help labor achieve some of its goals, namely opening the management system of the *chaebols* and establishing minority shareholding. Little progress has been made toward implementing such a trade-off.

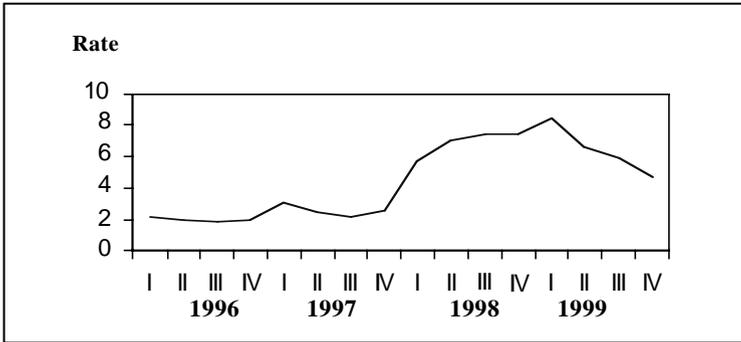
**Post-Crisis Developments:** The criteria for labor reform can also be defined in terms of moral hazard. In the past, the government ensured employment for Korean workers through legal restrictions on layoffs and the hiring of temporary workers. Kim Dae Jung introduced more permissive rules on layoffs in February 1998. The flexibility of the labor market may be measured in terms of how responsive wages and employment are to aggregate demand. However, the issue at the company level is how easily managers can lay workers off when they are legally allowed to do so. Again the evidence is mixed. Although unemployment has risen, there have been few formal layoffs. Due to informal pressure against layoffs, employers have reduced their work force by freezing new hires or employed informal tactics to fire workers.

The largest of Korea's *chaebols* have laid off more than 25 per cent of their workers. In publicly listed companies, payrolls have dropped 34 percent. However, these represent temporary layoffs rather than improvements in labor market flexibility as a whole. Managers depend on legal permission to lay off workers. Dismissal conditions remain strict, requiring that employers rehire laid off

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workers if they recruit within two years of the dismissal date. During the consolidation of the semiconductor industry last year, management pledged not to lay off any workers, an indication of the continuing rigidity of Korea's labor markets.

**Figure 7: Unemployment Rate**



Source: International Financial Statistics, IMF; Third & Fourth Quarter of 1999 from the Ministry of Finance and Economy, Korea.

Social safety nets, such as the government-funded employment insurance system and public works programs, do exist. These were weak during the crisis, however, leaving many workers without jobs or adequate benefits, and they continue to be weak.

By all measures labor has been the loser in the crisis (see Figure 7). Its organizing power has weakened and labor is divided over key issues. Reform efforts involving labor in a second tripartite committee have failed. The division of unions between large and small companies, as well as between union federations, has prevented labor from acting together. Labor's weakness has been one reason chaebols have been able to resist reform.

### *Will There Be a New Korea?*

Compared to financial restructuring, little progress has been made on enterprise reform. While Korean banks may be able to grow out of their problems, it is doubtful that corporate restructuring

has been adequate to foster financially viable corporations. Durable economic recovery depends on further progress in both areas.

Most problematic are the continuing links between non-bank financial institutions and the corporate sector. The concentration of corporate control in the hands of a few families, not to mention the strong political connections of these families, is an obstacle to deep institutional reforms.

At the outset of the crisis, significant opportunities for reform existed. When the government was on the verge of defaulting on its international payments and turned to the IMF, the crisis affected every social interest in the country. The IMF wisely saw an opportunity to draw attention to the need for fundamental institutional reform to help Korea withstand future regional downturns. However, the breathing space provided by the IMF altered the incentives of different groups to cooperate in preventing future crisis. A window of opportunity existed because the crisis cut deeply into the fabric of society and affected the ability of all groups to earn future income. The possibility of aligning all the relevant interests evaporated shortly after the bailout funds were received.

The vision of a liberal Korea came largely from international capital, with the IMF and the World Bank taking the leading role. While seeing where Korea needed to go, the IMF and World Bank were poorly equipped to overcome the political obstacles that lay in the path to reform. The interconnectedness of the issues—the importance of labor reform for gaining support for financial market liberalization—required a political, not merely a technocratic, response.

A deal brokered by international capital might have broken the stalemate between labor and banking reforms (see Figure 8). International capital might have effectively brokered structural changes had a means of trading the advantages of a more flexible labor market for concessions on financial reform by the *chaebols* been available. A trade of labor flexibility for financial market reform might have led to open markets for bond, equity, and insurance, coupled with the emergence of a contract-labor market that allows some permanent layoffs. In this scenario, the level of management sharing would be far above what was acceptable to the

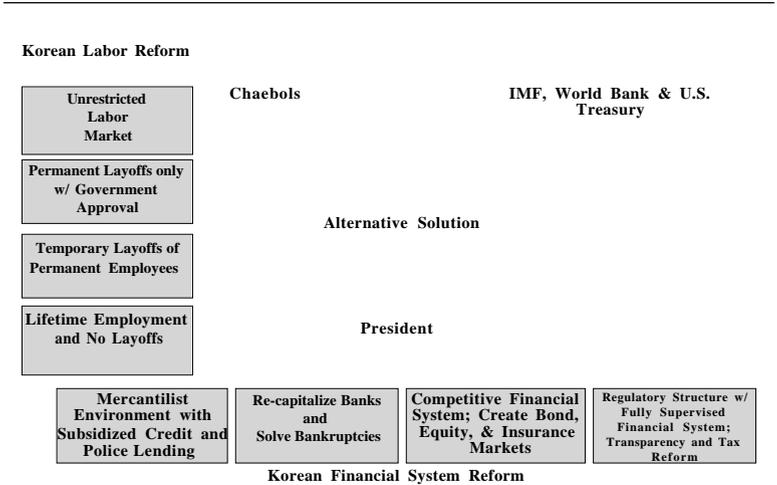
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*chaebols*. By allowing some labor participation in management, a broad-based societal consensus might have been forged.

A grand social bargain needed to include:

- a more flexible contract labor market;
- a competitive financial system; and
- diversified *chaebol* ownership with management sharing and minority shareholder rights (Figure 8).

**Figure 8: An Alternative Solution: an IMF/World Bank-Brokered Deal Linking Banking and Labor Reform**



With recovery in the air, no urgency exists for the different parties to put down their differences and work to prevent future crises. Three years after the onset of the crisis, the consensus for fundamental reform seems to have evaporated and with it political cohesion to build a durable foundation for economic competitiveness. The March 2000 parliamentary elections have weakened President Kim's prospects for proceeding forward.

Improvements in the allocation of investable funds will require better-capitalized banking systems and deeper institutional reforms

in financial regulation and supervision, corporate governance, and bankruptcy procedures. Loan classification and provisioning guidelines in Korea still trail international best practices. Corporate governance rules have improved but are not fully enforced. Korea has passed new bankruptcy and collateral laws, but creditor's rights have improved only marginally.

In the absence of a consensus for fundamental reform, several opportunities exist. One approach would be more fully funded pension schemes, which would operate as institutional investors that could provide independent oversight to the corporate and financial sectors. Corporate restructuring funds could be created to acquire the ownership stakes now held by banks or the state. Even if these funds remain publicly owned they can be privately managed.

One source of Korea's recovery is its relatively competent, meritocratic bureaucracy that now manages the financial system much the way it did under General Park Chung Hee.<sup>3</sup> Thus Korea's experience offers few lessons that can be copied by other crisis countries, most of which do not have Korea's bureaucratic capacity.

The government took a large stake in the financial sector and that stake may rise in the future. Instead of a competitive financial system, Korea finds itself with a government-directed system of finance. The ten state banks now have 58 percent of market share. The policy mechanisms of government remain opaque. A situation now exists in which government can force private actors into agreements that they are not legally obligated to perform, leaving companies with no way to protect themselves from future governments that may choose to act in an arbitrary manner.

Despite the augmented governmental control over the economy, many say that they cannot distinguish which way the country is going. It is difficult to distinguish between rhetoric and reality because existing institutions are inadequate for the country to undertake needed reforms. Many insiders doubt that the bureaucracy is ready for reforms that would trim its role from the levers of eco-

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<sup>3</sup>Hilton L. Root, *Small Countries, Big Lessons: Governance and the Rise of East Asia* (London: Oxford University Press, 1996).

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conomic decision making. But another interpretation is that lacking legislative or judicial capacity, Korea simply has no alternative but to fall back on its traditional strength—bureaucratic capacity. Although the instruments of the developmental state are still intact, they have been considerably weakened, leaving government without the tools to articulate or implement its vision as it was able to do in the past.

If a single universal message stands out from Korea's experience of procrastination in policy reform, it is that before the bailout, the overall condition of the economy was everybody's concern. After the bailout, each separate interest could ignore the overall plight of the nation in trying to feather its own nest. Crisis can bring change when the interests of key players are at stake. The rescue of Korea from immediate disaster leaves the President weaker vis-à-vis the groups whose cooperation he depends upon. With little reason to cooperate on future reforms, from which they had little to gain and much to lose, gridlock appears to be the most likely outcome in the short-run. While these influential groups represent but a minority, civil society is still relatively undeveloped. Korea's weak political parties are organized around regions and personalities so that political authority depends upon a few well-organized groups that are in many cases stronger than they were before the crisis.

Recovery without comprehensive reform is unlikely to be politically secure or socially durable. Although partial reform has opened the country to greater foreign ownership, it also makes the country ripe for future discord and social conflict. Labor has not gained management reform; enterprises have not gained the possibility of permanent layoffs; the industrial empires still have a politically driven credit system to exploit. The few winners now own more of what is profitable, being able to foist loss-making activities onto the public. Labor has taken a beating, gaining nothing in return for what it has lost. The government now has the type of control over the financial system that it has not had since times of the developmental dictatorship. The public will be left with a huge bill for the recovery yet civil society has few ways to make its demands heard or to shape future policy. If the costs are

not borne evenly, a populist backlash remains a distinct possibility; today's foreign investment may be the target for tomorrow's unrest.

*Conclusion: The Thirst for Funds Will Drive Change*

The government of Korea has not enjoyed enough support to implement the comprehensive reform program envisioned by President Kim. The voices for change have not been sufficiently strong, largely because political parties and voluntary associations are still embryonic. The parliamentary elections of 2000 further weakened Kim's ability to effect deep change. Without coordinated political reform, brokered by well-organized political parties, progress in legal reform is likely to be piecemeal and haphazard. However, where government has failed, necessity may still succeed. With the banks still years away from a full recovery and labor having suffered severe losses, the pre-crisis business environment will not return.

Certain changes seem likely despite the hesitant legislative progress. Even without the enactment of liberal labor legislation, the labor market may become more flexible. Contract labor, once instituted, may never be rescinded. Temporary layoffs may be temporary for so long that many workers will find new employment, most likely on a contract basis.

Changes in the legal and policy framework will not be the benchmark for wider changes occurring in the economy. While efforts to clean up the financial regulatory regime drag on, the search for new sources of capital will require that firms change. They will have to seek market-based financing because Korea's banks will be too weak to sustain future growth. The quest for equity finance and the rise of Internet transactions will motivate the *chaebols* to change their management practices. Attracting finance from outside the region will compel a focus on shareholder value and levels of disclosure beyond what is required by Korean law. Eventually, to woo international shareholders, a new generation of internationally trained professionals will run companies, hired and fired by independent boards. Companies will become more transparent, despite governmental gridlock, because the firms that do not adopt tougher standards will fall behind while the companies

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that embrace market-based financing will enjoy significant advantages.

It seems certain that firms can no longer depend on easy credit with government directing the banks where to lend. The banks will have to be more selective, which will weaken the links between *chaebols* and politicians. New forms of financial intermediation, Internet banks, bonds, equities, and venture funds will take the place of bank loans. The surviving banks will be forced to focus more on consumer services and less on high interest margins from loans of dubious quality.

Durable recovery will depend on creating strong institutional foundations upon which a new generation of financial services can be sustained. Ultimately, a legal framework that includes strong provisions for bankruptcy and the protection of minority shareholder rights will be needed to undergird effective capital markets. These changes will ensure capital-market competition, and the sooner they are institutionalized the more certain the economy will be able to resist future shocks. Competition in the financial sector is the best hope to foster a sound and prudently run banking system.

## Root

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