The Korean Business Conglomerate
Chaebol Then and Now

MYUNG HUN KANG
To my wife,
Saeraan
The Korean Business Conglomerate
Chaebol Then and Now

MYUNG HUN KANG
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It is now widely recognized that large private business groups such as Daewoo, Hyundai, and Samsung have played a critical role in South Korea’s rapid export expansion and economic growth over the past thirty years. In fact, the expansion of these large business groups has paralleled that of the South Korean economy, and given their importance in the economy South Korea’s success in achieving rapid economic growth can be said to be the success of these large business groups. It is, of course, true that small and medium-sized enterprises have also contributed to economic growth, but their contribution nevertheless pales in comparison with that made by large private business groups. In 1982, for instance, 271 large enterprises out of the total of 35,971 firms in South Korea’s manufacturing sector accounted for more than one-third of the value of shipment, value added, and capital in the entire manufacturing sector. What is more striking is that most of these large enterprises belonged to the top 30 business groups.

This book is about these large private business groups in South Korea, called chaebol. It discusses their origin and characteristics, their relationship with the government, their effect on the economy, and the implications of their presence and further expansion in the South Korean economy. Its publication now is especially timely as the success of the South Korean economy, which has partaken in the so-called East Asian miracle, has been too often attributed mainly to the adoption of sensible macroeconomic policies. Such an interpretation does no justice to the critical role played by individual entrepreneurs and the large business groups that these individuals control in the rapid industrialization of the South Korean economy. By carefully examining these business groups and their role in the economy the present book makes an important contribution to understanding how and why South Korea has been able to achieve rapid industrialization and export expansion in a short span of thirty years.

This book goes beyond studying South Korea’s business groups. It also examines their relationship with the government, which has effectively utilized them as an instrument of its development policy. Recently, however, with the political liberalization that has taken place in South Korea the powerful influence that the government
exerted in the past over these business groups has weakened. They will be freer to pursue their own narrower objectives and, consequently, how their new relationship with the government will affect the future growth of the South Korean economy is a question that will have profound implications for political development as well as future economic growth in South Korea. By looking into the past and the future of these large private business groups, this book thus provides fuel for thought for those who are concerned with the future of the South Korean society as well as its economy.

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A number of recent studies in industrial organization have been concerned with explaining the institutional phenomenon of business groups. In many countries, a large share of industrial activity is organized through networks of legally independent firms, affiliated with one another under a common group name. The business group is a variant of the modern industrial enterprise that is found in every industrialized country; is multidivisional, i.e., it is composed of large-scale production units; and is managed hierarchically. Yet the business group in late-industrializing countries is unique in that it is more diversified in unrelated products than the modern industrial enterprise on the one hand, and more centrally coordinated than the conglomerate on the other.

The group form of organization is particularly salient in South Korea (hereafter Korea), where “financial cliques,” or chaebol, reach into all sectors of the economy. Characterized by the central control of member-firms through mutual shareholding or direct family ownership, the chaebol have grown rapidly in size and number over the last three decades. Though not legally recognized as single entities, chaebol are readily discernible within the Korean economy. The groups have emerged as a result of the importance of the government in the business-government relationship, of numerous economic and non-economic factors, and of the intricate relationship between entrepreneurship and economic growth.

The successful entrepreneurs who emerged after liberation were typically generalists who utilized politicians' urgent needs for political funds and the corruption of ranking bureaucrats to gain preferential access to government-controlled resources and other government favors. These included foreign aid, government-controlled foreign exchange, government properties expropriated from the Japanese, government construction contracts, low-interest loans, import monopolies, and the overlooking of large-scale tax evasion. Capitalizing on
the rent-seeking opportunities made possible by these favors under the protective conditions of import substitution, these budding chaebol groups reaped large windfall profits, which they used to expand their business activities and create the capital base for these future industrial giants.

The rise of large chaebol groups is a striking feature of Korea’s economic development. Most Korean chaebol were founded less than four decades ago as small businesses by entrepreneurs who still exercise strong control over them. From these humble beginnings, large chaebol groups expanded by diversifying into a wide range of business areas. Many now produce and export a variety of products from toys and textiles to automobiles and tankers. The chaebol are usually organized around a few flagship companies that control and own stock in other companies. The controlling power of a group is concentrated in the hands of the owner-founder, generally called the “chairman.”

Today chaebol occupy a dominant position in the Korean economy and are beginning to make their presence known in the world market. In 1984, the 10 largest chaebol had combined sales equivalent to over two-thirds of the country’s gross national product (GNP) of the same year. As of 1989, the share of the 30 largest chaebol in the manufacturing sector reached 35.2 percent in terms of the value of shipment and 16.6 percent in terms of employment. Furthermore, the chaebol also figure prominently in non-manufacturing sectors. The shares of the 30 largest chaebol in the audited corporations’ total sales in 1987 were 54.1 percent in construction, 88.6 percent in transport and storage, 82.5 percent in commerce and trade, and 76.1 percent in real estate and service. Internationally, 11 chaebol groups were listed in 1987 among the Fortune 500 largest industrials outside the United States. Four of these groups were ranked in the top 100. Korean chaebol have made big jumps in the rankings in recent years.

The following scenario demonstrates well the dominance of chaebol in the Korean economy. A Samsung alarm clock wakes up Mr. Kim in the morning. He rolls out from under a Hanil synthetic fiber blanket and goes to the bathroom, where he uses Ssangyong toilet paper. The washstand is from Daelim. Kim busies himself with a Lucky-Goldstar toothbrush and dental cream, Daewoo shampoo, a Lucky-Goldstar razor, and Pacific Chemical after-shave lotion. When Kim sits down for breakfast, he sees a Hyundai table setting. His morning snack consists of Lotte milk, Samsung ham, and bread from a nearby chaebol bakery chain. In preparing the meal, Mrs. Kim was helped by a Daewoo refrigerator, a Samsung microwave oven, and a Lucky-Goldstar toaster. Kim proceeds to dress himself for the day with a Samsung necktie,
Dainong shirt, and Samsung suit. Then the mid-level company manager, in his early 40s, drives a Hyundai car away from his Hanyang-built apartment. Mrs. Kim turns to a Lucky-Goldstar washing machine, a Daewoo TV, and a Samsung stereo for her late-morning routine. Junior Kim—who wears Kukje shoes, likes Korea Explosives ice cream and Haitai candies, and has recently joined the Doosan (OB Bears) pro baseball team’s fan club—also leaves for Hyundai high school (Business Korea 1984).

The record of development in Korea over the past three decades has attracted the attention of foreign policymakers, leaders, and scholars. There is little dispute either within Korea or abroad that the engine behind Korea’s rapid economic growth has been the large business groups or chaebol. In other words, the fast growth of chaebol has played a major role in Korea’s industrialization and economic development. The extensive growth-led strategy, combined with a higher degree of diversification, was advantageous for the growth of chaebol as the Korean economy was characterized by subcontracting-based export promotion during the 1970s. However, since the 1980s, the strategy of extensive growth and excessive diversification has been inappropriate.

The distinctive characteristic of the Korean case is that the expansion of the chaebol has been striking, with the government being largely responsible for this rapid growth. The rapid growth of chaebol, however, also created unwanted consequences and problems. For example, criticisms have been raised about the excessive concentration of economic power associated with the growth of chaebol in the Korean economy. But the phenomenon of economic concentration is not unique to the Korean case, and, in fact, in many countries, a substantial portion of economic activity is performed by a small number of giant corporations. However, in Korea, the concentration of economic power has created a broad range of serious economic, political, and social problems. More specifically, the country began to perceive the dominant chaebol as a structural impediment to sustained growth. In addition, the growing dominance of the chaebol has been perceived as a major source of class conflicts.

Therefore, the negative effects arising from the concentration of economic power of the chaebol have induced changes in the chaebol’s strategy as well as in the government’s policy toward chaebol. Such strategies as aggressive managers, heavy government support, and cheap labor of the large chaebol groups was well suited to the old Korean economic environment. However, there have been increasing doubts about whether the old corporate structure, and the concentra-
tion of economic power that goes with it, would benefit the nation's comparative advantage in the future.

To answer these questions, in Part I we trace the origins of chaebol, which is extended to the Japanese colonial period, with the emerging dynamics of two representative entrepreneurs. Though many got their start prior to 1960, the most rapid growth period for the chaebol was the 1960s and 1970s. A review of the growth path of the chaebol over that period will permit us to have a more objective view of chaebol's growth and diversification strategies and will provide us with some evidence of the special chaebol-government relationship. It is a common view that the big business group dominating the economy of a country with a centralized control system originated from the prewar zaibatsu of Japan. Because Japanese business groups provide a good example of the most essential characteristics of business groups and had a similar growth path to the Korean chaebol, in Chapter 4 we take a closer look at Japanese business groups to obtain some comparative insights.

Part II discusses the characteristics and the growth mechanisms of the Korean chaebol. The most distinctive characteristics of chaebol are management by the owner-family and excessive diversification. While the proportion of professional managers has been increasing steadily, ownership and management are not separated in most chaebol. Although the modern industrial enterprises in late industrializing countries take the form of the diversified business group, the chaebol are especially criticized for their "octopus-arm" style of expansion, including aggressive infringement into business areas suitable for small and medium-sized companies. Many factors have contributed to the growth of the chaebol, including strong government support associated with the experienced bureaucrat, organizational superiority, strong entrepreneurship and enthusiastic management, the diligence of the Korean worker, distorted factor markets, and the role of general trading companies in promoting exports. For many chaebol, a close relationship between government and business was inevitable. To analyze the role of government in this regard, we assess the impact of various government policies on private entrepreneurship, financial markets and credit allocation, and the emergence of general trading companies.

Finally, in Part III we look at the position of chaebol in the current Korean economy. Chaebol have dominated the Korean economy in every aspect and gained increasing international recognition as well. Recently, the excessive concentration of wealth by the chaebol has emerged as an important social issue, especially in relation to the
speculation in real estate by the *chaebol*. Any evaluation of *chaebol* must look at the way these groups have grown, the extent and degree to which the economic power of the *chaebol* has been exercised, and the value system of the society at large. Usually, organizational efficiency is seen as a desirable outcome of large business groups while concentration of economic power is considerable negative effect. What is needed to cope with the new economic environment in the 1990s should include a reorientation in the role of government and a new recognition of the challenges that lie ahead for the *chaebol* itself. The primary role of government must shift from direct intervention to providing the resource foundations for upgrading and creating a more challenging environment in which firms can compete. At the same time, the *chaebol* must find a way to adapt to changing socio-economic conditions, as well as other challenges from the outside world, if they are to continue to grow and prosper in the future.
PART 1

ORIGIN AND GROWTH
OF CHAEBOL
CHAPTER 2

ORIGINS

The record of development in Korea over the past three decades has drawn the praise, envy, and belated scrutiny of foreign leaders and scholars. There is little dispute either within Korea or abroad that the economic engines behind the high real economic growth have been the large business groups or chaebol. As yet, however, few studies of the origins of these organizations in Korea are available. There are many controversies about the origins of the chaebol. While some studies focus on the foundations of the chaebol establishment, others extend the analysis to the origins of indigenous entrepreneurs or enterprises. In the former argument, chaebol are viewed as the development of a few entrepreneurs toward a diversified business group during the colonial period. Those using the latter concept extend, the origins of chaebol to the late Chosun dynasty before the formal Japanese annexation in 1910.

Most scholars insist that many of the biggest chaebol of today began their first ventures around the middle of the 1950s. The occupation of Korea by Japan from 1910 to 1945 stifled any potential entrepreneurial class in Korea, and the Korean war of 1950–1953 had devastating effects on all sectors of Korean society. Not until Korea began its industrial development efforts in the early 1960s did entrepreneurial power first emerge in Korea. However, McNamara (1990) argues that the commercial and industrial growth of Japan’s leading prewar colonies suggest that the colonial experience contributed greatly to subsequent economic growth; others find little more than economic exploitation in the years of Japan’s rule. Such polemics offer little insight into the beginnings of modern capitalism on the peninsula. If the Korean road to economic prosperity is to influence development strategies elsewhere, we can ill afford to overlook origins in the rush to analyze recent success.

While a handful of the Korean chaebol groups got their start under the adverse circumstances of the Japanese occupation and the Korean
War, nearly all of today's successful chaebol owe their positions to specific policies of postwar regimes. Although Korean industrialization began and many of the companies existed as small enterprises during the Japanese colonial period, there were few group-formed organizations at that time. The history of the chaebol in Korea is even shorter when one considers that the foundation dates are usually those of the mother firm, and not those of the establishment of the chaebol. Following this practice, among today's largest chaebol, the Doosan group founded in 1896 is probably the oldest business group in Korea.

The structures and ideas of modern Korean enterprise have their roots in the colonial experience and in the immediate postcolonial years of division, war, and reconstruction. As the experience of several group-formed indigenous entrepreneurs sheds light on the colonial roots of Korean enterprise, we look to the origins of these groups in the colonial period, as well as to postcolonial developments. In this chapter, after briefly reviewing the various definitions of the chaebol, we examine the origins of the chaebol under Japanese rule and their development after liberation.

**Definition**

What is a business group? Perhaps one of the reasons that business groups have only rarely been the subject of systematic investigations is that they are usually equated with what is in the United States a corporate form of business organization. Business groups, however, are not corporations in the conventional meaning of the term. As a rule, business groups are composed of a set of legally independent firms that may or may not have economic or fiscal relationships among themselves and that normally have no overarching accounting or management systems that coordinate the activity of member firms. In some cases, all firms in the group are at least partially owned by a core firm, sometimes a holding company, a bank, or a key manufacturing firm. At other times, an individual or a small group of individuals, sometimes a family, owns or controls the business group. Therefore, even consolidated ownership is not the defining characteristic of a business group. Instead, the defining characteristic of business groups is that they are organized networks of independent firms, with the nature, manner, and consequence of their organization left open to investigation (Hamilton, Zeile, and Kim 1990).

The business group carries various names in different areas, such as
chaebol in Korea, los grupos economicos in Latin America, zaibatsu in Japan, super-control groups and Konzern in Western Europe, and industrial houses, investment groups, and enterprise groups elsewhere. However, the terms are not clearly defined and are used to refer to a variety of entities in the spectrum of concentrated economic power. In Chinese characters, the chaebol is identical to the well-known Japanese zaibatsu and is a combination of the character expressing "wealth" or "finance" and the character for "clique." The Japanese pronunciation of these two characters is zaibatsu, which is defined as a system of highly centralized family control through holding companies.

In the academic arena, several definitions of chaebol are available. For example, Byun (1975) defines a chaebol as a set of large business groups working under a uniform system with common finance, labor relations, and management. Each firm in the business group is independent superficially, but each is, in fact, dependent on the others. Jones and Sakong (1980) define a chaebol as a family-controlled organization managed centrally through a holding company. The organization is a business group managed by the owner and his family with business diversification. The business group is heavily dependent on outside money and pursues growth through its export drive and its close relations with government.

Lee and Lee (1985) define a business group instead of chaebol as an organization owned and controlled by a single person and his family and composed of multiple large-sized and monopolized firms in many business areas. Chu (1985) also defines a chaebol as a business group that controls multiple firms through a holding company controlled by a specific kinship. Hattori (1986), after reviewing several definitions available in the literature, suggests that there are two requisite dimensions inherent in the various conceptualizations of chaebol: ownership by family and diversified business operations. Other characteristics typically associated with the Korean chaebol are (1) quantum growth stemming from unrelated diversification, (2) monopolistic position in the marketplace, (3) close relations with government, (4) highly centralized structure with top-down decisions, (5) low formalization and standardization, (6) flexible lifetime employment practices, and (7) paternalistic leadership practices.

Chaebol could be defined as a family-controlled group of businesses operating in many unrelated industries. Thus two features characterizing chaebol include the ownership structure controlled by one or a few families and the degree of business diversification. Characteristics of chaebol include (1) doing business in several industries that are not interrelated, (2) being owned by a specific family, (3) depending on out-
side money, (4) having centralized control, (5) having a paternalistic management philosophy, and (6) depending on foreign management resources (Jung 1987). Yoo and Lee (1987) define chaebol as a business group consisting of large companies that are owned and managed by family members or relatives in many diversified business areas. Thus, to be a chaebol or a zaibatsu, an organization should satisfy two conditions: (1) it should be owned by family members or relatives, and (2) it should have diversified business operations.

Kim (1987) defines a Korean business group as a large multicompany association that operates in different markets under common financial and management control and maintains a relationship of long-lasting trust, loyalty, and cooperation among group members. Three distinctive features are evident from the above definition: (1) business groups are large and therefore exercise tremendous economic power; (2) they have diverse operations across different industries; and (3) their intragroup behavior is governed by a long-lasting fiduciary atmosphere that is often, especially in their early stages, based on family ownership and control. The chaebol may be defined as any group of two or more legally independent firms producing goods and/or services within various product sectors of the Korean economy. The firms in the chaebol are typically (1) owned and controlled by a single family and managed paternalistically, (2) completely independent from one another with unambiguous firm membership, (3) diversified across products and industries, (4) not in control of major financial institutions and thus dependent on external sources of fund, and (5) closely linked to the government (Fields 1991).

Synthesizing the above definitions, chaebol may be defined as a large diversified business group that is owned and managed by a closed kinship. Whereas “diversified” in this definition means running businesses in many unrelated business areas, “closed kinship” refers to the founder of the business group and his blood-related family members.

Besides these academic definitions, there are several technical definitions of a chaebol for the purposes of policy regulation and empirical study. Beginning in the early 1980s, the term chaebol acquired technical connotations as the government decided to (1) restrict big business groups’ seemingly undisciplined expansion through an interlocking and cross-shareholding structure and (2) control the growing concentration of bank credits in big business groups. To address these two major concerns over chaebol activities, the Economic Planning Board (EPB) and the central bank defined chaebol as follows. First, the EPB defines chaebol in terms of combined total assets including those of
subsidiaries. The threshold level is 400 billion won (equivalent to about US$550 million). As of 1992, 78 business groups passed this threshold and were subject to guidelines with respect to cross-shareholding and equity investment in affiliates. Second, the central bank defines *chaebol* in terms of combined bank credits (i.e., borrowings and guarantees). Business groups with combined bank credits in excess of 150 billion won (equivalent to about US$200 million) are ranked on the basis of combined total assets, and the top 30 such groups are put on a credit control list. With this criterion, there were 49 large business groups as of 1990.

It is worth noting that for some Koreans, the term *chaebol* has the same negative connotations that are often associated with the terms *zaibatsu* in Japan and ‘conglomerate’ in the United States. These negative attributions have resulted in large part from the perception that some of the *chaebol* accumulated their wealth either because of an unfair advantage or through government connections. Some but certainly not all of these corporate groupings have been accused of exploiting their employees for the sake of corporate profits. It should be noted, however, that most large-scale enterprises around the world—in the United States, Japan, Western Europe, and even the Soviet Union—have been similarly accused (Steers, Shin, and Ungson 1989).

**Genesis**

Although Korean business groups, in general, went through their formative stages during the 1945–1960 period, several indigenous enterprises were already in the genesis stage during the colonial period. Most indigenous enterprises established in the late Chosun dynasty were bankrupted easily because they lacked the capital, technology, and managerial ability available to foreign commercial capital. A remarkable exception was Park Seung-Jik and Company, a textile wholesaler that later became the mother firm of Doosan Group, which is one of the largest *chaebol* in Korea today.

Theories of enterprise, state, and class give direction and depth to an analysis of Korean business in the colony, and analysis in turn reveals the distinctiveness of the Korean experience. A close examination of the colonial origins of Korean enterprise helps refine those same analytic frameworks and broaden our understanding of Asian society. Studies of both entrepreneurship and industrial organization, especially of the development of Japanese combines or *zaibatsu*, pro-
vide a framework for examining early Korean enterprises. Given the prominence of economic priorities and of state-directed strategies for growth, McNamara (1990) applied the concept of a “strong state” to the Japanese colonial administration and probed the methods of economic direction on the peninsula through 1945.

The colonial state in Korea—the government-general and affiliated institutions—played a major role in private enterprise. Adaptability to state economic priorities was a prerequisite for successful large-scale enterprise. Certainly adaptability is demanded of native entrepreneurs in any colonial situation in which an alien state and alien enterprises hold the upper hand. Colonial state supervision is accompanied by offers of state support, leaving local business in a dilemma between growth and alien control. Hirschman’s cooperative entrepreneurship became a trademark of successful large-scale local enterprise outside of agriculture in colonial Korea. Yet one cannot help but be impressed with the persistence of native ownership and management in a few major firms despite close relations with the state and large Japanese firms. Dependent on the colonial state for credit financing and even subsidies for high-risk ventures, a few entrepreneurs found ways to adjust to administration priorities without losing ownership and internal direction of their large-scale investments.

Practices common among Korean large landowners, such as concentration of capital and adaptation to a centralized state, were already apparent in the late nineteenth century and earlier. With the transportation and financial networks developed during the colonial years and the competition on the peninsula with Korean and especially Japanese private enterprise, distinctive features of concentration in enterprise, state relations, and class ties came to the fore in the few large-scale indigenous firms that survived and prospered through 1945. Class dynamics among major Korean business leaders also helped to distinguish the government-business relations in the colony.

To observe the emerging dynamics of the genesis of these few indigenous enterprises for the origins of chaebol, we look into two representative entrepreneurs during the colonial period—Samyang group and Hwasin group—who continuously owned and managed their groups even after the liberation. We also examine how they adjusted and maintained indigenous ownership and direction. Although the Doosan group has the longest history and is a unique third-generation chaebol, the business activities of Seung-Jik Park, the founder, were relatively meager as compared with the founders of the above two chaebol.

Perhaps the most famous and successful of the colonial Korean en-
entrepreneurs, Yon-Su Kim was the younger brother of the eminent educator and politician Sung-Su Kim (1891–1955). He graduated from Waseda University in 1912 and returned home as a teacher and administrator at Posung Middle School. He was appointed president of Kyungsung Weaving Company in 1917. Two years later he and Young-Hyo Park founded the Kyungsung Spinning Company, which is famous as one of the first large-scale modern industrial companies in Korea established by Korean entrepreneurs. He remained at the firm as director through 1927, and later as an adviser, while maintaining a large block of shares in the company. Sung-Su Kim founded the prominent vernacular Donga daily newspaper in April 1920, serving as president intermittently through 1927 and thereafter as director. In line with his early interest in Korean education, he also later helped found Posung College, the present-day Korea University. He emerged as a leader of the opposition party after 1945 and served briefly as vice-president of the Republic in May of 1951.

But it was his less prominent younger brother who directed the family’s investments. The son of a prosperous landowner, Yon-Su Kim (1896–1979) was a native of the Kochang area in North Chulla Province. He attended middle school in Tokyo and later graduated from the Kyoto Imperial University, where he had studied economics. Upon his return, he took charge of the family’s agricultural properties, expanding the family-owned Samyang Company with agricultural estates in Korea and Manchuria, plus holdings in other commercial and industrial ventures. He left his mark on Kyungsung Spinning as executive director from 1922 to 1927 and president from 1935 to 1945. In addition to the direction of major agricultural and industrial ventures, Yon-Su Kim was active in finance as executive and representative director of the Haedong Bank. He resigned his post at Kyungsung Spinning in 1945 but retained a large block of shares in the company until 1958. His efforts in the First Republic were directed toward development of the Samyang Company in trade and sugar production (Kim 1971).

Unlike the Kim family, Hung-Sik Park gave the impression of an ambitious and aggressive merchant from northern Korea. He was born in South Pyungan Province near Chinnampo in northwestern Korea in 1903. After the deaths of his older brother in 1910 and his father in 1916, the young Park supported his mother with some landholdings he later parlayed into local printing and cotton investments. He moved to Seoul in 1926 and quickly established Sunil Paper Goods with capital accrued from earlier ventures and bank loans. The company’s success led to a further investment in his famous and
widely successful Hwasin Department Store on Chongno Avenue in Seoul. Park was counted among the leading entrepreneurs of the day with domestic investments in wholesaling and retailing, trading ventures in China and Southeast Asia, and minority shares in other joint-stock firms. He led the Hwasin chaebol through the liberation and the First Republic in the south under Seung-Man Rhee, specializing in trade and textile production (Park 1981).

A distinctive pattern of investment portfolios and election to corporation boards was apparent by the last decade of the colonial period. The pattern included four concentric levels of business activity. First was an inner core of family-owned companies, usually in agriculture and real estate. The Samyang Company of Yon-Su Kim was a typical example. Wholly owned family companies with large paid-in capital served as holding companies for other commercial and industrial investments while providing consistent, extensive profits for investment elsewhere. Hung-Sik Park was the exception here because his family lacked extensive agricultural holdings. Instead, he developed the Hwasin Department Store and Hwasin Chain Stores along this pattern of nearly wholly owned and closely managed family enterprises. The other three levels of investment among these entrepreneurs were more conventional joint enterprises, but the family-owned enterprise remained the center of their investment portfolios.

The second level of investments included major investments with administrative responsibility in complex joint-stock enterprises, such as Kyungsung Spinning under President Yon-Su Kim and Hwasin Trade under President Hung-Sik Park. In each of these ventures, which were the most prominent native enterprises of the period, one major entrepreneur made a large commitment of capital, developed a tight, kinship-like management group, and elicited the smaller capital contributions of friendly investors. To date, this second level has received most of the scholarly attention, with some reference to the inner core of wholly owned family enterprises.

The third and fourth levels of business activity by these entrepreneurs have been largely ignored by scholars thus far; case studies of particular entrepreneurs and their major enterprises have absorbed most of the attention. A focus on business-state relations rather than the enterprise itself demands attention to common patterns of investment and networks of mutual support. Here one begins to see the need for diversified investment portfolios in the colonial era, investments not unrelated to the family-owned agricultural companies or their major joint enterprises. A third level included smaller investments by Kim or Park in medium-sized joint ventures, without major
administrative responsibilities. What distinguishes this group of ventures is a team of major Korean entrepreneurs and a few former Japanese government officials. The Korean business elite put together capital in ventures that were often parallel to their own agricultural or commercial companies. For example, Yon-Su Kim and Hung-Sik Park invested heavily in the Chosun Engineering Company for mining and military equipment; they put up the funds for Shibuya Reiji’s Daiko Trade based in Mongolia; Yon-Su Kim was the minor partner in the Okkye Gold Mine Company with Japan Gold Promotion Company and Park and other Korean entrepreneurs appeared as major investors in the Japanese-managed Keijin Enterprises.

A fourth level of activity in major Japanese ventures on the peninsula differed from the third level only in the terms of scale and major ownership. Whereas Koreans were among the major investors in the joint enterprises of the third level, the scale of investment on the fourth level excluded all but the minor participation of Korean capital. For instance, Hung-Sik Park was on the board of the North Korea Paper and Chemical Manufacturing Company and served with Yon-Su Kim on the board of Chosun Petroleum, one of the 10 largest Japanese investments in the peninsula. If class ties with other Koreans and Japanese investors were reinforced through investments in the third circle of firms, Kim and Park were in contact with executives of Mitsui, Mitsubishi, and Noguchi Jun’s Japan Nitrogenous Fertilizer companies in this fourth circle.

These multilevel portfolios provide a more comprehensive perspective on this dynamic adaptation of dependent capitalists in colonial Korea, especially when set in the context of Korean ideologies for colonial enterprise. The ideology of an unequal but widely beneficial Korean capitalism with at best limited autonomy helped sustain the efforts of large-scale Korean enterprise in the colony. The Haedong Bank, Kyungsung Spinning, and Hwasin enterprises serving Korean markets were known as Korean firms, indigenously owned and managed. Sung-Su Kim, and later Yon-Su Kim, and Hung-Sik Park built native enterprises serving Korean markets with Korean managers and Korean investment capital. One obvious continuity was their promotion of solidarity among Korean producers, investors, and consumers in the development of indigenous enterprise. Less directly stated, but nonetheless clear, was their sense of competition and commitment to survival. Local ownership and direction here would coincide with the initial sense of “native” capital, but the ideology of the “native products” campaign would further suggest benefit for the wider population. Table 2.1 indicates indigenous enterprises related with Yon-Su
Kim and Hung-Sik Park, both of whom are indigenous entrepreneurs representative of the colonial period.

Korean business leaders paraded the fact of indigenous ownership and advertised the wider benefits of their enterprise in an effort to gain agrarian capital for investment and bolster their nationalist credentials. Credible financial institutions were critical in the transition from agrarian capital to the more fluid capital demands of industry and commerce. As director of the Haedong Bank, Yon-Su Kim in 1933 called for consumer confidence, praising the inflation control policies of the Japanese cabinet and their effect on business in Korea. Kim had been involved earlier in well-publicized efforts to establish a spirit of cooperation between Korean producers and consumers at Chungsung Spinning. The company highlighted its national roots with traditional terms used for brand names such as “Taeguksung” and English labels with “Made in Korea” prominently displayed. Sales to Korean consumers were critical in the company’s early survival against Japanese competition. Cooperation among Korean investors in capital formation was also necessary to maintain growth in a capital-intensive, large-scale industrial venture, as highlighted in reports of the company’s need for increased funding.

The ideal of a Korean company owned by a large number of smaller Korean investors seemed implicit in the company’s founding ideologies. Yet by March 1925, the number of investors had decreased from 194 to 89, while capital investment by the remaining stockholders increased. The difficulties in gaining the support of the agrarian

Table 2.1 Indigenous Enterprises by Yon-Su Kim and Hung-Sik Park

<table>
<thead>
<tr>
<th>Yon-Su Kim</th>
<th>Hung-Sik Park</th>
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<tr>
<td>Chungang Commerce and Industry (1911)</td>
<td>Hwashin Co. (1931)</td>
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<tr>
<td>Kyungsung Spinning Co. (1919)</td>
<td>Sunil Paper Co. (1931)</td>
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<tr>
<td>Donga Daily Newspaper (1920)</td>
<td>Taedong Promotion Co. (1935)</td>
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<tr>
<td>Haedong Bank (1920)</td>
<td>Hwashin Chain Store Co. (1936)</td>
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<td>Samyang Co. (1934)</td>
<td>Chejudo Promotion Co. (1937)</td>
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<tr>
<td>Chosun Refining Co. (1935)</td>
<td>Chosun Industry and Management (1939)</td>
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<tr>
<td>Taechang Industries (1935)</td>
<td>Chosun Engineering Co. (1939)</td>
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<tr>
<td>Bong Mining Co. (1935)</td>
<td>Hwashin Trading Co. (1939)</td>
</tr>
<tr>
<td>Chosun Engineering Co. (1939)</td>
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Note: Numbers in parentheses refer to year of establishment.
Source: Han-Koo Lee (1989).
elite may explain this growing concentration. The more positive theme of solidarity among workers and managers stood out as the main emphasis among these admonitions. To root out divisiveness that impeded production, Kim set a high priority on the spirit of teamwork with other tenants on the agricultural estate. Efforts toward greater rationality in production among employees, joint investment efforts among investors, and the interplay between Korean producers and consumers were all part of the wider solidarity necessary for successful large-scale native enterprise.

Land was precious in the agrarian society of colonial Korea, particularly in the fertile plains of the Chulla provinces. Massive Japanese investment in land, and later in land reclamation, intensified competition in agriculture; yet Yon-Su Kim both integrated and expanded the landholdings of his father into the extensive agricultural estates of his Samyang Company between 1924 and 1940. The company reinvested tenant farm profits into purchase of neighboring plots, often from owners who were in debt. Competition for land with fellow Korean agricultural investors faded in the later colonial years as the company turned its energies to lucrative land reclamation projects, trying to gain the support of the government-general for such capital- and labor-intensive projects in competition with Japanese investors. The Samyang was busy in Manchuria relocating Korean farmers and organizing and managing agricultural estates toward the end of the colonial period, again in competition with Japanese firms. Kim was among the very few Korean industrialists able to compete with larger Japanese firms. The remarkable accomplishments of both his agricultural and industrial firms gave greater credibility to his practical ideology of wider benefits through competition (Kim 1984: 87, 94).

On the other hand, Hung-Sik Park boasted of Hwasin's uniqueness as a Korean department store challenging Japanese competitors such as Mitsukoshi, Chojiya, Minakai, and Hirata, which were in the more prestigious Chung-mu district of Seoul. He found a niche in the dry goods department and chain store business on a level above the larger Chongno-district Korean merchants and below the elaborate Japanese department stores in Chung-mu. His ambition and competitive spirit were evident throughout the later colonial years, whether in paper with Sonil Paper, in domestic commerce with Hwasin Department Store and Hwasin Chain Stores, or in foreign trade with Hwasin Trade.

If the capitalism of Kim and Park was benign in promoting solidarity for mutual though unequal growth and prosperity and solidarity for economic survival and possibly eventual Korean autonomy, it was
likewise competitive, with strong priorities of growth and profit. Competition was evident even in educational foundations aimed at enhancing their nationalist credibility. If their enterprises were advertised as native firms with Korean management, ownership, and capital, close ties with government offices and Japanese business leaders would eventually erode their claim to national capital for the wider benefit of the nation. The years of the Pacific War brought new pressures on the local entrepreneurs now closely linked with the state and further eroded their claim to private enterprise for the wider benefit of the populace.

Big businessmen with large-scale investments had to deal with the colonial administration and thus were obviously more vulnerable to collaboration, but also more important in the development of native enterprise. If close ties with the administration define collaboration, then the Korean businessmen in this study must be judged to have been collaborators. This relationship tells us much about the comprehensive economic control of the state but little about the dynamics in the origins of Korean capitalism. A more useful analytic dichotomy would contrast the *comprador* role prominent at the time in neighboring China with the "dependent capitalist." Compradors work mainly within foreign enterprises, investing their talents and capital for the most part in an alien firm in their own land. Dependent capitalists, in contrast, often invest in their own local enterprise, though nonetheless under the wider control of an alien administration and markets controlled by foreign investors (Kang 1980:202–16).

McNamara thought Sang-Yong Han best fit the term "comprador," but Yon-Su Kim's extensive wealth and political identification with the nationalist aspirations of the family-associated *Donga* daily newspaper and Posung College permitted the limited independence that is more characteristic of the "dependent capitalist." Others fit somewhere in between as each found ways to promote enterprise and deal with the alien objectives of the colonial government. The classic dependency of Korea's colonial situation left local entrepreneurs with two alternatives: more independent, local enterprise, usually of a small scale because of limited capital resources, or a career in foreign enterprises on Korean soil.

Local solidarity in relations with a powerful state and the massive presence of the *zaibatsu*, together with the common economic interest of a rising group of major local capitalists, helped to forge bonds among Korean business leaders. Interlocking corporate directorates of family members and close associates within family firms have been cited as an example of concentration of management and control in
the enterprises of Kim and Park. Apart from managing their own businesses, they also served on the boards of one another's enterprises and joined boards of joint investments. Interlocking corporate directorates of major native business figures were evidence of differentiation along an inner group axis, by which major corporate owners assured friendly investment and control of their own boards.

The record of investment and administrative commitment in the native enterprises suggests a more pressing issue of control in an unstable and unfriendly business environment. The insecurities prompting concentration can be cited as factors encouraging interlocking directorates as well. Insofar as relations with the state and the massive presence of major Japanese zaibatsu in the domestic economy helped the Korean business elite to pull together in this inner circle, the legacy of colonial business-state relations would foster common interests among an elite of major indigenous business leaders.

If insecurities in a very competitive situation and the exigencies of dealing with a strong, interventionist colonial state encouraged concentration and group solidarity, one result was a small core of indigenous "dependent capitalists" that were in company but not in competition with major Japanese business figures on the peninsula. A closer look at the patriotism and enterprise of the colonial entrepreneurs offers some insight into this basic but divisive issue of large-scale private enterprise and national development. Someone described the nationalist aims of a dependent capitalist as being "to gradually foster the real strength of indigenous capital within the colonial framework by enlisting the help of the government-general on the basis of confronting labor in cooperation with the government-general."

A small number of independent local businessmen combined local resources with state support to develop a third alternative; locally owned and managed large-scale enterprises. McNamara (1990) examines these local banks, commercial firms, and industries; their owners and executives; and the relationship in capital, organizational structure, and management personnel in colonial and postcolonial Korea. The colonial experience of dependent capitalism reveals much of chaebol origins, and more generally of enterprise, class, and business-state relations. He also notes that the Japanese colonial state found some advantage in successful local enterprise as evidence of the benefits of colonial rule for the wider local population, as long as local enterprise fit the state's economic priorities and did not challenge the state's economic control.
Formation of the Chaebol

Several thousand Korean businessmen ultimately assumed a position of influence after liberation and formed an important component of the new class of commercial and industrial capitalists which grew up in the 1950s. In fact, many of the successful entrepreneurs of liberated Korea were a part of this group. During this period, a number of chaebol having the characteristics of the business group were established. The majority of today's largest chaebol got their start during the late 1940s and 1950s. As of 1988, only six of the thirty largest chaebol got their start before liberation from Japanese rule. The majority (16) were established during the Rhee government; the remainder (8) were formed during the Park government.

The colonial patterns of local enterprise faded for a time in the turbulence of liberation in 1945 and the founding of the First Republic in the south in 1948. Business leaders scrambled to catch up with local rule and newfound opportunities for political voice in a fledgling democracy. All at once they faced a new business partner—the United States, a powerful Western capitalist state—while facing domestic pressure to curtail ties with Japan. But it was not long before a Korean style of major enterprise again came to the fore, a style that was quite different from the large enterprise of the West and even from the zaibatsu of Japan. Adjustments within an unstable context of new ideologies and institutions certainly forced some change from earlier patterns of business-state relations. But there was a remarkable persistence of earlier patterns such as the concentration in family-controlled business groups, the chaebol, and adaptability to state direction and support.

Events of the immediate postcolonial years left the leading Korean economic elite of the colonial period in disarray. Cool relations with Japan and hostility with Communist regimes deprived the earlier business leaders of familiar Japanese suppliers and funding sources and of markets in Japan, North Korea, Manchuria, and northern China. Domestic unrest in the south slowed production in the remaining textile and food-processing plants, and a new Western ally, the United States, became the dominant focus of foreign trade. Aggressive land reform programs of both the American military government and the early Rhee administration unraveled large-scale investments in agriculture. Three years of war (1950–1953) with the north destroyed much of the industrial plant and transportation network in the Republic. Apart from dislocation, reconstruction, and the salient role of the United States in the economy, the colonial elite also
found themselves struggling to find a political identity and a positive reception for private enterprise within the early Republic.

The colonial experience had much to do with the origins of the Korean chaebol. The most striking patterns among postcolonial continuities were concentration, continued prominence of the family in large-scale enterprises, and persistence of close business-state ties. Bureaucratic control of critical economic resources by a state with at least the ambitions for comprehensive direction remained a part of economic life in postcolonial capitalism on the peninsula. Concentration and the need for close state ties during the First Republic resulted again in an "inner circle" of major business leaders, including familiar figures such as Yon-Su Kim and his family and Hung-Sik Park, together with a host of rising new entrepreneurs such as Byung-Chul Lee and others. Land reform, which deprived the colonial agrarian elite of a capital base, discouraged land-based class ties from the 1950s; and although many of the colonial-dependent capitalists regained prominence with investment in trade and light manufactures, it was not a smooth transition.

During the period between the liberation in 1945 and the fall of the Rhee government in 1960, a number of chaebol were born, and these chaebol could accumulate wealth at a rate higher than the national average. The government played a significant role in this process of chaebol accumulation. Certain environmental characteristics helped shape the basic patterns of the government-chaebol relationship. First, Korean economic development in this period began under extremely underdeveloped conditions including an extremely low level of national income and savings; an underdeveloped social and economic infrastructure; a great information asymmetry; a low level of managerial, especially entrepreneurial, supply; a poor endowment of natural resources; and a general lack of administrative experience in the government.

Second, there was general social and political instability, and the primary concern of the Rhee regime was more with politics (for instance, the consolidation of its own power) than with economics. The scope of the interactions between politics and economics was narrow and limited to the occasions in which political allocation of economic resources and opportunities was considered necessary for the regime's political goals. Third, partially as a result of the second point, economic growth was not an integral part of the regime's political goals, and the regime did not make concerted efforts in economic affairs until the end of the Korean War. Consistency in the economic policies of the Rhee government, which were aimed at reconstruction and import-substituting industrialization, came only after the war.
Even after the establishment of the Korean government headed by Seung-Man Rhee in August 1948, the overall economic situation did not change much, and real national income decreased until the end of the Korean War in 1953. Widespread social and political unrest continued after independence, and there was little political attention to economic affairs. President Rhee's prime concern was to turn the country from a colony to a newly sovereign nation. Like many Third World political leaders of the time, he viewed charisma and expertise at political manipulation as the ultimate qualifications for office; thus, he devoted his energy to political action rather than administrative development and subsumed economic goals to integrative ones. In economic affairs, Rhee's concerns were not with growth, but with the short-term objectives of reconstruction and the maintenance of minimum consumption standards, both of which were to be achieved by aid maximization rather than investment and production.  

Furthermore, much of the already ill-managed industrial assets were destroyed in the Korean War. In addition to the severe physical damage of industrial assets, the war created a number of new phenomena, among which were skyrocketing inflation, greater influx of foreign aid from the United States and the United Nations, and increased demand for military supplies and government contracts for reconstruction. The period between the liberation and the end of the Korean War was a period of fundamental disorganization, and there was no consistent effort on the part of the government in economic affairs. Except for a few new legislative and fiscal policies—such as the determination of the foreign exchange rate and interest rate—the majority of government policies—such as the punishment of illegal business activities, bribery, and embezzlement—were ex post facts and ad hoc.

Although it was primarily a political action of the new regime, there was a large-scale purge against a group of so-called Anti-Nationalists that included most of the leading businessmen of the time. In January 1949, five months after the birth of the Republic of Korea, many business leaders who had accumulated wealth during the colonial period were arrested under the Special Law to Punish Anti-Nationalists. The major criminal charge against them was their financial contribution to the Japanese in exchange for political support. The death penalty was proposed at the beginning, but because of continuous social and political unrest and the Korean War, which broke out in the following year, few were actually punished. Though the law was not fully enforced, this attempt by the government was an important move and strongly influenced the shaping of the gov-
government-business relationship, in which the government dominated the other.

Immediately after the war, the Rhee government pursued the goal of reconstructing the infrastructure and factories that had been destroyed. As the reconstruction effort was under way and the country became stabilized, the government directed its policy efforts toward the following main goals: facilitating the inflow of foreign aid, promoting new import-substituting industries primarily in the manufacture of consumer goods such as food and textiles, and maintaining stable support for the agricultural sector. The government adopted the strategy of import-substitution industrialization. In mobilizing the necessary financial resources, the Rhee government relied on the inflow of foreign aid, its own revenue from the export of natural resources such as tungsten, and import duty collected from private traders, rather than make any serious efforts to increase domestic savings in the private sector. The government levied high tariffs and used other measures to protect domestic industries, although the domestic currency was kept overvalued throughout the 1950s. The interest rate in the official financial market was controlled and kept low by the government to provide incentives for private investors. These characteristics, as well as the general lack of a strong political commitment to economic growth and insufficient administrative expertise in the government bureaucracy, continued until the collapse of the Rhee government in April 1960.

Under such circumstances, the government had valuable assets to allocate to the private sector, such as the former Japanese properties and aid funds and materials. Government allocation of these resources was usually accompanied by allocation of other valuable resources and opportunities such as import licenses and low-interest finance. How the government allocated these resources and opportunities is subject to disagreement. Some say that corruption played a major role; others say that there were only a few qualified entrepreneurs. In either case, the primary source of chaebol accumulation was the transfer of such resources and opportunities by the government in a usually non-competitive process. We need to scrutinize in detail how these resources and opportunities worked to favor the formation and accumulation of chaebol.

Allocation of Vested Properties

At the time of liberation, Korea inherited 166,301 assets that formerly belonged to the Japanese. These vested properties—which included
3,551 operating plants and firms, land, infrastructure, and inventories and which accounted for approximately 30 percent of the nation's total wealth—were first entrusted to the American Office of the Property Custodian (AOPC) and were later distributed to Koreans. Of the industrial assets, 513 items were distributed by the AOPC; the remaining properties were passed over to the Rhee government in August 1948. The distribution of the vested properties was continued until 1957.

In the distribution process, the price was set at the pre-1945 book value, which was substantially lower than the real value, and the bulk of the items was distributed at an even lower price than the book value. Though these inherited industrial assets were poorly managed and many were destroyed during the Korean War, those who acquired these vested properties at bargain prices gained a windfall profit from this transfer of resources by the government. In addition to the low sale price, the sale of vested properties was accompanied by a number of preferential conditions, such as generous terms of payment with a long grace period and cheap bank loans, allocation of licenses to import raw materials and spare parts, allocation of scarce foreign exchange at the official rate which was unrealistically low, and protection of monopoly positions. Especially during the hyperinflation and supply shortage in the early 1950s, ownership of such industrial assets greatly contributed to accumulation of wealth.

Moreover, as of 1958, when the sales of the vested properties were completed, 37.7 percent of the outstanding loans were not repaid according to schedule. Though the above example may be an extreme case, the acquisition of vested properties obviously helped a number of private entrepreneurs become chaebol in later years. With regard to how those properties were allocated, it has been widely believed that the sales process was not open and thus became non-competitive. According to this view, those who had personal connections with high-ranking politicians and government officials or who had formerly been related to the properties by employment, kinship, or business were at a great advantage in the allocation process, and many of the new owners of the vested properties provided political funds for Rhee's party throughout the 1950s.

However, there is a different perspective. In this contrasting view, to define those who acquired the vested properties as "political capitalists" associated with corruption is an inadequate, oversimplified bias. According to proponents of this view, the government did not have a choice because (1) the markets were either non-existent or extremely inefficient; (2) there were very few proven entrepreneurs; (3)
the government lacked administrative experience; and (4) information was not readily available. Yet the government had to have some people run the industrial assets for the national economy. Whoever took over the vested properties would benefit from the same incentive system of the government and other environmental conditions such as high inflation. However, our view is a general one and does not necessarily exclude a possible political influence in the process.

**License of Import Trading**

For a few years following liberation, domestic industrial production dropped dramatically in Korea, and many of Korea’s channels of international trade in the colonial period were disrupted. Consequently, high inflation and a severe supply shortage prevailed for a large number of products. The wholesale price index was estimated to have increased fortyfold between June and August of 1945 and to have quadrupled again from then until the end of 1946. These new market deficiencies—severe imbalances of demand and supply—created lucrative opportunities for entrepreneurs. The immediate entrepreneurial response was trading. As private barter trading after liberation increased, the U.S. military authority instituted a system of administering restrictions in 1946 by establishing a tariff and by licensing imports and exports.

Though a license was required for import, the licensing system was remarkably simple and standardized. The U.S. authorities designated a list of items eligible for import, and no restrictions were imposed on the quantity of imports. The issue of import licenses was automatic as long as the items were eligible. Anyone was issued a license upon application, and there were 528 licensed Korean traders in 1946. With a sudden rise of trading volume in the late 1940s, some traders who were active early on were able to make a fortune. Someone has, in fact, noted that trading was an entry ticket to the chaebol world in the late 1940s. All the wealthiest businessmen were engaged in trading, and almost all the large chaebol in the following periods acquired business training in trading in this short period. After the foundation of the First Republic in 1948, the hyperinflation and excess demand continued, and the government instituted various measures to restrict imports. In 1949, the previous system of a 10 percent across-the-board tariff was replaced by a discriminating tariff system, whose average tariff was estimated to be 40 percent. This change was instituted to raise revenue for the government and to give increased protection to domestic industry. The tariff rate ranged from zero (i.e., duty free) for
food grains, capital goods, and raw materials, to over 100 percent for luxury items.

In the same year, the old licensing system was replaced with a new one that lasted until the end of the First Republic. Under the new system, import programs were to be announced indicating both the eligible items and the quantity of imports. These tariff and licensing systems became more complex over time. Furthermore, the government consistently kept domestic currency overvalued and relied only on quantitative measures to restrict imports. The overvaluation of domestic currency meant that acquisition of foreign exchange at the official rate was extremely profitable if used to finance imports. Thus, import continued to be a highly profitable business, while export was discouraged. With import trading being an extremely profitable business throughout the 1950s, 9 out of the 10 largest chaebol as of 1961 were actively engaged in import trading. Since import licenses and the necessary foreign exchange were allocated by the government, acquisition of import licenses and foreign exchange was critical for chaebol accumulation. Frequently it was indicated that political influence was an important, though not always required, factor in the acquisition of import licenses and foreign exchange.

 Allocation of Aid Funds and Materials

Since the volume of Korean exports was small in the 1950s, the source of foreign exchange necessary for import was easily supplied by the inflow of aid from the United States and the United Nations, foreign exchange earned by sales to the United Nations Armed Forces, and a small amount of foreign exchange earned from the national export of a few items such as tungsten. Of these sources, the inflow of foreign aid accounted for the largest portion, and the acquisition of these aid dollars became a critical element in chaebol accumulation throughout the 1950s. In addition to the attractive import trading, acquisition of foreign aid, whether in the form of dollars or raw materials, was an important factor in building a domestic industrial base and becoming a chaebol. For example, once foreign aid was allocated, the beneficiaries could build plants with only 15–25 percent of their own capital. This capital could be financed by government-arranged, long-term, low-interest bank loans similar to those associated with the sales of the vested properties described earlier.

In the context of hyperinflation and overvalued domestic currency, investments of this kind, which were often supported by the govern-
ment's recognition of a monopoly position, easily became a critical element in chaebol accumulation. Many chaebol were later accused, during the investigation of the Illicit Wealth Accumulation in 1961, of having illegally taken advantage of the government allocation of aid dollars and the overvalued domestic currency. They overdrew foreign exchange at an official rate that was much lower than the market rate by reporting prices of imports higher than the actual price and by funneling the extra foreign exchange into illegal importing or the local black market. As in the case of the sales of the vested properties, there are two contrasting viewpoints concerning the process of government allocation of the aid funds and materials.

**Preferential Access to Bank Loans**

Under the high inflation and low-interest-rate policy of the First Republic, there was a continuous shortage of financial supply, and anyone who acquired a bank loan could take advantage of the negative real interest rate. Since access to bank loans was interconnected with other factors—such as the acquisition of vested properties and allocation of aid funds and materials—the real individual contribution of preferential access to cheap bank loans is hard to identify with precision. However, a number of examples indicate that chaebol enjoyed preferential treatment in acquiring bank loans and that preferential allocation of domestic credit by the government to chaebol was intimately related to the political contribution of a chaebol. In the 1950s, the government did not have large financial resources nor much freedom in the allocation of credit to the private sector against which the regime would get kickbacks for political funds.

For example, foreign aid was limited in the amount and its use was restricted, and the issue of treasury bonds had to be approved by the national assembly. The governor of the Korea Development Bank (KDB) proposed the brilliant idea of the so-called link fund that could solve the regime's problem by circumventing the regulations. The basic idea was as follows. First the Ministry of Finance determines the priority in the allocation of industrial credit according to macro planning. For those projects, the KDB provides payment guarantees to the Bank of Korea (BOK). From the KDB's account at the BOK, commercial banks borrow funds at the rediscount rate of the BOK and then deposit the funds in their accounts at the KDB. With these funds, the KDB allocates credit to the private sector. These link funds were reported to have been allocated to pro-government chaebol, among which the Taechang chaebol was estimated to have benefited the most.
The preferential treatment for chaebol in the allocation of industrial credit was at its peak in 1956, when the government began to privatize the formerly government-held commercial banks.

In 1954, the government enacted the Commercial Bank Act and put up the government's share of bank stocks for auction. The prime motive of the regime was believed to be its need for political funding by supporting a few selected chaebol and establishing them as its financial support base. The commercial banks under government ownership could not be used as a long-term source of political funds because their accounting had to be audited by the national assembly and there was constant monitoring by other groups such as the mass media. However, if the commercial banks were turned over to private ownership, with which the regime could easily make a deal, they could become a stable, indirect, and safe source of political funds. The bank shares were not sold until the seventh round of auction in 1956. Eventually, in the seventh round, the shares were distributed to a few chaebol who were politically selected, regardless of their bidding price. As a result, Samsung acquired half of all the commercial bank shares even though its bidding price was the third highest, and Samho and several other chaebol became major owners of the commercial banks.

A typical example, which synthesizes the above sources of chaebol accumulation, is the growth of the textile industry during this period. A variety of state resources helped foster concentration in the industry, which was the leading sector of postcolonial industrial growth. The constitution of the Republic armed the state with extraordinary legal powers to intervene in private firms. The Rhee state intervened in the market with production, tax, and trade controls to promote local industries and protect against foreign competition. State controls on trade assured access to raw cotton for the licensed importers while restraining foreign competitors. In addition to legal controls, the Rhee state also commanded extensive material resources of technology, capital, and even raw materials. Much of the manufacturing sector in Korea in 1945, formerly owned by Japanese, was "vested" in the government of the First Republic for eventual transfer to private ownership.

Among the most important assets were the former Japanese textile plants, which were temporarily maintained as large state firms and later sold off to private interests. The very scale of the plants in Korea's primitive industrial structure after the war gave these properties a salient role in production in the growing textile market on the peninsula. The result was a small number of very large textile firms by the mid-1950s. While transferring this technological base to the private sector, the state also fostered concentration in textile manufac-
turing through access to local credit and foreign aid. Following liberation in 1945, the state invested in maintaining the machinery of earlier Japanese firms while temporarily operating the plants under state protection; following the Korean War, the state helped fund reconstruction. Direct foreign aid represented a further source of support for textile manufacturers. State-controlled access to American foreign currency coupled with official exchange rates far below the actual market value of U.S. dollars provided a further source for external financing. The Rhee state commanded an extensive legal, technological, and capital base for fostering concentration in the First Republic.

Postwar development of Samsung’s Cheil Wool and Cheil Sugar, Sung-Gon Kim’s Keumsung Textile, and the subsequent Ssangyong chaebol provide ample evidence of concentration of ownership and control and of close state ties. We see the influence of the earlier patterns not only in the new chaebol, but also in persisting organizations of the colonial entrepreneurs. How did the dependent capitalists of the colonial years respond to both the indigenous state and new market opportunities? Trade and light industrial production in sugar, flour, and textiles drew off the lion’s share of native investment capital through 1960. Major private entrepreneurs recognized at the same time the need for effective ties with the government to ensure necessary authorizations and access to credit funding and foreign currency. Yon-Su Kim and Hung-Sik Park were among those developing trade and consumer industries with help from the Rhee administration and foreign aid through 1960.

The colonial experience of business management and investment and a base of capital would permit a few of the earlier elite such as Kim and Park to take advantage of new market situations in competition with a larger group of local entrepreneurs. If they had learned of enterprise, they had also learned much of state relations. They had survived and prospered under an alien regime; they now found ways to adjust to the ambitions, controls, and ambiguous economic direction of the Rhee state. The double challenge of nationalism and capitalism continued. Yon-Su Kim and Hung-Sik Park were charged and jailed in 1948 for “anti-nationalist crimes” during the colonial period, and the firms of both men were prosecuted again in 1961. Although both gained acquittal in the earlier trials and although other less-prominent colonial period entrepreneurs were never brought to trial, the groups could hardly dominate the political direction of the Rhee administration in such an atmosphere.

The Samyang chaebol fared better than Hwasin in the transition after 1945. Although division from the north and from Manchuria, to-
gether with land reform policies in the south after liberation, deprived Yon-Su Kim of much of his agricultural investment, he was able to reinvest in sugar refining and a trading company after the war. Kim's efforts to redirect resources toward sugar manufacture reveal much about the new pattern of constraints and opportunities evident in the First Republic. The sugar company quickly gained a large share of the domestic sugar market. And if Kyungsung Spinning had prospered in the colonial period under the direction of Yon-Su Kim and his Samyang chaebol, reconstruction aid and further foreign aid permitted recovery following the Korean War. Kim relinquished the presidency of the textile venture in December 1945 to his brother-in-law, Yong-Wan Kim, while maintaining family investment in the firm through the late years of the First Republic. Renamed Kyungbang after liberation, the firm quickly reemerged as a leading textile producer, responsible for 8 percent of the nation's spindles in 1958.

Hung-Sik Park had reorganized his earlier trading venture into Hwasin Trade in December of 1946 with a capital of 40 million won under the direction of his nephew, Pyong-Gyo Park. With the severing of links with China from late 1946, Hwasin redirected exports of ginseng, vegetable gelatin, and marine products to Hong Kong and Macao, opening a branch office in Hong Kong in February 1948. The trading company was integrated into the larger holding company, Hwasin Industrial, in January 1950 with a capital of 300 million won. Park also gained control of the Inchon plant of the Teikoku Hemp Spinning Company, a vested enterprise, and established the Heung Han Spinning Company in 1953, an investment in light industry, to balance his commercial investments.

A review of the postcolonial enterprises of Kim and Park highlights two characteristics of business-state relations. The continuity with their formative entrepreneurial experience under the Japanese colonial administration was evident in their organizational patterns of large family-owned companies, managed by family members and close associates. There was continuity in their reliance on state support for credit funding as well, and on state authorization for access to foreign technology and expertise. One can also point to their experience in international trade and to adjustments to transportation and finance difficulties in developing new areas for exports and imports. Their adaptation to a new political situation in the Rhee state further distinguished business-state ties. It is interesting to note how quickly the Rhee administration and private enterprise found ways to cooperate once mutual dependence became apparent. Accustomed to dealing with the strong colonial state, leading private entrepreneurs from the
colonial period adjusted to the Rhee interlude of a "weak state" direction and "strong state" economic ambitions.

One scholar had emphasized institutional continuities from the colonial years, but McNamara (1990) points to other factors promoting concentration in ownership and management and to close state ties evident in postwar chaebol development. For instance, the postwar state did not set about breaking up the assets of earlier chaebol or discouraging other forms of concentration. Indeed, the record of distribution of vested properties would suggest just the opposite. Whether by design or default, the Rhee state fostered concentration in the textile industry by maintaining the earlier Japanese properties. If we look to private enterprise, collusion with bureaucratic officials to gain licenses and credit, domestic market insecurities, and the availability of large amounts of capital and raw materials through foreign aid certainly did not discourage concentration.

Kim (1987) argues that during this period, the chaebol sector in general underwent the stage of formation: i.e., a few family-owned businesses took widening steps, but there were few large-scale deepenings. The deepening of the largest magnitude during this period took place only in the so-called three white industries—sugar and flour, textiles, and cement—although their scale of deepening was much smaller than that during the next decades in other industries such as heavy and chemical industries. A few chaebol entered the stage of consolidation as a result of their deepenings in the three white industries. For example, Samsung's deepenings in sugar and woolen textiles made possible 10 widening steps; Samho's deepening in cotton spinning made it a top-class chaebol and enabled five widenings, which continued until the end of the 1950s.10

Although no chaebol made a widening step into the industries characterized by large economies of scale until the end of the 1950s a few chaebol had become dominant players in the national economy. Table 2.2 shows the year of establishment, number of member companies, and major business areas of the largest chaebol in 1960 i.e., at the end of the Rhee government. Although only six of the 14 largest chaebol got their start during the colonial period, most chaebol having the characteristics of a business group were formed during the Rhee government. The average number of member companies was 5.1, and the major business fields engaged in were import trading, banking, and the three white industries.
### Table 2.2 Largest Chaebol in 1960

<table>
<thead>
<tr>
<th>Chaebol</th>
<th>Year est.</th>
<th>Member companies</th>
<th>Major business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Samsung</td>
<td>1938</td>
<td>13</td>
<td>Import trading, food, textiles, banking</td>
</tr>
<tr>
<td>Samho</td>
<td>1950</td>
<td>7</td>
<td>Import trading, textiles, banking</td>
</tr>
<tr>
<td>Kaepoong</td>
<td>1949</td>
<td>9</td>
<td>Import trading, cement, banking</td>
</tr>
<tr>
<td>Taehan</td>
<td>1946</td>
<td>5</td>
<td>Import trading, food, textiles</td>
</tr>
<tr>
<td>Lucky</td>
<td>1931</td>
<td>4</td>
<td>Import trading, consumer chemical</td>
</tr>
<tr>
<td>Tongyang</td>
<td>1956</td>
<td>4</td>
<td>cement, food</td>
</tr>
<tr>
<td>Keukdong</td>
<td>1947</td>
<td>4</td>
<td>Import trading, shipping</td>
</tr>
<tr>
<td>Korea Glass</td>
<td>1954</td>
<td>2</td>
<td>Import trading, glass</td>
</tr>
<tr>
<td>Dongrip</td>
<td>1949</td>
<td>2</td>
<td>Food</td>
</tr>
<tr>
<td>Taechang</td>
<td>1916</td>
<td>2</td>
<td>Import trading, textiles</td>
</tr>
<tr>
<td>Samyang</td>
<td>1921</td>
<td>9</td>
<td>Import trading, textiles, food, mass media</td>
</tr>
<tr>
<td>Hwashin</td>
<td>1931</td>
<td>5</td>
<td>Import trading, department store</td>
</tr>
<tr>
<td>Hyundai</td>
<td>1947</td>
<td>3</td>
<td>Construction, cement</td>
</tr>
<tr>
<td>Ssangyong</td>
<td>1939</td>
<td>2</td>
<td>Textile, cement</td>
</tr>
</tbody>
</table>

Notes

1. The term "fiduciary atmosphere" was originally used by Strachan (1976).
2. There are exceptions to this definition among today's largest chaebol. Several chaebol are operated completely by professional managers instead of closed kinship. A typical example is the Kia group which is a famous automobile-specialized group in Korea.
3. This section is partly summarized from McNamara (1990).
4. This section is partly summarized from Kim (1987) and McNamara (1990).
5. Byung-Chul Lee of Samsung was the most prominent of the postcolonial business leaders. He was instrumental in the founding of the Federation of Korean Industries in 1961, which provided an institutional base for the major business leaders.
6. This view has been generally held by the majority of Korean people, especially in the academic and journalistic world. However, there is a contrasting view as to the political concern with economics during the Rhee period.
7. A typical example is the case of the sale of the Chosun Spinning Taegu Plant to Kyung-Dong Sul, who later became the owner of the Taihan chaebol. The market price of the plant was said to be in excess of 3 billion won in 1947, but the government appraised price was only 700 million won. The plant was eventually sold at 360 million won, or 51 percent of the appraised price, and the payment was arranged to be made on an installment basis over 15 years financed by low-interest bank loans. By 1962, 15 years later, the wholesale price index increased 193 times making the sale a gift with a premium.
8. A generally accepted reason for this is that the politically selected chaebol's bidding price was not the highest.
9. The following nine firms each operated at least 30,000 spinning machines: Taechang, Keumsung, Chunnam, Taehan, Chosun, Kyungbang, Tongyang, Samho, and Taechun (Korean Textile Association 1960).
10. A few observers believed that Samho had been as big as Samsung and that more elite college graduates had aspired to join Samho than Samsung.
CHAPTER 3

THE GROWTH PATH

Growth of business groups has involved continuous repetition of a "deepening" process and a "widening" process. "Deepening" refers to the movement toward the point of operation on the production function that is determined by technology and the scale of operation. The process also involves expanding the current production function through reinvestment. "Widening" is a business group's expansion into additional—both related and unrelated—businesses. More specifically, widening refers to diversification—i.e., creation of new business line(s)—and/or expansion of existing business(es). Successful business groups were those that could sustain this continuous process of deepening and widening. Whereas the formation stage is a period from the establishment of the initial enterprise to the completion of one cycle of the deepening and widening processes, the growth stage includes the consolidation, expansion, and mature stages.

Kim (1987) defines the consolidation stage as the period from the end of the formation stage to the point when the first widening step is taken in large-scale and/or fast-growing industries. The expansion stage is a period from the point when large-scale deepening takes place to the time when the frequency of further widening processes becomes substantially low. In the consolidation and expansion stages, there may be a number of deepenings and widenings. The mature stage is a period when the growth of a business group is primarily sustained by deepenings and frequency of widening is significantly lower than in the previous stage. The key to a Korean business group's growth was first widening into those industries that later enabled large-scale deepening. In order to take such a widening step, a business group in Korea had to acquire a license to invest from the government and financial resources of large magnitude. Therefore, in addition to a business group's entrepreneurial decision to take such widening and deepening steps, the government allocation of licenses to invest and industrial credit were the most critical factors in a business group's growth and life cycle.
Although most of today’s largest *chaebol* were established before the Park government—which pursued rapid economic growth with the series of Five-Year Economic Development Plans—the real growth of the *chaebol* is much indebted to the aggressive government policy of the 1960s and 1970s. Therefore, while the formation stage begins from 1945—the year of liberation from Japanese occupation—we use the year 1961, when General Park took power by a military coup, as the starting point of the growth stage.

Following the definition of Kim (1987), the growth stage is divided into three periods: the consolidation period, the expansion period, and the mature period. The consolidation period refers to the 1960s, which was a period of high, sustained economic growth, strong political commitment to development, effective and extensive intervention by the government, and a turnaround from an inward-looking to an outward-looking strategy. The expansion period refers to the 1970s, when the growth of the *chaebol* as well as economic growth accelerated. Although the basic attitude of the government toward economics remained largely unchanged, this was a period of even stronger political commitment to economic growth, the complete establishment of an outward-looking strategy, and the transformation of the economic structure from labor-intensive light industry to capital-intensive heavy and chemical industry. The mature period refers to the 1980s, when economic growth slowed. The Chun government aimed for stable growth, reduced government intervention and placed greater reliance on the market mechanism, and increased regulation of the *chaebol*. While the extensive growth of the *chaebol* continued, the growth was largely based on the deepening of the *chaebol* structure.

**The Consolidation Period**

Korea’s sustained rapid economic growth began shortly after the establishment of a government headed by Chung-Hee Park, who took power by a military coup in May 1961. Through the First and Second Five-Year Economic Development Plans (FYEDP), the Korean economy grew twice as fast as it did during the previous post-Korean War (Rhee) period. During this impressive growth period, a number of *chaebol* grew much faster than the national economy. The role of the government during the rapid growth of the *chaebol* was significant, which was very different from its role during the previous period. Certain characteristics of the markets and the government heavily influenced the government’s economic policy, the basic patterns of
the government-chaebol relationship, and the chaebol accumulation process.

First, the overall markets, though slightly improved during the previous period, were still underdeveloped in the early 1960s. For example, Korea had one of the lowest income levels in the world, poor social and economic infrastructure, a small number of proven entrepreneurs and managers, a great information asymmetry, and a low level of domestic savings and technology. Second, the political orientation of the Park regime toward economics was totally different from that of Rhee’s. Economic development was at the top of the regime’s value hierarchy. Park’s goal was fast, visible quantitative growth, and the consistent economic strategy of the government throughout the Park period was rapid outward-looking industrialization. Third, to achieve its goal the government intervened extensively in economic affairs. For effective government intervention, Park created and relied on a strong and centralized bureaucracy. Fourth, from the inception of the regime, the government regarded the private sector as the primary engine of growth and maintained a cooperative relationship with the private sector, especially with chaebol. In this relationship, however, the government consistently dominated the private sector.

During the 1960s, the Korean economy achieved an unprecedented rate of quantitative growth. In this process, many chaebol benefited from the government’s allocation of resources and opportunities to the private sector. However, the allocation of this period was different from that of the Rhee period in three ways. Whereas during the Rhee period it was dominantly a transfer of resources (e.g., vested properties and aid materials) that could directly and readily contribute to the chaebol accumulation, during the Park period the transfer of opportunities (e.g., license to invest), which had to be combined with entrepreneurial and managerial efforts to contribute to chaebol growth, became more important. Another difference was that, although political favoritism did remain in the Park period, the allocation process was often influenced by a body of technocrats in the bureaucracy and was, thus, more competitive than during the Rhee period. Finally, unlike the Rhee government, the Park government monitored and controlled closely the activities of the private sector, especially the chaebol, to ensure that the resources and opportunities allocated by the government would be used productively to contribute to the country’s growth and export promotion. In controlling the private sector, the Park government used discretionary power and various combinations of incentive systems and command.²

Except for a short period at the beginning of the Park government
when the government purged the chaebol sector, the government and the chaebol sector maintained a close and cooperative relationship in which the main function of the government was supportive. As the economy became larger and more complex and as the chaebol sector grew, the regulating function of the government also increased. In general, the decision-making process of the Park government for chaebol-related issues was characterized by high centralization, high complexity, and low standardization. During the 1960s, the chaebol sector in general underwent a consolidation stage: i.e., a few family-owned chaebol took widening steps into industries characterized by large economies of scale such as oil refining, electronics, and automobile manufacturing. By the end of the period, chaebol had become dominant players in the national economy, especially in the industries designated by the government for intensive development.

During this period of rapid growth and extensive government intervention, the government affected the chaebol sector, both directly and indirectly, through various policies and measures. Among them, the most important were the allocation of investment licenses and industrial credit, especially those that were of large scale. Often these two factors were closely related. For example, an entrepreneur who had already acquired a license to invest in a project specified in the FYEDP was at a great advantage in acquiring credit allocation by the government. Similarly, an applicant who had already arranged a loan from a foreign lender could acquire a license to invest and the government’s payment guarantee more easily than could applicants without financing arrangements.

At this point, a brief background description is necessary to understand why certain policies and measures of the government resulted in chaebol accumulation and why certain people were able to appropriate the opportunities in a concentrated way while others could not. The answer can be found by understanding both the government and the private sector. In the government sector, three factors—the regime’s political goal, its growth strategy, and Park’s personal motivation and personality—led the government to concentrate its support to a few entrepreneurs. In manufacturing, maximization of economies of scale was a key to success. With limited resources available, the government concentrated its resources in a few large projects rather than in many small projects. Concentration had two other benefits: (1) government control could be more effective and flexible, because the political cost of failure was too large; and (2) new, shiny, modern plants of large scale could be used as a political symbol of success by the new government.
In the private sector, only a small number of entrepreneurs had demonstrated their talent during the previous period, and they stood out in a small and evenly poor market. However, by the early 1960s, virtually all the proven entrepreneurs were criminally prosecuted for their illicit accumulation of wealth during the Rhee period. Then there was a dramatic turnaround in the relationship between the proven entrepreneurs and the regime that led to a happy marriage throughout the Park period. In the meetings with General Park, Byung-Chul Lee, the founder and chairman of the Samsung chaebol, proposed that the accused businessmen be given an opportunity to build factories and donate their share to the state instead of being subjected to real punishment.

A few weeks later, Lee's proposal was accepted by the regime and implemented in the form of the "Investment Law." The criminal sanction was removed, and most of the formerly accused entrepreneurs were given opportunities to participate in the major projects specified in the FYEDP. In August 1961 these entrepreneurs formed the Korea Businessmen's Association, which became an influential interest group. The members also traveled abroad to solicit the foreign capital necessary to finance the projects. The association evolved into the Federation of Korean Industries (FKI) in 1968 and has gained influence ever since in the Korean economic scene.

The Park government's successful effort to investigate and prosecute collusion in government-business relations of the previous administration was an early sign of the "strong state" policies that would characterize the disciplined economic direction of the administration through 1979. Effective government controls on access to foreign technology, foreign markets, and especially on credit financing would serve as a pattern of opportunities and constraints for the private sector. But if the private sector would need government support, so also would the government need the private sector, as indicated by the resolution in 1961 of directed investment rather than simply fines and lengthy prison sentences. The Park government needed the base of private enterprise for economic development on the peninsula. The Rhee administration came to recognize the private sector as a source for political funding and leadership in trade and light industry. The emphasis of the Park government on economic growth gave the major chaebol an even greater role in the national economy, though under careful government supervision.

In the consolidation stage of chaebol, the primary source of chaebol growth was the transfer of resources and opportunities by government in a usually non-competitive process. What were the resources
and opportunities, and how did these factors operate to favor chaebol growth? During the 1960s, much of the economic growth came from new investments under government planning rather than from increased productivity in existing establishments. The government intervened extensively in private investment activities by allocating licenses to invest. Government intervention of this type often created protected positions for certain players; such intervention was, at the same time, a major barrier to entry for others. Virtually all of the largest chaebol during this period benefited greatly from the exclusive investment licenses allocated by the government.

Government approval was widely required in making an investment, from a start-up to a change in an existing business such as capacity expansion. The underlying rationale was that unregulated competition in a small market is undesirable both economically and politically. However, the result was different from the original intention of the government, and, in fact, the chaebol sector expanded enormously. Many of the major investment licenses were allocated to the largest chaebol, or a few other smaller chaebol could become much larger by taking advantage of the exclusive investment licenses granted to them by the government. How did such an allocation happen? The government's decisions on allocating investment licenses were made in different ways according to the nature of each license. For example, a decision on who was to build a fifty-million-dollar oil refining plant was made at the top of the regime that had the discretionary power, whereas a decision on who was to run a small local grocery store was made at a low level of the bureaucracy according to a fairly standardized procedure.

It is clear that there were at least two necessary conditions to acquire a major investment license. One condition was the objective qualification as specified in the guidelines. The other was access to the final decision making body. The condition of the objective qualification of the applicant was in fact not always completely objective: first, the qualifications were hardly stated in a quantitative form; second, the measurement and determination of qualification depended largely on the discretionary power; and finally, the applicant's track record and current financial status were the most important factors in determining qualification. The result was highly restricted competition among a few that already had sizable operations and connections to the bureaucracy. In addition, most bureaucrats are extremely risk averse and their psychology is highly stereotyped. For them, less well known small players appear risky regardless of their actual business capability. Consequently, the bureaucratic connection was costly and the bureaucratic barriers to entry were self-reinforcing for non-chaebol.
In terms of the second condition, political connection is generally much less accessible than bureaucratic connection. It takes a lot of time, effort, and sometimes luck to establish a trust- and loyalty-based relationship with political leaders. Though Park expanded the size of the bureaucracy, his effort to purify it created a tendency in bureaucrats to avoid decision making and responsibility. As a result, key decisions were usually passed to the top of the regime. Park himself was well informed, even on many operational matters, and he was a military man who was ready to make decisions quickly. The detailed patterns of interaction between the regime and the private sector were diverse. However, the ramification was clear. Political connection was a very important factor in the process of allocating major investment licenses and was a key factor in chaebol growth throughout the Park period.

The other source for chaebol growth is credit allocation, which is an important resource for corporate survival and expansion. This was particularly true for Korean firms, especially chaebol, during the 1960s. Two points on the Korean financial market serve as a general background for understanding the effects of government's allocation of credit on chaebol accumulation. First, Korean firms were highly dependent on external borrowing, and the dependence increased rapidly during this period of rapid economic expansion. The average debt-equity ratio of the manufacturing sector rose from 1.36 in 1961 to 3.94 in 1971. In other words, the rapid expansion of the corporate sector was largely financed by debt rather than by internal savings or new equity.

Second, government intervened extensively in the allocation of credit, both domestic and international, by controlling the price and quantity of financial resources. The interest rate for bank loans was set by the government, and the government controlled all the banks' decision making on credit allocation through its ownership and power to appoint top management of the banks. All international borrowings were subject to government screening, approval, and payment guarantee. The interest rates in this government-regulated financial market were substantially lower than the rates applied to the unregulated financial market, and sometimes the official interest rate was even negative in real terms. Therefore, during this period of rapid economic growth and the dual structure of the financial market, cheap finance was a critical element in the corporate growth process, and the most dominant sources of cheap finance were bank loans and international borrowings, both of which were strictly controlled by the government.

During this period, there was a rapid expansion of the domestic
construction market, which was one source of chaebol growth. Since the private sector was still small in the early 1960s, the expansion was largely supported by the government’s efforts to develop basic industries and infrastructure, such as highways and harbors. In the allocation of government projects, the government set a rule of a so-called bidding limit. The bidding limit was set by the Ministry of Construction according to a complex mathematical formula in which the variables represented such factors as each firm’s financial status and contract amount in the previous year. Only firms having a bidding limit greater than the size of the project were allowed to participate in the bidding. Thus, to win a big project, the company had to be big enough to bid, and as a result, it was much easier for already big companies to become even bigger. In effect, the bidding limit set by the government worked as a critical barrier to entry.

Leading construction companies also began to explore overseas construction markets. The bidding limit became even more critical in the overseas expansion of a construction firm, because the government required every firm wishing to enter overseas bidding to acquire the government’s approval and guarantee. Because overseas construction contributed to Korea’s foreign exchange earnings, the government issued approvals and payment guarantees almost automatically to the applicant as long as its bidding limit was above the contract volume. Upon approval, the government (through banks) issued a payment guarantee—where the Korean government would take the responsibility for loss incurred in case of default—to foreign customers. Although the original intention of the government was to ensure the credit of Korean companies, the bidding limit was a critical barrier to entry for domestic firms.

Beginning in the mid-1960s, the Korean government had privatized a number of state-owned enterprises (SOEs). Those SOEs were all monopolies and were perceived as extremely attractive by the chaebol. Chaebol were in a much more advantageous position than small non-chaebol firms in acquiring such properties from the government for the same reasons given for the government’s allocation of investment licenses and credit. The competition was intense, but it was only among a few chaebol. It was reported that a political connection had a strong influence in the sales process. Although not all acquisitions of the SOEs turned out to be successful for chaebol growth, many favorable conditions were attached to the sales agreement, such as unusually long and cheap bank loans, converting outstanding bank loans into equity, and protection of monopoly.

Although the government was not directly responsible, a few other
dominant sources of chaebol growth are worth describing. In Korea, land is a very precious commodity, and its price has increased dramatically over the last three decades. Real estate was an important element in the chaebol's asset portfolio. In addition, the real estate market in Korea was heavily influenced by the government. For example, the government's announcement that a highway or government buildings would be constructed in a certain area raised the land price of the specific area by usually more than 10 times overnight. With the chaebols' superior resource base and information power, they could, and did, take advantage of the rapidly increasing real estate prices. Real estate could also be used as collateral for bank loans. In many cases, a chaebol's decision to build factories was more influenced by the prospective land price hike rather than by efforts to optimize production.³

The other interesting source of chaebol growth was the so-called Vietnam War boom in Korea. A number of Korean firms took advantage of the boom. The most successful case was Hanjin, which monopolized the ground and marine transportation between Korea and Vietnam and also took a significant share in the same business for the U.S. troops. A few years later, Hanjin purchased the Korean Air Lines from the government and became a major chaebol. Although the degree was different, many other firms, especially construction firms, captured a considerable amount of business that was generated by the war and Korean participation. As Korea's trade volume—and, more important, the chaebol's own volume of trade—grew rapidly, many chaebol established their own transportation and warehousing companies following the Hanjin chaebol.

The Expansion Period

During the 1970s Korea's government and leading industrialists were very proud to build a number of the world's largest plants, including shoe-manufacturing factories, shipyards, and plywood factories. The government encouraged projects of large scale by planning them and subsidizing them financially. The private sector competed intensely to participate in the large-scale projects planned by the government. The result was impressive growth of the large-firm sector—especially the chaebol sector—leaving the small-firm sector virtually unaffected in the fast-growing economy. The chaebol sector realized unprecedented expansion, but it also gained a few disgraceful nicknames. Chaebol were often described as "octopus legs," "dinosaurs
with huge appetites,“ and “department store-style corporations.” Octopus legs with strong suction cups and dinosaurs with devouring appetites were employed as images of the phenomenal growth of chaebol through mergers and acquisitions; and their diversified structure—having many business lines, from retailing to world-class shipbuilding—was often compared to that of a department store.

During this period, the characteristics of the government as described in the previous decade continued, although the overall market conditions improved with the rapid growth of the national economy. In addition to these characteristics, certain characteristics of the government and the environment heavily influenced the government’s economic policy, the basic patterns of the government-chaebol relationship, and the process of chaebol accumulation. First, Park’s political motivation for economic growth was strengthened. In October 1972, Park declared a state emergency and amended the constitution to extend his presidency, causing deep political frustration among the people. To justify his extended regime, Park promised the nation accelerated economic growth with a growth target of “$10 billion export, $1,000 GNP per capita, and my-car possession by 1978.” Under the new constitution, Park held even more power in the government decision-making process than in the previous decade.

Second, whereas the previous decade had been a transformation period from an inward-looking to an outward-looking strategy, this period saw the outward-looking industrialization strategy completely established. From the outset of this period, the Park government put a special emphasis on the heavy and chemical industries and on export promotion. Under the slogans of “heavy and chemical industrialization” and “export industrialization of entire industries,” the Park government allocated enormous amounts of resources to the heavy and chemical industries and strengthened government support for exports. Consequently, Korean industry went through a significant structural change: the share of output of the heavy and chemical industries in total manufacturing grew from 39 percent in 1971 to 55 percent in 1979 and the share of exports in GNP increased from 16 percent in 1971 to 36 percent in 1979.

Third, Korea’s economic growth was accelerated (the average annual growth rate of GNP was 10.2 percent as compared to 8.8 percent during the previous decade), and the growth of the chaebol sector was even more accelerated. The estimated aggregate value-added of the 10 largest chaebol as a percentage of GNP grew from 4.7 percent in 1974 to 9.7 percent in 1979. Fourth, since much of the economic growth came from increased foreign trade and inflow of foreign in-
puts (especially capital), the Korean economy became more vulnerable to changes in the international environment. As a result, speedy and flexible control over the national economy became a critical concern to government decision makers. Finally, as the national economy grew rapidly in size and became more complex, the government began to realize a limitation in its capacity to support the economy extensively. Therefore, government support became selective and the government encouraged more private initiative.

Because the chaebol were viewed by the government decision makers as an even more attractive means to achieve the goal of accelerated growth in a rapidly changing environment, chaebol benefited from concentrated support from the government. In the process, chaebol benefited from both the content of the government policy (i.e., allocation of scarce opportunities and resources) and the process of the governmental decision making. Consequently, a few of the largest chaebol became integral elements—both economically and politically—of the national economy. During the 1970s, the chaebol sector as a whole went through the stage of expansion; i.e., the largest chaebol realized rapid growth through frequent widenings as well as from large-scale deepenings. The chaebol's high frequency of widening was made possible by the large-scale deepening resulting from their previous widening steps, as well as from the government's allocation of scarce resources and opportunities.

President Park's persistent desire to build heavy and chemical industries in Korea brought about a rapid expansion of the chaebol sector in the 1970s. From the outset, the Korean government formulated the heavy and chemical development plan selectively with a belief that either a monopoly or an oligopoly would be more desirable than a competitive structure because of the small size of the domestic market, the importance of economies of scale, and the huge capital requirements in these industries. Consequently, the government maintained a strict licensing system and designated participants. Excluding the steel industry in which the government had ownership and control, licenses to participate in the remaining five strategically selected heavy and chemical industries—i.e., non-ferrous metals, petrochemicals, general-type machineries, shipbuilding, and electronics—were given to a small number of chaebol that enjoyed either monopoly or dominant oligopoly status. The participants in the major industry groups designated as the heavy and chemical industries by the government were protected by the government not only from domestic competition, but also from imports. These participants were the largest users of policy loans; during the 1975–1979 period, approxi-
mately 70 percent of all policy loans went to the heavy and chemical industry sector.

Although the government-led development of the heavy and chemical industries transformed Korea's industrial structure significantly, there were criticisms of this strategy. First, the government-directed huge investment, preferential tax system, and protection from competition (both domestic and foreign) of these industries resulted in a serious distortion of resource allocation. Second, the government's plan for the heavy and chemical industries was made hastily and without sufficient consideration of Korea's comparative advantages. Third, Korea started with large-scale heavy industries that were, by nature, based on assembly and thus required a strong basis of component suppliers; however, Korea did not have such component suppliers domestically. Finally, in the latter half of the 1970s when energy price's were high and global demand was low because of the economic depression, Korea moved into energy- and capital-intensive industries; thus the poor performance of the heavy and chemical industries accelerated the depression of the domestic economy in the early 1980s. In fact, many of the ill-managed companies during the late 1970s and early 1980s were in the heavy and chemical industries, and the Korean government poured large amounts of financial resources into them to prevent them from going bankrupt.

As the chaebol became even larger during the 1970s, their competitive advantages in financial markets became greater. Their good track records and sheer magnitude became more attractive to the regime, which was under high pressure to show immediate growth in quantitative terms. With their strengthened corporate structures, especially their information, power, and connections to the high-level political and bureaucratic world, chaebol had a greater advantage over small non-chaebol firms in acquiring industrial credit. The largest chaebol possessed most of the licenses to participate in Korea's predesignated strategic projects of large scale for which the government allocated anywhere from 53 to 63 percent of the total domestic loans in the 1975-1979 period.

The same advantage existed in international borrowings, which had to be screened and approved by the government. International borrowings accounted for approximately 14.6 percent of total corporate funding in the 1970s. Under the financial environment described earlier, acquisition of international borrowing almost guaranteed a high profit. Although the foreign exchange market distortion was marginal, the real interest rate applied to international borrowings was negative and even lower than that of domestic bank loans during
most of this period. As international borrowings were an attractive source of wealth accumulation, there were frequent political scandals in this regard.

These characteristics had two implications. First, in the Korean financial market where there was always excess demand for industrial credit, anyone who could draw more money, whether from institutional lenders or private informal lenders, had an advantage over those who could not. Second, when the real interest rate for bank loans was usually negative, anyone who drew more credit from institutional lenders had a greater advantage than those who could not. The first implication is on the quantity of financial resources, and the second is on the price of the resource.

With respect to the quantity of financial resources that firms could mobilize, the largest chaebol relied more heavily on debt for growth than did average firms. The most important measure on the price of financial resources that was taken by the government during this period was the 8/3 decree of 1972, which replaced all the firms' high interest rate loans—both informal and formal—with cheaper ones with generous terms. The implications were clear: any firm with loans could benefit from the newly reduced interest rate structure, and those with more loans benefited more.

With a development boom in the Middle East following the first oil price hike in 1973–1974, penetration into the Middle Eastern construction markets became an important source of corporate expansion for many Korean firms. With the capability of completing construction projects at a very competitive price and in a timely manner, Korea became the sixth largest contractor, representing 6.6 percent of the market in the region in the 1975–1978 period. The chaebol took advantage of the booming construction markets in the Middle East; during the 1970s, 13.3 percent of the asset growth of the 10 largest chaebol was in construction. Since overseas construction had significantly positive effects on Korea's foreign exchange earnings, employment, and export promotion (most of the construction materials such as steel beams, cement, and other building materials were shipped from Korea), the Korean government provided the same type of subsidy for overseas construction as it did for exports.

At the same time, the Korean government intervened in a few important ways in the process of Korean firms' penetration into the Middle Eastern construction markets. First, any firm wishing to participate in bidding overseas had to possess an overseas construction license issued by the Korean government. The Korean government strictly controlled the issue of these licenses to prevent incapable firms
from participating in international bidding. Therefore there was usually a high barrier to entry in acquiring the license from the government. The overseas construction license was traded with a very high premium, and many chaebol who did not have a construction company or an overseas construction license took over—at high prices—many small-scale or financially troubled construction companies that possessed overseas construction licenses. Second, the bidding limit set by the Korean government for each registered construction company also applied to international biddings. Third, every overseas construction contract—even if a Korean firm won in the bidding abroad—had to be approved by the Korean Minister of Construction. Fourth, Korean law required every domestic firm to acquire financial guarantees from domestic banks to participate in international bidding. The law also required any Korean firm to acquire a payment guarantee from a domestic bank against any liability denominated in foreign currency. Since all domestic banks were owned and controlled by the government, the Korean government reserved the power to control all the domestic construction companies in foreign markets.

Under the above conditions, the most critical element in the chaebol expansion in overseas construction was the overseas construction license because all of the other requirements were relatively easy to acquire for chaebol that already had large resource bases, high-level contacts with the government, and the capability to increase the bidding limit. Except for Hyundai, the largest chaebol were latecomers, and therefore they needed the overseas construction license. The 1975–1979 period saw mergers among chaebol and acquisitions of small-sized construction companies possessing the license: more than fifty small and medium-sized construction companies were taken over by large firms, most of which were chaebol.

One of the most significant measures the Korean government took in the export drive was the creation of the General Trading Company (GTC), which was another source of chaebol growth. The GTC is a large-scale international trader whose products and markets are highly diversified. In an effort to make a breakthrough in the sluggish growth of national exports, the government created a few GTCs that would be internationally competitive by specializing in international trade and by being large and diversified enough to appropriate economies of scale and scope at a global level.

The Korean government issued GTC licenses to 13 companies. Among them, Koryo was a unique small-scale, state-owned enterprise that was to specialize in exporting the products of small and medium-sized companies only; the remaining 12 GTC licenses were
owned by the largest chaebol. The growth of the GTCs in terms of both gross revenue and exports was phenomenal. The eight largest GTCs in 1979, which were owned by eight of the top 10 chaebol, recorded a compound average growth rate in revenue of 68.6 percent, as compared to 55.5 percent for the 10 chaebol overall in the period 1976-1979. The share of the GTCs’ sales in the aggregate sales of the 10 chaebol also increased from 19.9 percent in 1976 to 25.4 percent in 1979. The impressive growth of the GTCs came primarily from exports. During the 1975-1979 period, the share of exports in the sales of the GTCs was between 87.8 percent and 90.6 percent. With the GTCs’ rapid growth of exports, their share of national exports also increased from 12.4 percent in 1975 to 31.5 percent in 1979.

The reorganization of ill-managed companies by the Korean government has been another source of chaebol growth. In the 1970s, some 62 ill-managed companies were run under government supervision. A major reorganization of these ill-managed companies did not take place until the early 1980s. During the 1970s, however, 17 of them were sold to other private firms. Among them, 13 companies were purchased by the top 10 chaebol. For the transfer of the ill-managed companies, the Korean government provided many favorable terms and conditions, such as turning the bank loans into equity, providing generous financing, and assuring preferential taxation. For example, Daewoo’s acquisition of the Korea Machinery Company, Shinjin Motors, and Okpo Shipyard became a critical turning point for Daewoo in establishing dominant positions in the general-type machinery, passenger automobile, and shipbuilding industries. (Korea Machinery Company became Daewoo Heavy Industry Company; Shinjin Motors became Daewoo Motors; and Okpo Shipyard became Daewoo Shipbuilding Company.) Hyundai’s acquisition of the Inchon Steel Company, was an important strategic entry into the steel industry, for which Hyundai had not been able to acquire an investment license from the government. Samsung’s acquisition of the Korea Engineering Company, was also made to enter into the booming overseas construction business.

After the nationalization of commercial banks in 1961, many chaebol began to take over non-bank financial institutions, such as insurance companies and security companies. Though these financial institutions were not a direct source of chaebol growth, they made a few significant contributions: they could facilitate mobilization and flows of funds; they could be used as an effective office to control the group structure with a number of subsidiaries; they could be used as a legal means to circumvent government regulations on taxation and stock
Origin and Growth of Chaebol

trading; and they could be used as an agent to manage the owner’s personal assets. During the 1972–1978 period, the 10 largest chaebol purchased or established 14 financial institutions and incorporated them into their group structure.

These financial institutions were valuable for the chaebol in several ways. First, the financial institutions could mobilize funds from external sources in a more efficient way than non-financial firms in the chaebol group. Second, they could facilitate the flows of funds within the chaebol structure. For example, short-term borrowing among non-financial member companies—which was prohibited by law—could be made possible by intermediation by the chaebol-owned financial institution, whose decision making was controlled by the chaebol for the interest of the chaebol as a whole rather than for the profit of the financial institution itself. Third, the financial institutions could be used for better internal management of the chaebol’s financial and ownership structure. For example, a security company owned by a chaebol could be used as an effective agent to take over other firms in the stock market and to manage the stocks (usually interlocking shareholding) of the member firms of the chaebol. Fourth, the financial institutions could be used to circumvent government regulations. For example, a chaebol-owned security company could perform the public offering of a member company’s stocks (public offering was strongly recommended by the government in many cases and sometimes mandatory—to acquire a license for a GTC, for example) without affecting the dominant shareholding position of the chaebol owner. It could also perform efficiently the transfer of chaebol stock to other family members in a legal way so that the minimum amount of tax was paid. It was difficult for these functions to be subcontracted out in Korea as the market for such kinds of transactions was extremely imperfect.6

Many chaebol also took advantage of the land price hike. As of the end of 1979, Samsung, Hyundai, and Ssangyong were the nation’s largest private owners of land: Samsung had 19.5 million pyungs (approximately 15,650 acres); Hyundai had 11.8 million pyungs (9,480 acres); and Ssangyong had 10.1 million pyungs (8,080 acres). The above figures do not include the land owned personally by the owners of the chaebol or their family members. The largest chaebol were also the owners of many buildings in urban areas. Most of the tallest and largest buildings in Seoul belonged to chaebol. The chaebol’s real estate investment took various forms: they bought much larger plots of land than necessary for plants; they were lavish in buying land to build recreational facilities for their employees; they were desperate to buy or build golf courses;7 and sometimes they built large-scale
farms. Each of the 10 largest chaebol had one or more companies specializing in real estate investment and management. Interestingly, however, many chaebol frequently purchased real estate with borrowed funds.

The Mature Period

In the 1980s, many Korean people strongly felt that the extent to which their national economy was dominated by a few chaebol owners was dangerous to the democracy they desired. They felt that the public had a right to information concerning the chaebol that only the government, which refused to do so, could reveal. Certain characteristics influenced the shaping of the government-chaebol relationship and the process of chaebol accumulation during this period. First, outward-looking industrialization continued to be the backbone of the new government’s economic strategy. This strategy was continuously challenged by increasing protectionism in export markets, Korea’s heavy external debt and debt service, the volatile interest and exchange rates and energy prices in the international market, and domestic political unrest.

Second, the consistent economic policy of the government during this period was balanced growth through stability. In this regard, the Chun government made a few important policy changes such as a greater reliance on the market mechanism through reduced government intervention and import liberalization; more attention to the small and medium-sized company sector; and reorganization of industry policy from the previous strategic industry-oriented policy to a project- or function-specific one. Korea’s economic growth was lower than during the previous decades—the GNP deflator decreased from 25.6 percent in 1980 to 3.6 percent in 1985—but Korea achieved lower inflation.

Third, throughout this period, the government maintained a policy of regulating the chaebol sector. The financial status and expansion (through merger and acquisition) of the largest chaebol, as well as their real estate investments, were closely supervised by the government. In addition, the government enacted the Fair Trade Acts, the first anti-trust legislation in Korean history. In general, the governmental decision-making process for regulation of the chaebol sector was characterized by relatively low centralization, high complexity, and high standardization. However, for certain types of the supporting and regulating functions of the government (such as the allocation of a large amount of cheap finance and reorganization of the industrial struc-
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ture), the policy process was highly centralized, complex, and unstandardized. Finally, despite the government regulation of chaebol, chaebol grew much faster than the national economy during this period. The estimated aggregate value-added of the 10 largest chaebol in terms of percentage of GNP almost doubled during the 1979-1985 period.

Although chaebol’s growth patterns differed from the previous decades in a few ways, the government’s effect on chaebol accumulation continued to be significant, most critically through the allocation of industrial credit and control of licenses. The chaebol sector in general was in the mature stage during the 1980s. Their widening was almost non-existent, and their growth came largely from deepenings. These arguments are evidenced in Table 3.1, which lists the top 10 chaebol for the years 1965, 1975, 1985 and 1994. While only three chaebol from the 1965 list maintained continuously their position, all but three from the 1975 list remained among the top 10 in 1985. Only two chaebol from the 1985 list dropped out of the top 10 in 1994.

That the list changed greatly between 1965 and 1975 but very little among 1975, 1985 and 1994 implies that the major groups had solidified their positions and were beginning to show they could survive by their own strength by 1975. Since that time, the chaebol groups—particularly the largest—have continued to expand and extend their dominance in the Korean economy. Table 3.1 indirectly supports the assertion that the growth period of chaebol groups was the decade following 1965 and that the chaebol sector went through the stable and mature stage thereafter. This has occurred despite at least nominal attempts by the Park government, and the subsequent Chun and Roh regimes, to

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<td>Samho</td>
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<td>Samyang</td>
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<td>Tongyang</td>
<td>Daewoo</td>
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<td>Taehan</td>
<td>Doosan</td>
<td>Donga Construction</td>
<td>Korea Explosives</td>
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curb the growth of chaebol and various aspects of their concentration, diversification, ownership, speculation, and indebtedness.

The problems of overinvestment and excess capacity of the heavy and chemical industries were passed over to the Chun government. During the 1980s, most of the largest chaebol also had exclusive government-granted licenses in some areas. Of course, some of the licenses had been granted by previous governments, but those licenses were protected by the Chun government, both explicitly and implicitly. The most important measures that the Chun government took were the so-called 8/20 and 10/7 measures in 1980 for reorganization of the heavy and chemical industries. Although not fully carried out as planned, these government measures transformed the heavy and chemical industries into an even more concentrated structure with a few large chaebol, each of which had an exclusive monopoly.

Although the government began to sell its shares of commercial banks in 1981, the government maintained its control over the appointment of top management and major decision making on credit allocation. Therefore, as in the previous decades, the government exercised a strong influence over corporate survival and expansion by controlling the quantity and price of financial resources. During the early 1980s, the 10 largest chaebol relied more heavily on debt than did the average Korean firm: 83.5 percent of the asset growth of the 10 largest chaebol was financed by debt, whereas the Korean average was approximately 65.2 percent. When the Korean government first revealed the information on the amount of domestic credit allocation to chaebol in 1982, the five largest chaebol accounted for 20.3 percent of total outstanding bank loans and 26.4 percent of total domestic credit (bank loans and payment guarantee). Clearly, the concentration of credit allocation in a few large chaebol had continued with the chaebol’s share of domestic credit being significantly larger than their share of value added in Korean GNP.

With respect to the price of financial resources, after the Korean government lowered the bank lending rate substantially from 17 percent to 10 percent in June 1982, domestic bank loans became even more attractive. It was estimated that the 10 largest chaebol saved more than 800 billion won, which was equivalent to 4.6 percent of M2 in 1982. The new interest rate structure created a new demand structure for financial resources. Although the inflow of foreign capital was large, the amount of commercial loans decreased. Unlike during the previous decades, the attractiveness of international borrowing decreased substantially as the interest rate of domestic bank loans became lower than that applied to foreign loans.
The second-round oil price hike in 1979–1980 increased the Middle Eastern governments' revenue and their demand for construction. As during the previous decade, Korean construction companies continued to penetrate the Middle Eastern market successfully during this period. Although the markets shrank as the oil price declined after 1980, overseas construction revenue accounted for 39.4 percent of Korea’s total commodity exports during the 1980–1985 period. The largest chaebol were active in overseas construction, and their share in the Korean total was significant. The 10 largest chaebol of 1985 accounted for 49.8 percent of Korea’s total overseas construction during the 1980-1985 period. The Korean government controlled the overseas construction activities of the Korean firms by allocating business licenses, providing payment guarantees, approving the firms’ participation in biddings, setting the bidding limit of each firm, and approving the contracts. During the 1980s, the overseas construction license per se became less important because the overseas market was already in decline and there was less demand for the license.

During this period, the GTC also played an important role in the growth of chaebol. Chaebol-owned GTCs registered an impressive performance in exports, and their share in Korea’s total commodity exports was substantial, ranging between 38.6 percent and 49.7 percent during the 1980–1985 period. With export promotion being one of the prime objectives of the Korean government during this period, the Korean government provided extensive subsidies for exports, of which the most important was the preferential allocation of credit. Anyone with valid evidence of an export order could borrow a certain portion (usually over 70 percent depending upon the regulation set by the Ministry of Finance and the Ministry of Commerce and Industry) of the export amount from the banks. Additional advantages were given to GTCs. For example, GTCs, as the largest exporters, had better access and communication channels to the top-level government officials (for example, face-to-face meetings with the president and ministers) and gained strong bargaining power against the government.

A number of “ill-managed companies” failed to service their debt. The Korean government used different measures, from providing emergency bank loans to compulsory reorganization, to deal with the problem of the ill-managed companies according to time, industry, and magnitude. The first measure the government took toward this problem was in the heavy and chemical industries in the early 1980s. With the help of the government and with the recovery of domestic and export markets, the ill-managed companies in the heavy and
chemical industries showed significant improvement in the mid-1980s.

After the early 1980s, however, a more serious problem of ill-managed companies began to appear in the overseas construction and shipping industries. With the decline in oil prices after the early 1980s, many Korea construction companies faced serious problems. They were engaged in cutthroat competition, even among other Korean companies, and they suffered from stiff, and sometimes negative, margins. A few Middle Eastern governments cancelled construction projects that were already under way. They often refused to pay in currency, but instead offered their crude oil at a price higher than the international market price. As a result, many Korean construction companies were on the verge of bankruptcy. For these firms, the Korean government extended emergency credit; this credit exceeded one trillion won during the 1984–1985 period. Despite the huge financial injection by the government, many of these construction companies did not show financial improvement, and finally the government disposed of a few of the worst. In 1986, the Korean government reorganized 50 ill-managed companies, which included 23 member companies of Kukje chaebol, four companies of the Samho construction chaebol, two companies of Hanyang construction chaebol, and some of Korea’s other large construction companies such as Kyungnam Enterprise, Myungsung Construction, and Namkwang Construction. Among them, the government arranged for the larger companies to be taken over by some of the largest chaebol, including Daewoo, Ssangyong, Korea Explosive, Hanjin, and Daelim. In the reorganization process, the government exercised preferential treatment.

More recently, large-scale ill-managed companies have appeared in the shipping industry. In the mid-1970s, the Park government designated the shipping industry as one of its strategically selected industries to be developed intensively. Each year, the Park government set targets to increase shipping capacity and provided extensive supports to the shipping companies that achieved targets. In 1986, Korea’s shipping capacity became the thirteenth largest in the world, but the expansion was financed by borrowed funds. When the global shipping industry declined after the early 1980s, the Korean shipping companies suffered a huge loss. During the 1982–1986 period, the Korean shipping industry as a whole suffered approximately 200 billion won of net loss each year, and its debt-to-equity ratio increased from 4.60 in 1981 to 26.30 in 1985. In 1985 and 1986, the Korean government extended 2.9 trillion won of credit to the shipping companies and prepared a preferential taxation structure for them.
In line with the liberalization policy, the Chun government began to privatize a few large SOEs in the early 1980s. Among the privatized SOEs, the most important was the Korea Oil Corporation (KOC), the largest petroleum refiner. The government announced four qualifications for candidates that would take over the KOC: (1) the capability to import crude oil on a stable long-term basis, (2) financial capability, (3) a wide global network to diversify the import of crude oil, and (4) managerial capability. After intense competition among the few largest chaebol, the KOC was sold to Sunkjung chaebol in December 1980. The Korean business community was surprised by the government's decision because the KOC's sales volume in 1980 was 5.5 times greater than that of Sunkyung group as a whole before the takeover. Sunkjung, which was the tenth largest chaebol in 1979, became the fourth largest chaebol in 1980. In addition, the government provided US$100 million in loans to Sunkjung, and therefore many observers estimated that Sunkyung put up virtually no capital of its own to take over the KOC. In 1981, the Korean government granted Sunkyung a monopoly to import crude oil from Saudi Arabia; these imports accounted for approximately 80 percent of Korea's total crude oil imports.

The chaebol also continued to expand into the financial sector. Especially after the large-scale curb market scandal in 1982 known as the "Madame Chang case," the government liberalized the non-bank financial sector in an effort to convert informal financial markets (primarily the curb market) into official financial markets. Government controls on entry into and ownership participation in non-bank financial institutions were released. Among the non-bank financial institutions, short-term finance companies were the most profitable, and they were heavily regulated by the government. As of April 1984, among 32 short-term finance companies in Korea, 13 companies were exclusively or jointly owned by the 10 largest chaebol, and 29 companies were owned by the 30 largest chaebol.

Chaebol that owned non-bank financial institutions used them not only as an effective means by which to mobilize funds but also as an effective means by which to expand the chaebol structure by circumventing government regulations. During the 1981–1983 period, the government sold its share of five city banks. Although the government prohibited the 26 largest chaebol from the auction and limited the maximum share of a single person or a corporation to 8 percent, the largest chaebol became the largest shareholders of the banks. The chaebol purchased the bank shares through their member financial institutions and owner family members. The 10 largest chaebol as a whole held anywhere between 11.9 percent and 51.6 percent of total
bank stocks as of October 1983. These figures did not include the stocks held by individuals of chaebol families.

Despite the government's overt policy (namely the 9/27 measures in 1980) to regulate the ownership of real estate by chaebol, chaebol continued to purchase real estate. During the four years following the 9/27 measures, the 26 chaebol that had been selected for close supervision by the government purchased new land 20 times greater in value than the land they had been ordered to sell. As of the end of June 1983, the 30 largest chaebol owned 94.3 million pyungs of real estate (approximately 75,696 acres) whose appraised value was 3.4 trillion won. Of the real estate, 94.6 percent was land and the remaining portion was buildings. Although land prices declined relative to inflation during the 1979–1982 period, they resumed their pace of rapid increase after 1983. Obviously, those who had more land benefited from the land price hike. The benefit had been even greater if the land had been purchased through cheap bank loans.

With the excess demand for financial resources, capital was always a major bottleneck for corporate expansion. Constrained by limited capital, many chaebol expanded through interlocking investment in this period. A chaebol could increase its capital by investing mutually among member companies in bookkeeping without actual capital injection. With interlocking investment and stockholding, chaebol could take over other firms with less capital, reserve control, and draw more credit from banks. As of the end of 1983, the 30 largest chaebol invested 36.9 percent of their net stockholders' equity in their member companies, and their total intercompany stockholding (including investment in non-group firms) amounted to 45.2 percent of their net stockholders' equity. Because this type of creation of imaginary capital deteriorated firms' financial structures, the government amended the Commercial Law in 1984 to limit intercompany investment to 40 percent of the investing company's stockholders' equity. Despite the government's regulation, the level of interlocking investment by chaebol did not decrease until the end of 1985. To prevent chaebol's continued expansion through this type of imaginary creation of capital, the Korean government amended the Fair Trade Acts in September 1986.

During the 1980s, the chaebol moved into the so-called high-tech industries such as computers, semiconductors, and genetic engineering; they also began to undertake foreign direct investment. The largest chaebol were successful in a few high-tech industries. Samsung's mass-production of 64KD RAM (in 1984) and 256KD RAM (in 1985), closely followed by Lucky-Goldstar, made Korea the world's third country to produce these products. Daewoo's personal computer,
commonly known as the "Leading Edge Model D," became a well-known, successful product in the U.S. market. Although not a high-tech product, Hyundai's subcompact car, the Hyundai Excel, became one of the best-selling imported cars in the U.S. in 1986. In the mid-1980s, semiconductors, computers, fiber optics, ceramics, genetic engineering, aerospace, and telecommunication were among the strategic industries of the largest chaebol. Foreign direct investment was also initiated by the largest chaebol in the 1980s. Samsung built color TV manufacturing plants in Portugal and New Jersey and a semiconductor research lab in Silicon Valley. Lucky-Goldstar set up a color TV manufacturing plant in Alabama, and Hyundai built an automobile manufacturing plant in Canada. The chaebol also participated in overseas resource development. To name a few instances, Samsung and Hyundai jointly participated in development of liquid natural gas (LNG) and coal in Alaska, and Samsung invested timber development in New Zealand.

Table 3.2 shows the growth pattern of the nine largest chaebol, which were in the top 10 lists of both 1979 and 1985. During the 1972–1979 period, the increase in the number of member companies and in the number of industries the nine chaebol participated in was phenomenal. Their total number of member companies grew from 72 in 1972 to 231 in 1979, and the average number of two-digit SIC industries increased from 8.0 in 1972 to 17.9 in 1979. This implies that the growth of the chaebol sector was through diversification into different industries, as well as growth in their original domain. During the 1979–1985 period, the nine largest chaebol realized impressive growth, but their average number of member companies and number of industries in which they operated changed little. The average annual growth rate of sales was 34.5 percent while the average growth rates of the real GNP and the GNP deflator were 5.4 percent and 9.9 percent for the same period. The total number of member companies of the nine largest chaebol increased slightly from 231 in 1979 to 233 in 1985, and their degree of diversification in terms of two-digit SIC showed a moderate increase from 17.9 in 1979 to 20.0 in 1985. This is a striking contrast to their growth pattern during the 1970s. The change was largely due to the government's strict restrictions on chaebol expansion and to the government's efforts to rationalize the chaebol group structure. These facts can be used as evidence for the assertion that whereas the 1970s was an expansion period for the chaebol sector, the 1980s was a period in which it reached its maturity.
Table 3.2 *Number of Member Companies and Sales of the Nine Largest Chaebol, 1985*

<table>
<thead>
<tr>
<th>Chaebol</th>
<th>Number of member companies (industry*)</th>
<th>Sales in billion won</th>
<th>Annual growth rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Samsung</td>
<td>16(15)</td>
<td>33(26)</td>
<td>39(26)</td>
</tr>
<tr>
<td>Hyundai</td>
<td>6 (5)</td>
<td>31(15)</td>
<td>43(23)</td>
</tr>
<tr>
<td>Lucky</td>
<td>18(14)</td>
<td>43(24)</td>
<td>48(24)</td>
</tr>
<tr>
<td>Daewoo</td>
<td>2 (3)</td>
<td>34(20)</td>
<td>29(24)</td>
</tr>
<tr>
<td>Sunkyung</td>
<td>5 (6)</td>
<td>14(16)</td>
<td>14(17)</td>
</tr>
<tr>
<td>Ssangyong</td>
<td>6 (7)</td>
<td>20(13)</td>
<td>14(15)</td>
</tr>
<tr>
<td>Korea Explosive</td>
<td>7 (8)</td>
<td>18(16)</td>
<td>21(19)</td>
</tr>
<tr>
<td>Hanjin</td>
<td>8(10)</td>
<td>14(16)</td>
<td>12(16)</td>
</tr>
<tr>
<td>Hyosung</td>
<td>4 (4)</td>
<td>24(15)</td>
<td>13(16)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>72(8.0b)</strong></td>
<td><strong>231 (17.9b)</strong></td>
<td><strong>233 (20.0b)</strong></td>
</tr>
</tbody>
</table>

Notes: a. By 2-digit SIC codes.

Notes

1. This chapter is partly summarized from Kim (1987).
2. Jones and Sakong (1980) described Park's economic intervention as a "hard state" having both the willingness and the ability to enforce any policies. The terms "hard state" and "soft state" were originally defined by Myrdal (1968).
3. Some have argued that real estate speculation is a zero-sum activity and that chaebol should realize their importance in the national economy. That is, real estate speculation is not something that a chaebol is supposed to do. What is more deplorable is that chaebol speculate in real estate with cheap bank loans and international borrowings.
4. This is a summary of the opinions expressed by former and current bureaucrats and other experts generally.
5. Amsden (1989) described Korea's mode of entry into the Middle Eastern construction market as unique among countries insofar as it involved collective contract migration. Compared with independent migration by each factor of production, common work norms increased productivity, and packaged exports improved delivery times.
6. The most critical factor in the Korean case was trust. Virtually no chaebol owners would trust outsiders for such delicate transactions as circumvention of government regulation.
7. In Korea, acquiring a license from the government to open a golf course was extremely difficult.
8. The 10 largest chaebol's total amount of loans and payment guarantees outstanding in June 1982 was estimated to be in excess of 11.4 trillion won based on the information collected from each chaebol.
9. This number did not include six ill-managed construction companies that had been reorganized without change in management and ownership.
10. KOC's sales were 1,967.6 billion won in 1980, and Sunkyung's total sales in 1979 were 361 billion won.
11. The banks' line of credit is proportional to the borrower's equity base in Korea of that time.
CHAPTER 4

THE JAPANESE BUSINESS GROUP:
ZAIBATSU

Big business groups such as chaebol are not a phenomenon unique to Korea. Industrial and economic control organizations can be seen in highly industrialized countries as well as in developing countries. According to many studies, the big business group phenomenon is found in European countries such as Sweden, Germany, and France; in Latin American countries such as Mexico and Brazil; and in Asian countries such as India, Pakistan, and the Philippines. Even in historical China, there were 10 big family business groups, such as the Chang family and Song family, that came into economic and political power.

Nevertheless, the common view is that the big business group has its origin in Japan. Although big enterprises and business groups appeared earlier in Western industrialized countries and formed big capital groups independently (for example, Du Pont and Morgan), these groups did not develop as organizations that controlled affiliated firms and industries with an elaborate system as did the groups in Japan. Therefore, it is reasonable that big business groups with centralized control systems that dominate the economy of a country originated from the prewar zaibatsu of Japan.

Because present Japanese business groups are different from Korean chaebol in many respects, it is not particularly meaningful to compare these two directly. But because Japanese business groups embody the most essential characteristics of business groups and have a period in their growth path similar to Korean chaebol, it may be useful to take a closer look at Japanese business groups in studying the chaebol.

Japanese business groups are divided into two categories in terms of their characteristics and their process of formation. First are the traditional zaibatsu business groups such as Mitsui, Mitsubishi, and Sumitomo, which were formed before World War II. The second cate-
gory contains other business groups such as Fuyo, Sanwa, and Daiichikanging, which were formed around major banks after World War II.

**Prewar Zaibatsu**

Zaibatsu played a very important role in Japanese economic development before World War II. The three largest zaibatsu groups—Mitsui, Mitsubishi, and Sumitomo—took up about 23 percent of the total paid-in capital of all Japanese businesses combined (this figure would be 25 percent if the fourth-largest zaibatsu, the Yasuda group, were added). In addition to this prewar "big four," however, there were also a number of lesser zaibatsu such as the Ayukawa, Asano, Furukawa, Okura, Nakajima, Nomura, and other combines. In terms of business structure and management style, the zaibatsu resembled the old Edo merchant houses. Two leading zaibatsu—Mitsui and Sumitomo—had, in fact, been merchant houses during the Edo period.

**Formation of Zaibatsu**

Before observing the characteristics of prewar zaibatsu, we need to survey the ownership and management of merchant houses in the Edo period (1603–1867). Large Edo-period merchant houses were founded during the second half of the seventeenth century, and the families—more specifically, Mitsui, Konoike, and Sumitomo—became powerful merchants by the beginning of the eighteenth century. Next to them, second-class large merchants, such as Shimomura (now Daimaru Department Store) and Nakai (an Omi merchant), appeared during the middle of the eighteenth century. Most of these second-class merchants started their careers with a small capital base and became successful after several decades (Yasuoka 1984).

The founders, and the sons who assisted them, were in most cases talented managers. Konoike and Sumitomo both had excellent restorers in the third generations. Given an incompetent master in the third generation, the large merchant families would have been easily ruined if it had not been for the talented banto (head clerk). But in most large merchant families, the method of selecting talented managers was firmly established, so whether the present master was competent or not, the business continued successfully.

It is generally believed that the Japanese merchant houses hired their men on a lifetime basis, but this is not wholly true. The most
compotent men finally became top managers, but in rising up the ladder, they were carefully selected at each stage. From 1696 to 1730, the Kyoto headquarters of Echigoya drapers (Mitsui) hired 239 apprentices, but only 13 (5 percent) of these apprentices were allowed to be live-out clerks (and not live-in employees). These live-out clerks correspond to today's company directors who gather at meetings of management, decide policies, and control the business. Old merchant families that continued for a century or two most often adopted such a system of control. Masters also took responsibility for retired employees with good records. This type of treatment might be considered a kind of paternalism or labor-management policy with a long-term perspective.

The owners of capital of these family businesses were, for the most part, the masters and family members. In some cases, however, bekke (branch family with no blood relations) and tedai (clerks) were allowed to be investors, but of course they were not on an equal investment footing with their masters. The capital inherited by the masters and their families was always succeeded to as a whole, so the family members, including the master, could not request division of their property. Each owner could only receive a dividend on profits. Clearly, the family system in Japanese society is closely related to the form of property ownership.

From the beginning of the Meiji era, the government tried to propagate joint-stock companies that did not rely on investment by only one family. But its popularization was very slow, because most merchants of the time had hardly any experience with co-investment. Almost all family businesses continued to exist, and even after the enforcement of the new Commercial Law in 1893, they maintained their traditional form of enterprise. At the same time, however, large family firms began to adopt the systems of unlimited and limited partnership. The investors in such ventures were almost entirely masters and family members. The investment of hired managers was nominal because the owners of family businesses tried to keep the investment "pure."

Given this situation, control rested in the masters only or, in the case of old family businesses, in the hired managers. This is the special "managerial control" established by custom in the Edo period; it did not appear with the dispersion of stock ownership. From the formal point of view, zaibatsu family members, through their capital, owned the Japanese zaibatsu; administration was conducted by managerial control—which had been delegated by the owners. To maintain such systems, large family companies regulated the activities of each family member under family codes (Yasuoka 1978, 1982).
The joint-stock company system, which had been introduced in Japan through the two promotion booms—that is, the national bank mania from 1876 to 1879 and the railway and cotton mills mania from 1887 to 1889—was more widely applied to other industrial enterprises after the issue of the General Incorporation Act in 1893 and through the industrial booms during and after the Sino-Japanese War (1894–1895) and the Russo-Japanese War (1904–1905). In short, the joint-stock company system had, within 40 years after its introduction, spread into the major fields of the Japanese economy except agriculture and retailing. This rate of expansion was several times greater than that of England. There are several reasons for such a rapid development of the joint-stock company system. First, new industries in Japan had to start as large-scale competitive firms by absorbing resources from the public money market. Second, the newest Western industrial technologies introduced were accompanied by the newest business organizations. Third, the educated sons of ex-samurai preferred to be employed by joint-stock enterprises rather than by traditional family businesses. Fourth, members of family enterprises that expanded through investment in external economies at the early stage of industrialization turned to investment in new industries in the form of joint-stock companies.

With such development of joint-stock enterprises in various industries, a new class of specialist corporation managers emerged, especially after the mid-1890s when the Mitsui combine was reorganized by Hikojiro Nakamigawa, a president of the Mitsui Bank. Being enthusiastic for the industrialization and modernization of the Mitsui family business, he recruited many able college graduates, mainly from Keio University, and put them in charge of the various sections of the reorganized Mitsui combine, paying them exceptionally high salaries. These policies attracted an increasing number of able and reliable young men to the business world, and the joint-stock companies, staffed with such specialist managers, grew more prosperous and started to attract public investors.

The rise of the new class of corporation managers gave rise to another type of diversified investment in various product lines. In addition to high salaries, corporation managers were usually given a substantial executive bonus, and with the sum thus amassed, most of them gradually became major shareholders of their companies. Some of them also invested their own resources in stocks of various kinds of other prospective companies, usually becoming the directors of these industrial firms and thus earning more executive bonuses. It was not uncommon for a leading businessman to serve as a member
of the board of directors in more than 30 joint-stock companies. Needless to say, such practices often led to unreliable management and business failures.

But such irresponsible entrepreneurship could not prevail in the enterprises controlled by the zaibatsu combines. The head offices of Mitsui and Mitsubishi were already well organized, and their individual industrial enterprises were closely supervised by the zaibatsu banks and their markets shrewdly organized by their general merchants (sogo-shosha). For example, through the reorganization of the Mitsui family business by H. Nakamigawa, each of their four main enterprises—banking, trading, mining, and cloth retailing—was formalized into a legal partnership (geomeikaisha) in 1893, and the industrial department established the following year was authorized to control all the subsidiary manufacturing firms, such as the Kanagafuchi Cotton Mills, Oji Paper Mills, and Shibaura Electric Works.

To solidify and mobilize this diversified enterprise, three major partnerships—the Bank, Bussan, and Mining—were reorganized into joint-stock companies in the period between 1907 and 1911; in addition, the administrative department (kanribu) of the Mitsui Family Partnership was incorporated into a legal partnership, the Mitsui Company (Mitsui Gomei), to hold the stocks of the three newly established joint-stock companies.

The course of the development of Mitsubishi in this period was to some extent the same as that of Mitsui, although the trading activities of the former were fairly backward compared to those of the latter; all the lines of Mitsubishi business were organized just as departments in the Mitsubishi Limited Partnership. The combined effort of the banking and trading departments proved to be a powerful means for acquiring and controlling new mines in the Kyushu and Hokkaido areas. But the Mitsubishi Company in its early stage of development can be considered to be primarily a mining enterprise combined with shipbuilding. In addition to the Takashima Coal Mine, which produced coal of the best quality, it owned and operated the Yoshioka, Osaruzawa, Makimine, and many other high-yield copper mines as well as the Sado gold and Ikuno silver mines. Some of these mines had a high profit return, as copper was one of the most important exports of Japan throughout the nineteenth century. Furthermore, we should remember that the stock dividend from the Nippon Yusen Kaisha was the largest item in the company's revenue.

Before World War I, Mitsui and Mitsubishi had purchased and controlled many independent industrial firms through their own banking and trading activities. Because these industrial firms had passed the
unprofitable gestation stage, and, furthermore, were furnished with adequate resources by the zaibatsu banks, they quickly became highly profitable. They could now expand by ploughing back their own profits, without offering their stocks for public subscription. In proportion to the ability of zaibatsu subsidiaries to be thus self-financed, the role of zaibatsu banks as "agent banks" decreased after the beginning of this century. On the other hand, since many non-zaibatsu banks went into bankruptcy through frequent crises after the Russo-Japanese War and World War I, the deposits of the Japanese people as a whole became increasingly concentrated in the major zaibatsu banks. It is no wonder that the zaibatsu banks ventured into financing the development of new industries during and after World War I. For example, the development of the electric light and power industries and the electric railway industry was financed in the 1920s by the flotation of debentures that were aggressively underwritten by zaibatsu banks. At the same time, the zaibatsu themselves ventured into various new industries, especially into heavy industries.

Holding companies of the zaibatsu were formed on the eve of World War I, and the zaibatsu grew rapidly during the war. Zaibatsu groups began forming during the period from 1909 to 1920. The first incorporated zaibatsu was Mitsubishi, which was established in 1893; Mitsui and Sumitomo were established in 1909 and 1921, respectively. It took only 30 to 40 years for zaibatsu groups to grow into gigantic business enterprises. Mitsui made wealth from the textile and money exchange businesses, Sumitomo from copper refining and mining businesses, and Mitsubishi from the shipping business and expansion into more profitable areas through related product diversification.

Characteristics of Zaibatsu

The prewar zaibatsu—particularly Mitsubishi, Mitsui, and Sumitomo—have different origins and histories; they also differ in the precise details of their internal constitution and structure. All, however, were closely linked to the government and military and contributed enthusiastically to the policy (first enunciated in the Meiji period) of creating a "rich country and a strong army." Within these groups, therefore, the outlines of a characteristic zaibatsu structure gradually emerged (Toshio 1989).

The prewar zaibatsu can be viewed as a more primitive precursor of the modern kontserun, in the sense that they were family-owned and acted primarily as a vehicle for preserving and extending the wealth of the controlling family. They were financial forms of monopoly capital,
whose purpose was to minimize the risks of investment by spreading their capital over a wide and diverse range of industrial sectors rather than concentrating it in a single area of production. At the same time, they can also be seen as successors to the *seisho* (political merchants). The continuing importance of commercial capital in the *zaibatsu* is apparent in the powerful role that *zaibatsu*-related general trading companies such as Mitsui Bussan (known in English as Mitsui Company) and the Mitsubishi Shoji (Mitsubishi Corporation) came to play in Japanese commerce.

As will be apparent from these comments, the prewar *zaibatsu* had a number of distinctive characteristics that differentiate them from the forms of finance capital that emerged in other developed capitalist nations. At the center of each of the prewar *zaibatsu* was the *honsha* or holding company. The *honsha* controlled a large network of companies—some directly, others indirectly (as subsidiaries of directly controlled companies); others were "associated companies" in which the *zaibatsu* holding company had a substantial, but not controlling, interest. In some cases, the stock of the holding company was wholly or almost wholly owned by a single family. This obviously endowed such families with a great deal of power. Their enormous personal estates and incomes (some were billionaires) indicate the extreme concentration of wealth in prewar Japan. The *zaibatsu*-owning families included the imperial family—which occupied an exceptionally powerful position in the prewar Japanese economy—whose economic position was further strengthened after World War II.

Let us briefly look into the ownership and management of Mitsui, Sumitomo, and Mitsubishi. In 1944, Mitsui consisted of 22 subsidiary and affiliated companies. In that year, the Mitsui families owned practically the entire Mitsui group with ownership of 67 percent of the holding company stocks and more than 50 percent of the stocks of all subsidiary and affiliated companies. It is difficult to present documented evidence concerning the management of the Mitsui group before World War II. However, judging from the Minomura Reform in the early Meiji era in 1867 and the Fujuwara Kinjiro Reform in 1887, we can see that the transition of Mitsui from a promising small business in the Edo period to a modern enterprise and then to a *zaibatsu* was led by the professional managers from non-*zaibatsu* families. Mitsui families self-imposed a strict rule against involvement in company management (Hattori 1989).

In 1945 the Iwasaki family owned 55.5 percent of the Mitsubishi holding company, which owned more than 52 percent of subsidiary and affiliated companies. The Iwasaki family owned only 0.4 percent
of the subsidiary and affiliated companies. In management, the Iwasaki brothers held the president and vice-president positions, but all other executive positions in the Mitsubishi parent and subsidiary companies were held by professional managers from non-Iwasaki families. Although ownership and management were not completely separated because of the direct participation of the Iwasaki brothers in company management, there were extensive layers of professional and career managers comprising managerial hierarchies.

Compared with Mitsui and Mitsubishi, the Sumitomo family showed a lower ownership percentage in 1946, owning 29 percent of the group's holding company and 13 percent of subsidiary and affiliated companies. But the parent company exercised much financial and personnel control over the subsidiary companies, as compared to Mitsui and Mitsubishi. In management, Mr. Domonari, head of the Sumitomo family, at one time held the office of president. However, his role was largely ceremonial, and actual management was performed by professional executives and managers.

In summary, the ownership structure of traditional zaibatsu groups before World War II followed a pyramidal pattern in which zaibatsu families possessed a large share of the stock of the holding company, which, in turn, owned a large portion of the stocks of subsidiary and affiliated companies. In the case of Sumitomo, the parent company maintained strong control over company resources and was the last zaibatsu group to relinquish power. As for management, even though the Mitsui and Sumitomo families participated in company management, the actual power was exercised by professional managers. In the case of Mitsubishi, the head of the families held management power, but the group was also managed by professional managers.1

As Mitsui and Sumitomo grew into zaibatsu, the owner families were no longer involved in direct management, and professional managers were given total responsibility for running the business. Management of Mitsubishi was also put in the hands of professional managers, but had long been characterized by a system with a strong president. As the zaibatsu's growth expanded, they also began to exercise political power. In particular, as the center of political influence moved away from political parties toward the military following the so-called Manchu incident in 1932, the giant zaibatsu and the military coagulated into a single ruling entity, which governed "Japan at war" from the first period of the Showa (1927–1989) until 1945. One can note from table 4.1 the extent of the zaibatsu's control over the Japanese economy at the end of World War II.

The financial dominance of the zaibatsu families can be seen from
Table 4.1 Role of the Zaibatsu in Terms of Paid-Up Capital, 1945*  

<table>
<thead>
<tr>
<th>Industry</th>
<th>Big Four zaibatsu</th>
<th>Other Six zaibatsu</th>
<th>Ten zaibatsu</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial</td>
<td>49.7</td>
<td>3.3</td>
<td>53.0</td>
</tr>
<tr>
<td>Industrial</td>
<td>32.4</td>
<td>16.6</td>
<td>49.0</td>
</tr>
<tr>
<td>Light industry</td>
<td>10.7</td>
<td>6.1</td>
<td>16.8</td>
</tr>
<tr>
<td>Other</td>
<td>12.9</td>
<td>2.6</td>
<td>15.5</td>
</tr>
<tr>
<td>Total</td>
<td>24.5</td>
<td>10.7</td>
<td>35.2</td>
</tr>
</tbody>
</table>

Notes:  
a. The numbers denote percentage of the national total.  
b. Mitsui, Mitsubishi, Sumitomo, and Yasuda.  

the available figures on the concentration ratio of the zaibatsu and their affiliated companies. For example, in 1945 the “big four” zaibatsu owned about one-quarter (24.5 percent) of the total paid-up capital of all corporations in Japan. If the shareholdings of other minor zaibatsu were added to this figure, the percentage would of course be much larger. It is particularly significant that this concentration ratio had risen rapidly during the war period. The “big four” zaibatsu more than quadrupled in size (a 430 percent increase) in the eight years between 1937 and 1945 (Holding Company Liquidation Commission 1950).

Some salient characteristics of the prewar zaibatsu can be summarized as follows. First, the zaibatsu operated in a feudalistic spirit through the monopolistic control of a few members of a family. This trait was not compatible with modern corporate management. Second, the internal control mechanism of the zaibatsu took the form of a pyramid, where the top holding company hierarchically controlled a multilayer of companies including the top holding company (zaibatsu honsha, subsidiary companies (chokkeikaisha), affiliated companies (kokaisha), and related companies (magokaisha). Third, the zaibatsu did business in almost every industry. In those industries in which they dominated, other firms were subject to their control or remained in the industry only marginally. Fourth, the zaibatsu controlled not only the manufacturing sector, but also the financial sector. They owned banks, trust companies, insurance companies, and other financial institutions; these served as their major sources of capital and their principal means of controlling other firms (Lee 1990).
The Dissolution of the Zaibatsu

Shortly after World War II ended, the occupation policy of the Supreme Command of the Allied Powers (SCAP) was based on a series of "democratization" measures. These included the legalization of trade unions and the introduction of land reforms. The dissolution of the zaibatsu was an important part of this "democratization" process.

The American Mission on Japanese Combines summed up the consequences of the existence of the prewar zaibatsu to the following effect. Reviewing the adverse effects of the zaibatsu from a broad perspective, their extreme concentration of industrial control prolonged the existence of semi-feudalistic labor relations, a situation that resulted in a lowering of the wage rate and hampered the development of labor unions. At the same time, the zaibatsu deterred independent entrepreneurs from launching businesses and prevented the rise of a middle class. Because there was no middle class, there was no economic basis for individuals to become independent. Consequently, there was no countervailing power to deploy against the military establishment, nor could a democratic or humanistic national mood develop. Moreover, because of the low wages and accumulated profits brought about by the economic control of the privileged zaibatsu, the domestic market could not expand (Fair Trade Commission 1977). Because of this situation, commodity exports became all the more important for Japan and eventually led the country to an imperialistic war (Lee and Lee 1990).

Basing its actions on these evaluations, SCAP decided to dissolve the zaibatsu, in the belief that so long as zaibatsu continued to exist, Japan would remain firmly under their control. In September 1945, SCAP adopted a basic policy line for the management of the Japanese economy: non-militarization, economic democratization, and the preservation of the peacetime economy. In November 1945, the program for economic democratization was further spelled out as a combination of land reform, the legislation of the Labor Union Act, and industrial democratization. "Industrial democratization" specifically included two types of measures. One consisted of adopting temporary measures—such as the dissolution of the combines, deconcentration of economic power, and removal of private cartels—to eliminate anti-competitive institutions. The other method entailed enforcing the Law for the Prohibition of Monopoly and the Establishment of Fair Trade, which was enacted in 1947. To carry out the dissolution of the combines, SCAP established the Holding Company Liquidation
Commission (HCLC) in 1946; HCLC was empowered to enforce specific programs for the dissolution of the prewar zaibatsu.

The main elements of the zaibatsu dissolution program were as follows. First, the zaibatsu honsha and a number of other large holding companies were selected for dissolution. Their stocks were taken over by the occupation authorities (in return for certain compensation) and sold to the public. In all, 83 companies were dissolved in this way, including the holding companies of the Mitsui, Mitsubishi, Sumitomo, Yasuda, Fuji, Nissan, Asano, Shibusawa, Okura, and Nomura enterprises. By offering the stocks of these companies to the public, it was hoped the zaibatsu would be broken into their component parts, which would then become independent, unrelated companies (Toshio 1989).

The total amount of securities transferred to the HCLC amounted to 42 percent of the total paid-in capital of all Japanese joint-stock companies in 1946. In those days, however, the Japanese public was not in a position to absorb to any significant degree the securities released by zaibatsu because of the country’s low income level and shortage of food. Thus, in practice, a large amount of the securities eventually found their way back to their original owners. One may, therefore, term the outcome of the measure to be “the confusion of ownership” rather than “the dispersion of ownership” (Misonou 1987). To sever the ownership linkage between firms, the HCLC designated a total of 2,843 companies including “restricted concerns” (seigenkaisha) and their subsidiaries and affiliates, and prohibited their directors from acquiring the securities or bonds of other companies, or from forming interlocking directorships with other companies.

Second, members of the old zaibatsu families were barred from resuming positions as company officers in the ex-zaibatsu enterprises. This restriction applied to 56 individuals and was aimed at breaking the human nexus of semi-feudal control that had lain at the center of the zaibatsu structure. Third, the use of the traditional zaibatsu trade names (Mitsui, Mitsubishi, etc.) and insignia was prohibited. Since names and trademarks had symbolized the cohesion of the prewar zaibatsu, this prohibition was clearly intended to discourage association between former zaibatsu-member firms. Fourth, not only the zaibatsu themselves but even some of their largest component enterprises were subject to dissolution. In particular, the giant zaibatsu-related trading companies, Mitsui Bussan and Mitsubishi Shoji, were divided into many small enterprises. In addition, the 1947 Law for the Elimination of Excessive Concentration of Economic Power opened the way for a sweeping plan to break up the Nippon Steel Corporation,
Origin and Growth of Chaebol

Mitsubishi Heavy Industries, and some 323 other very large corporations. Finally, the 1945 Law Concerning the Prohibition of Private Monopolies and Maintenance of Fair Trade Practices (usually referred to as the anti-monopoly law) was enacted with the intention of preventing a future rebirth of the zaibatsu.

Having taken measures to sever the capital and human linkage within the zaibatsu, SCAP also sought to prevent the individual firms that had formerly belonged to the zaibatsu but that had been made independent by combine dissolution from establishing new monopolies. With a view to reorganizing the giant firms, especially the large-scale multiplant firms, the Act for the Elimination of the Excessive Concentration of Economic Power was enacted in 1947. Pursuant to this act, the HCLC initially announced the designation of 257 companies from mining and manufacturing fields, and subsequently 68 companies from the distributive and services sectors, for reorganization, making a total of 325 companies. Although these zaibatsu dissolution measures failed to realize the primary objectives, the actions achieved considerable tangible results and dealt a severe blow to the system of Japanese finance capital.

Postwar Business Groups

The zaibatsu as business entities were broken up by the SCAP. But in their place six big business groups emerged—Mitsubishi, Mitsui, Sumitomo, Fuyo, DKB, and Sanwa. Each of these large firms has vertically aligned affiliate and subsidiary firms, a pattern called keiretsu. In addition, affiliates and subsidiaries maintain long-term subcontract relations with small and medium-sized firms that are not part of the keiretsu. Subcontract relationships are ranked as primary, secondary, and tertiary, depending on the role they serve in the production process.

Mitsubishi, Mitsui, and Sumitomo grew directly out of the zaibatsu groups that controlled Japanese industry before World War II. In the postwar period, the American occupational forces tried to dissolve these zaibatsu groups into many independent firms; but after the occupation, the firms rebuilt their network linkages, though in a less centralized fashion. The other three groups—Fuyo, DKB, and Sanwa—grew in the postwar period around prominent city banks; these new groups are sometimes known as the bank groups. Each of these three, moreover, was a grouping of two or more of the smaller zaibatsu companies. Fuyo, for example, was built around the former Yasuda group
of companies, and DKB inherited many companies from the Fujisawa and Kawasaki groups.

In addition to these six groups, there are also other, smaller independent business groups that came into being somewhat later. These include Shinnitetsu, Toyota, Nissan, and Hitachi, which are based in the manufacturing sector, and Tokyu and Seibu, which are based in the distribution and services sector. These independent industrial and financial groups represent a network vertically integrated firms in one or more industrial sectors (except for two financial groups—Tokai Bank and the Industrial Bank of Japan). Independent groups are organized as keiretsu, each consisting of a large, highly successful parent company and vertically aligned subordinate companies. Independent groups developed in the 1950s and 1960s, as Japan's economy grew rapidly. Some of the firms were, and some still are, associated with one or more of the intermarket groups (i.e., the six big business groups), but their great success enabled them to gain autonomy from intermarket groups.

Reformation of the Zaibatsu

Before zaibatsu dissolution measures were fully put into effect, a dramatic change in world political conditions affected events in Japan. With the development of confrontation between the United States and the Soviet Union—centering on issues such as economic reconstruction in Western Europe and the rise of national liberation movements in China and elsewhere—the policies of American imperialism in Japan and the Far East began to take a new direction.

The old objective of keeping Japan's industrial and competitive power at a low level was replaced by a new desire to foster, in Japan, an Asian arsenal against "the menace of communism." In these circumstances, anti-zaibatsu policies were gradually relaxed. One by one, companies that had been designated for subdivision were removed from the list; plans to break up the major banks and other financial concerns were dropped; and in the end, the powers of the 1947 Elimination of Excessive Concentration Law were applied only to 18 large corporations (this figure excludes the large electricity-generating companies, which were also dissolved under this law). At the same time, purged members of the ex-zaibatsu families were gradually allowed to return to public life, and, in 1952, the prohibition on the use of zaibatsu names and trademarks was lifted (Toshio 1989).

The reversal of the earlier approach was also evident in the fate of the anti-monopoly law. This law was revised twice—once in 1949 and
once shortly after the end of the U.S. occupation in 1953. The watering down of this law can be seen as part of a wider economic policy known in Japan as the "Dodge Line" (after U.S. banker and economic adviser Joseph Dodge). The main thrust of this policy was the promotion of heavy and chemical industries (which were dominated by large enterprises) at the expense of small and medium-sized enterprises, farmers, fishermen, and workers. It therefore involved the creation of conditions in which industrial concentration could increase and monopoly capital could be consolidated.

When the Korean War broke out in June 1950, the U.S. government began a massive program of war-related procurements in Japan. These procurements proved a windfall for Japanese monopoly capital. Large firms pushed forward with new investment projects based on both internal accumulation of capital and long-term loans from financial institutions. At the same time, the San Francisco Peace Treaty, by restoring Japan’s political sovereignty, smoothed the way for the reconstruction of the old zaibatsu on new lines.

As has been seen, the dilution of the anti-concentration measures had left many large enterprises (particularly large financial enterprises) untouched. These firms soon emerged as the core of the new finance capital. Interlocking shareholding between the giant enterprises that had belonged to the zaibatsu increased, and the old zaibatsu-related city banks promoted the process of reconstruction by expanding their shareholdings in, and financing of, affiliated firms. From 1951 onward, the former zaibatsu trading companies, which had been dissolved during the American occupation, began to reconstitute their dismembered parts. Mitsubishi Shoji was finally reunited in 1954, and Mitsui Bussan in 1959. Their reappearance was indeed symbolic of the revival of Japanese finance capital.

By about the mid-1950s, therefore, the major prewar zaibatsu had been remodeled into “modern” monopoly enterprise groups that corresponded to postwar economic and political conditions, and the first stage of their postwar development was complete. It was around this time that the Mitsubishi, Mitsui, and Sumitomo groups (all descendants of the prewar zaibatsu) inaugurated their shachoukai (president’s club) as a means of coordinating group policies.

Firms from prewar zaibatsu that had lacked an influential financial agency began to regroup around the other major city banks. Corporations that had been connected to the Asano, Nissan, Okura, Mori, and other interests developed links with the Fuji Bank. Similarly, Furukawa, Suzuki, and Fujiyama enterprises affiliated themselves with the Dai-Ichi Bank while several large firms from the
Kansai (western Honshu) district formed financial connections with the Sanwa Bank. This process of consolidation went furthest in the Fuji group. Nevertheless, none of these three bank-centered groups can be said to have become fully fledged kontserun in this period; they remained at an intermediate stage of coordination that might be described as the "quasi-kontserun" stage.

In fact, large firms that became independent by combine dissolution launched business integration in two ways. First, they established vertical relations with small firms through subsidization (keiretsuka). Second, they formed horizontal linkages with other large firms through intercompany shareholding. This horizontal linkage grew into the shachoukai, whose members were presidents of large core companies of business groups.3

In the early 1950s when business groups began to be formed, the prewar type of industrial structure, based primarily on mining and light industries, was fundamentally transformed by the introduction of new technology. The implication was that business groups would inevitably be reshaped under a new industrial structure. New industries such as synthetic fiber, petrochemicals, home electronics, and automobiles began to flourish, leading to a rapid increase in private investment in heavy and chemical industries in general. In response to these industrial changes, the internal structure of business groups was reorganized as well. Light industries and mining industries such as coal and non-ferrous metals lost their predominant position in business groups and were replaced by the petrochemical and electrical and electronic machinery industries. At the same time, large-scale independent firms tended to grow faster than business groups (Lee and Lee 1990).

The Japanese economy resumed its rapid growth after the recession of 1965, but this was merely an extension of earlier rapid growth, since the industrial structure remained dominated by the same heavy and chemical industries. Under these circumstances, business groups restructured their internal organization and regained their dominance over large-scale independent firms. It was in this stage that Fuyou, Taiichi Kangin, and Sanwa grew out of the embryonic stage and took the full shape of a business group. In those days, there were a number of large-scale mergers between independent firms, most of which were a response to the growing strength of business groups. On the other hand, business groups steadily merged and acquired independent firms to consummate vertical integration. The liberalization of capital since 1967 further accelerated industrial restructuring and business groupings. As a protective means against acquisitions by
foreign capital, the degree of intercompany shareholding increased rapidly.

Gradually, the *kontserun* centered on the Fuji and Sanwa banks followed the lead of Mitsubishi and Mitsui and formed cohesive and self-supporting monopoly enterprise groups. In 1966, the Fuji Group established its own presidents' meeting—the Fuyo-kai—and the next year the Sanwa Group initiated its Sankin-kai (Toshio 1989). Under the conditions of high growth fostered by the Liberal Democratic government, intense competition between the big *kontserun* took place. One after another, they advanced into new industrial fields—the petrochemicals industry, real estate and housing, the exploitation of marine resources, and so forth. In most cases, the constituent enterprises of the presidents' groups would jointly put up the money to finance these new ventures.

As their economic power strengthened in the 1960s, the representatives of these enterprise groups came to play a leading role in a variety of big business organizations such as Keidanren (the Federation of Economic Organizations), which helped to weld together business and politics in Japan's capitalist system. Because of Japan's extremely high dependence on imported raw materials, the 1973 oil crisis had a severe effect on the economy. In the wake of the oil crisis came the economic recession of 1974–1975. In terms of its depth and extent, this was the most serious crisis of overproduction in the postwar history of world capitalism.

Japanese monopoly capital attempted to overcome this crisis by forcing through a program of "rationalization." At the same time, the structure of the *kontserun* was strengthened and consolidated. For example, the DKB group (so called since the merger of the Dai-Ichi Bank and Nippon Kangyo Bank in 1970) reorganized and tightened its structure, and in 1977 a central presidents' committee (the Sansui-kai or Third Wednesday Club) was established. Simultaneously, the number of firms belonging to the DKB group increased to 45. With the emergence of a unified DKB, it can be said that the evolution of Japanese monopoly capital was complete.

At the same time, the other *kontserun* were expanding their networks of power. Firms that joined the Mitsui group's presidents' committee in the 1970s include the Toshiba Electrical Company, the Mitsukoshi retail firm, and the Toyota Motor Company. Mitsubishi also added a new member firm to its presidents' committee in 1976 and, two years later, set up four ancillary presidents' meetings coordinating the activities of firms in specific industrial sectors. Meanwhile, the Sumitomo group and the Sanwa group increased the number of
member firms represented in their committees by four and three, respectively. Like the 1960s, the 1970s and the 1980s saw the big monopoly enterprise groups move into new areas of economic activity including overseas resource exploitation, the information industry, and so on.

In 1987, the number of non-financial member companies of the presidents’ clubs of six major business groups was 163, corresponding to 0.006 percent of all non-financial corporations (1,929,754) in Japan. However, this number belies their substantial presence in the Japanese economy. Non-financial member companies accounted for 13.28 percent of total assets, 14.68 percent of the total value of shipments, and 15.19 percent of total paid-in capital of all non-financial corporations (Table 4.2). As indicated by these figures, the six business groups exert a strong influence on the Japanese economy, comparable to that of prewar zaibatsu. This is further evidenced by the fact that in 1987, of the top 100 non-financial companies in terms of total assets, 54 were member companies of the six business groups.5

Table 4.2 Role of Six Major Business Groups, 1987 (percent of total)*

<table>
<thead>
<tr>
<th>No. of companies</th>
<th>Paid-in capital</th>
<th>Total assets</th>
<th>Shipments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Member companies of presidents' club</td>
<td>163 (0.006)</td>
<td>15.19</td>
<td>13.28</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>4,960 (0.257)</td>
<td>3.86</td>
<td>4.21</td>
</tr>
<tr>
<td>Affiliated companies</td>
<td>6,875 (0.356)</td>
<td>12.98</td>
<td>9.46</td>
</tr>
<tr>
<td>Total</td>
<td>11,998 (0.622)</td>
<td>32.03</td>
<td>26.95</td>
</tr>
</tbody>
</table>

Notes: a. This table excludes financial member companies. The six major business groups are Mitsui, Mitsubishi, Sumitomo, Fuyou, Sanya, and DKB.


However, despite the development of the big business groups, a zaibatsu revival in the exact sense of the phrase has not occurred. In fact, business groups differ a great deal. A direct cause for this is the prohibition of holding companies like the prewar zaibatsu head companies under the Anti-trust Act, as well as the prevention of strong financing affiliations from being formed for the reasons noted above. But a more important role has been played by technological innovations that promoted the development of heavy and chemical industries and
the sophistication of the industrial structure, thereby making industrial organization more competitive. In other words, the Japanese system of big business was characterized as a competitive oligopoly system (Kiyonari and Nakamura 1980).

The emergence of this kind of industrial organization may be attributed to the dissolution of the zaibatsu. On the other hand, this industrial structure itself plays a part in preventing the revival of zaibatsu-type industrial groups. New groups were formed by giant firms in heavy and chemical industries, outside of the former zaibatsu groups. Intergroup competition increased. Autonomy of member firms was emphasized in the former zaibatsu groups. Financial institutions' control of business was restricted. Intriground intragroup competition arose, and new industrial affiliations were formed outside the framework of existing groups. Competition intensified among big businesses despite the formation of such powerful industrial groups because some say, industrial groups, restricted by financial affiliations, each tried to acquire a complete set of rising enterprises in every industry. This thesis is popularly known as the one-set principle.

**Characteristics of the Postwar Business Groups**

With the U.S.-Japan peace treaty in effect in 1951, Japanese corporations started business integration, and old familiar names like Mitsui, Mitsubishi, and Sumitomo began to reappear. About 1955, presidential clubs such as Kinyokadi, Nikikai, and Hatsuigami were organized and met regularly. The three old zaibatsu groups began their move to reestablish their position as major corporate groups. However, the old families and holding companies that controlled the prewar zaibatsu groups never regained the same degree of original ownership and power. Postwar Japanese business groups were different from prewar zaibatsu in many ways. First, the mode of ownership changed from a hierarchical ownership, in which zaibatsu families owned the stock of the holding company, which in turn owned the stocks of affiliated companies, to an interlocking ownership pattern with the member companies owning the stocks of affiliated companies (Hattori 1989).

Member firms mutually hold the stock of other members of the same group (cross-stockholding). However, each member firm's share of the stock of another member firm is small. In the case of manufacturing firms, their shares were 0.7 percent, although trading companies held 2 percent, on the average, of the stock of other member firms of the same group, and banks held 5 percent on the average in 1974. On the average, 22.6 percent on the average of each member
firm's stock was held by other firms of the same group when their holdings are combined. This cross-stockholding has increased since the crash of the stock market in 1965. But here it must be noted that in Japan, the major part of a firm's stock is normally held by other corporations; 66.2 percent of the outstanding stock of all listed companies was held by corporations, whereas the share attributable to individual stockholders was 33.5 percent in 1974 (Goto 1982).

Clearly, stockholding by corporations is ubiquitous throughout large Japanese firms and is not a phenomenon specific to business groups. However, if member firms' shares are combined, cross-stockholding among group members may be a significant characteristic of group relations, even though each member firm's individual share is not very large. Interlocking directorates between group members is also a significant characteristic of business groups. In 1974, 69 percent of firms that belonged to six major business groups had directors (including auditors) who were sent from other firms belonging to the same group. Among these directors, 45 percent were sent from trading companies and principal banks. This matrix form of company control or interlocking shareholding relationship was not observed before the war and cannot be found in foreign countries. This interlocking business relationship is peculiar to postwar Japanese big business.

Second, a presidential club comprising the group presidents of member companies with mutual ownership of stocks was formed. Although there is no central decision-making unit like a holding company in a big six group, the exchange of information and various types of interfirm coordination are made at the presidents' club meetings, usually held monthly, and at other lower-level meetings. It is difficult to know from the outside what is discussed and what kind of information is exchanged at these meetings. Judging from fragmentary evidence obtained from interviews and newspapers, the main topics of these meetings include the opening up of business opportunities, new technologies, government regulations, foreign market situations, the granting of permission to a firm to use the group name, and the assignment of contributions to be made to charitable organizations from among member firms. But these meetings do not have the power to compel member firms to carry out specific actions (Goto 1982).

Several examples illustrate this lack of control over member firms. The Sumitomo Light Metal case in 1972 illustrates that some sort of persuasion or pressure can be used when member firms' interests directly conflict with one another. More important, it also indicates that each member firm is an independent decision-making unit and has
autonomy despite all the persuasion and coercion from other member firms. This is even more the case in non-zaibatsu groups where relationships among member firms are not as close. Therefore, a presidents' club can be viewed as the human organization at the base of this sort of interdependent relationship of capital. Or perhaps the presidents' club was actually established as a human organization first, and gradually strengthened its base by consolidating the interdependent network of capital.

Third, each corporate group consisted of subsidiary and affiliated companies, which were diversified in a wide range of businesses. Independent business groups are composed of large firms and their subsidiaries. While member firms of the big six groups are usually all large-scale firms, independent groups consist of only one large-scale firm and its subsidiaries. It is important to note that the big six groups and independent groups are not mutually exclusive. On the contrary, the member firms of the big six groups usually form their own independent groups, composed of themselves together with their subsidiaries. However, many large firms that form independent groups do not belong to the big six groups. The parent company of one of the largest independent groups, Nippon Steel, is a good example of this. In contrast with the big six group—where member firms are essentially equal in power and no single member firm can direct or subordinate other members—decision making in the independent group is centered in the parent company. In fact, some of the subsidiaries form an integral part of the parent company and can be viewed as being essentially divisions of the parent company in the sense that they don't have autonomy in decision making (Goto 1982).

The measures of control over subsidiaries by a parent company are, according to the Fair Trade Commission: (1) stockholding, (2) a strong relationship in transactions, (3) interlocking directorates, and (4) financial aid. A “strong relationship in transactions” means that the parent company controls its subsidiary through its monopsonistic market power of buying services and intermediate goods from subsidiaries. The Fair Trade Commission’s survey of the 50 largest firms in terms of paid-in capital in 1970 (excluding those in the finance, public utility, and airline industries) and their subsidiaries (using the 10 percent or more definition) found that 4,271 out of the 50 largest companies' 5,456 subsidiaries were vertically related to their parent company. Among these vertically related subsidiaries, 63 percent were situated downstream from the parent company (e.g., subsidiaries were engaged in marketing the products of the parent company), 29 percent were situated upstream from the parent company.
(e.g., subsidiaries supplied intermediate goods, materials, and parts to the parent company), and 8 percent were characterized by some other form of transaction.

Interlocking directorates are also common. In the case of the independent group, this relationship is unilateral; that is, some of the directors of the subsidiaries are sent from the parent company and often keep their position at the parent company, but the opposite is not the case. According to another Fair Trade Commission study of the 172 largest firms in terms of paid-in capital in 1972 and their 12,247 subsidiaries (using the 10 percent or more definition), 9,878 of the subsidiaries had one or more directors sent from the parent company. The average number of directors who were sent from the parent company per subsidiary was found to be 3.0, and 36 percent of these subsidiaries had a chairman and/or president who was sent from the parent company.

“Financial aid” means that the parent company gives trade credit, loans, and/or credit guarantees to its subsidiary. In the Japanese financial market where the availability of funds for firms depends heavily on the size of the firm, the access of subsidiaries to funds is limited because most firms are small in size. Therefore, trade credit and credit guarantees given by the parent company are an important source of funds for small-scale subsidiaries.

Fourth, each corporate group was organized around a major commercial bank and a general trading company that assisted the financing of affiliated companies. Financial firms (i.e., banks, and brokerage and insurance companies) within the business group facilitate the growth of member companies through financial assistance. The fact that other business groups are organized around such large city banks as Fuji, Sanwa, and DKB proves the importance of financial firms in business groups. And each corporate group has a general trading company that plays a central role to the group's companies. Through various transactions and information services, the general trading company performs valuable functions for group companies. Recently, trading companies have begun to take a pioneering role in setting up information networks across all companies within a group (Hattori 1989). These trading companies—most notably, Mitsubishi Shoji, Mitsui Bussan, Sumitomo Shoji, Marubeni, C. Itoh, and Nissho-Iwai—not only perform normal sales functions but also purchase shares in and lend money to other enterprises, organize new investment projects, collect business information, and so forth. In this way they have come to be crucial to the coordination of each kontserun.

Member firms rely on banks and other financial institutions, such
as insurance companies, that belong to the same group for a large part of their loans. The rate of reliance on these "group loans" was 22 percent in the six major groups, on the average, in 1974. Here, the rate of reliance on group loans is the ratio of the total amount of loans member firms of a group received from member banks and insurance companies to the total amount of loans received by member firms. However, because Japanese firms rely heavily on bank loans to finance their rapid growth, their reliance on non-group banks and financial institutions is also high. The difference between the ratio of loans from the group bank (which is usually the largest lender to the firm) to the total amount of loans received by the firm and the ratio of loans from the second-largest lender to the total was not substantial. One must also keep in mind that in the Japanese funds market, a large-scale firm has favorable access to many sources of funds, especially long-term funds, including the stock market, the bond market, and the bank loan market.7

The main characteristics of business groups can be summarized as follows. First, large firms within a business group are interrelated organically by mutually holding each other’s shares. For a business group as a whole, such intercompany shareholding takes a circular form. Second, each business group has a presidents’ club. Because each president represents the combined shares of fellow member companies that his company holds, this club acts like a board of large shareholders. Third, large city banks hold lion’s shares in business groups, and hence, form the core of intercompany shareholdings. At the same time, they also serve as financial intermediaries within their business groups, catering to the capital requirements of other member companies. Fourth, in addition to banks and general trading companies, business groups have subsidiaries in a large number of industries. Not only do they constitute a conglomerate, but they also contain a comprehensive industrial complex often called a one-setism (Lee and Lee 1990).

The modern business groups look similar to the zaibatsu because they perpetuate many of the old company names, most prominently, the names of member financial institutions and general trading companies. They differ from the zaibatsu, however, in many important respects. First, a business group has neither a holding company nor a controlling family. Stocks in member companies are cross-held, and thus the relationships among the member companies are horizontal (as opposed to the vertical zaibatsu structure). Presidents of member companies assemble once a month at a joint meeting, but no individual dominates the discussions. In this regard, business groups repre-
sent models of democratic cooperation among equals. The fundamental difference between zaibatsu and Japanese business groups today lies in the nature of their ownership structure. Whereas the zaibatsu had one-sided vertical ownership structures stemming from top holding companies, today’s Japanese business groups are owned by their subsidiaries through intercompany shareholding (Figure 4.1).

Figure 4.1 Ownership Structure of Japanese Business Groups

a. Prewar Period: Pyramidal Structure

b. Postwar Period: Star Structure

Second, the banking arm of the business group plays a far more important role than its zaibatsu counterpart did. Although the zaibatsu bank was one of the related companies, the other enterprises within the group seldom relied on the zaibatsu bank for funds, because the holding company distributed funds to group companies. Within the business group, on the other hand, the member bank is most often the main bank of the member companies. Third, "one-setism" emerged as a feature of the business group. Zaibatsu families tended to be conservative with respect to enlarging the industry portfolio and refused to embark on new and risky ventures. Business group managers, in contrast, were not risking their own fortunes and thus became less risk-averse. The competitive spirit, fueled by their willingness to launch new businesses and increase production capacity, encouraged them to diversify horizontally, so that each business group would comprise a complete set of companies representing every major field of economic activity.

Comparison with the Korean Chaebol

In contrast to the relatively specialized and narrowly focused large Japanese company, the Korean chaebol coordinate a variety of resources and are much more self-sufficient in terms of the activities they directly control. Subcontracting is thus much less marked than among Japanese firms. However, the chaebol tend to focus on related business fields and vertical integration rather than on unrelated diversification. Similarly to the prewar Japanese zaibatsu, the Korean chaebol also limit themselves to distinct business sectors rather than competing with each other in all major areas.

Although a number of similarities can be noted between the prewar Japanese zaibatsu, the postwar Japanese business group, and the Korean chaebol, several distinct differences also exist. First, a marked difference between Korean chaebol groups and Japanese business groups is the strong connection between ownership and management in the former businesses. Despite government pressure to float their companies on the stock market, most chaebol remain firmly controlled by the founder and his family with equity funds being restricted to under one-third of the shares in a few of the constituent firms. Furthermore, many of the shares held by non-family members are owned by financial institutions largely controlled by the dominant family. In general, then, managerial independence from dominant shareholders is much less than in Japan, if not virtually negligible (Whitley 1990).
The strong influence of family ownership, in the direction of the *chaebol* is reflected in the highly centralized decision-making process. Authority stems directly from ownership and the founder, or his son, is involved in all major decisions, and indeed, many minor ones. Furthermore, most of the major subsidiaries are headed by family members so that although a considerable number of highly educated managers are employed in these large enterprises and although bureaucratic control systems are quite highly developed, personal, particularistic attributes and connections are more important than formal rules and procedures, and managers delegate upward.

Although the Korean *chaebol* and the prewar Japanese *zaibatsu* are both family enterprises, ownership and management are separated in Japanese *zaibatsu* but not in Korean *chaebol*. *Zaibatsu* families, especially Mitsui and Sumitomo, have never actively participated in management; rather management is entrusted to professional managers. The separation of ownership from management became much more definite in the business groups after the *zaibatsu* dissolution. Unlike the prewar *zaibatsu*, there is still little separation between ownership and management of *chaebol* firms. All group firms are invariably under the control and ownership of a single family. This family is, in turn, typically dominated by a single patriarchal figure who is almost without exception either the original founder of the *chaebol* or his chosen familial successor.

Second, as a result of extensive family ownership of Korean *chaebol*, the majority of top managers in Korea are family members. Hence, the percentage of professional managers who work their way to the top is considerably higher in Japan than in Korea. Much of this difference can be attributed to the relative newness of the Korean *chaebol* (many of the founders are still alive, whereas many of the major Japanese business groups are several hundred years old), and as time goes on a greater percentage of professional managers can be expected (Steers, Shin, and Ungson 1989).

Ninety-two percent of Japanese executives are internally promoted *tobagi*, and 74 percent of them were promoted at least once in a subsidiary or affiliated company. This internal personnel development system has a long history from 1925 throughout the old *zaibatsu* days and into the present. The fact that a large number of professional managers was developed through internal promotion was a major factor in the old *zaibatsu* groups' survival through the dissolution. In Korea professional managers are often recruited from outside. Because of the rapid growth of Korean *chaebol* groups, the development of *tobagi*-type professional managers was inadequate to meet the demand.
Third, Korean chaebol groups do not have major commercial banks or powerful trading companies as Japanese zaibatsu groups do. Although Korean chaebol have general trading companies, they are more like export companies than real general trading companies capable of performing financial, informational, and administrative functions as did their Japanese counterparts. Furthermore, financial firms within the Korean chaebol groups are in most cases owned by the owners or by holding companies, rather than owning their own stocks as is the case in Japanese business groups. This may be due to the limited ability of financial firms to provide financial resources for other companies within the group. At any rate, Korean chaebol are not in a powerful position in terms of their equity ownership or financial capability to support affiliated companies as were the Japanese zaibatsu (Hattori 1989).

Even more than Japanese companies, Korean chaebol are heavily dependent upon the major banks, which are state controlled, for loans. Thus the chaebol are much more directly linked to state agencies and dependent on their priorities than are Japanese firms, and their growth patterns reflect the preferences of, and opportunities provided by, politicians and planners (Jones and Sakong 1980). Indeed, the state as a whole in Korea still functions as an essentially patrimonial system and dominates the economic system. Certainly the leaders of the chaebol are closely connected to members of the political and bureaucratic elites and have received preferential treatment in many instances.

Therefore, the business-government relationship in Korea has a decidedly superior-subordinate nature compared to that of Japan, although the situation is changing slowly under the new government. In Japan this relationship (especially with the Ministry of International Trade and Industry) is not completely equal but is at least a little less one-sided than it has been in Korea. Because of the relationship with the government, this difference was notable in the nature of financing. Most borrowing for new ventures in Korea has been from the government, while in Japan far more borrowing is from group-connected banks; hence, Japanese concerns have greater freedom than their Korean counterparts.

What are the major factors responsible for the many differences between the large business group in Korea and Japan? First, we should consider the length of time that these business groups have been in business. Except for the Doosan group, which was established in the late nineteenth century, most Korean chaebol groups were founded about 1950. On the other hand, Mitsui and Sumitomo have a history of more than 300 years, and even Mitsubishi has more than a hun-
dred-year-old history. In contrast, Korean chaebol, with only 30 to 40 years of history, are still directly managed by the founders or second-generation owners. Therefore, the Korean chaebol maintain the characteristics of a family business (Hattori 1989).

Second, we should consider the ways that Korean chaebol and Japanese zaibatsu maintain integration among the group and affiliated companies. In Korean chaebol, integration is maintained through direct ownership and active participation in management. In Japan, the business groups were owned by zaibatsu families, but their management was left to professional managers who were not zaibatsu families. In the case of the postwar business groups, the group-member companies integrate the group companies through mutual stock ownership.

Third, we cannot ignore the cultural and social characteristics of Korea and Japan, especially in the concept of the family. The concept of family is different in Japan and Korea. In Japan, maintaining the family (ie) and increasing the family assets are of the utmost value. Hence if the owner feels his children are not capable of leading the family business, he adopts a son to whom the business is willed.

Whereas Japan has two different connotations of family—one based on blood relationships and another based on household or clan relationships—in Korea, family members are determined by blood relationships. In most cases, clan relationship, not blood, determines inheritance and succession in Japan. On the other hand, the Korean concept of family is strictly based on the blood relationship.

The difference in the concept of family in Japan and Korea has an important implication to the family inheritance and the ownership structure of zaibatsu and chaebol. In Korea, the family inheritance is strictly based on the blood relationship, with the eldest son given the first priority. This system is called "the unequal inheritance favoring the eldest son." In Japan, however, the concept of clan is applied to family inheritance, and its primary purpose is to maintain the wealth of the family under the leadership of a capable person rather than to bequeath the wealth only to the blood-related family. Therefore, the family wealth may be bequeathed to an adopted son with no blood relationship or to an in-law. In other words, under the clan concept, the head of the family is not as much the successor of blood lineage as the one who takes the leadership role in the family.

Understanding the difference in the concept of the family is critical in comparing the ownership and management structure of the Korean chaebol and Japanese zaibatsu. In Japan, because family wealth is inherited by a person on the basis of his or her ability to preserve it, regardless of blood relationship, the zaibatsu family hardly participates
in management of the *zaibatsu* business. The *zaibatsu* families in Mitsui, Mitsubishi, and Sumitomo, which have a long business history, have not participated in management. In the case of Mitsui, its family members are prohibited from participating in the management of those companies whose stocks they own, from being a guarantor to other people, and from belonging to a political party or being government officials. This separation of business ownership and management is to maintain the family wealth as an economic foundation. In contrast, in Korea, as the family wealth is inherited on the basis of the blood relationship, blood-related family members usually assume managerial responsibility. Consequently, the separation of ownership and management does not occur in Korean *chaebol* (Hattori 1989).

Many Korean *chaebol* are now in the process of succession to the second-generation owners, and it is possible that greater management power will be delegated to professional managers. It will be interesting to see what role the traditional culture plays in the succession process. If Korean *chaebol* apply the traditional method of dividing the business among the founder's children and the same process is repeated for later generations, management based on professionalization will not be realized. Changes in the business environment will also affect the process of succession in Korean *chaebol*. Advances in production and management technologies and pressures for democratization and rational management will require many changes in the managerial practices of Korean *chaebol*, although the ownership structure may not change much in the short run.
Notes

1. In fact, it was these professional managers who maintained the successful operation of each subsidiary company after the dissolution of the zaibatsu.

2. In the title of this law, the term “the excessive concentration of economic power” was somewhat misleading in our context, since this law was aimed at the dissolution of individual monopolistic or highly oligopolistic firms, and not business groups as a whole.

3. Since these “clubs” started rather informally, it is not always possible to determine when they began to be recognized officially. Their names, number of member companies, and dates of formation are as follows:
   - Mitsui: Second Thursday Club, 24 companies, October 1961
   - Mitsubishi: Mitsubishi Friday Club, 29 companies, about 1955
   - Sumitomo: White Waters Club, 20 companies, about 1951–1952
   - Fuyou: Fuyou Club, 20 companies, January 1961
   - Sanwa: Third Wednesday Club, 44 companies, February 1967
   - DKB: Third Friday Club, 47 companies, January 1978

4. The four groups are (1) the machine industry committee, (2) the chemical industry committee, (3) the service industry committee, and (4) a committee covering other miscellaneous industries.

5. For a detailed statistical description of these business groups, see Fair Trade Commission (1989).

6. The immediate causes of this rise in cross-stockholding after 1965 are the following. When the stock market crash occurred in 1965, two institutions—Shoken Hoyu Kumiai (Securities Holding Union) and Kyodo Shoken (Cooperative Securities)—were created to buy and freeze a certain amount of stock to stabilize the market. After stabilization had been achieved, these stocks were sold through the market. At this time, the Japanese economy was moving toward the liberalization of foreign investments, and most firms were fearful of being taken over by foreign firms. Therefore, the management of private firms asked other firms to hold their stock so that they could avoid a takeover (in the case of group-affiliated firms, member firms of the same group were asked). This was called the “stockholder stabilization operation.”

7. For further discussion, see Teranishi (1975).

8. Hattori (1984) indicates that in the case of the Japanese zaibatsu, virtually all management decisions were made by professional managers, not familial stockholders.
PART II

CHARACTERISTICS OF CHAEBOL
AND THE GROWTH MECHANISM
Although big business groups are a common phenomenon in advanced countries as well as in less developed countries, certain characteristics distinguish the Korean chaebol from big business groups in other countries. The most distinguishing characteristics of Korean chaebol are management by family and diversification, which were both included in the definition of the chaebol in chapter 2.

Ownership and management are not separated in most chaebol groups. This results in management by family, although the proportion of professional managers has been increasing steadily. As a result, top-down decision making is common in chaebol. Because chaebol have a relatively short history, many founders are still in top management positions. Managerial succession has become an important issue for chaebol because transfer of ownership as well as management is based on the blood relationship.

Although, according to Chandler (1977), the modern industrial enterprise in late industrializing countries takes the form of the diversified business group, Korean chaebol are criticized for their “octopus-arm” style of expansion, their aggressive infringement into the small business areas, and their lack of business ethics.

The Ownership-Control Structure

There is a general pattern of ownership and control in chaebol whereby the ownership structure is closely related to management control. In most chaebol groups, the major stockholder, who is the actual owner of the group, intervenes in the decision-making process of affiliated firms through formal or informal control even though each group has a structure specific to itself.
In the industrialized countries, ownership of large corporations is typically divorced from control with the former in the hands of diversified shareholders and the latter in the hands of professional managers. In Korea, most chaebol are characterized by unity of ownership and control. Even where individual companies have gone public and only 30 percent of the shares are retained by members of the founding family, that share is more than enough to insure control because the remainder is widely dispersed with a substantial portion often held by employees (Jones 1987).

Unlike in the industrialized countries, unity of ownership and control is the norm in less developed countries. However, it takes a variety of forms. For example, in Latin America, the group draws its capital and high-level managers from sources that transcend a single family. The capital and managers come from a number of wealthy families, but they remain within the group as a single economic unit. In marked contrast to such interfamily pluralism, the chaebol are strictly intrafamily groups. Ownership of significant shares is strictly single-family, though in some groups—such as Lucky-Goldstar—the relevant “family” is bilaterally extended over several generations.

Not only is ownership in Korea confined to a single family, but control is also generally concentrated in a single individual. Most groups are led by a chairman or president who typically established a single enterprise, brought it to prosperity, left it in the control of a relative or trusted subordinate, moved on to found a new firm, and so forth. Generally, shares in these firms are often widely dispersed among family members for tax purposes, but control is hierarchical and centralized. Exceptions to this pattern occur in an increasing number of cases of older chaebol where control has passed to a second generation (for example, Ssangyong and Lucky-Goldstar) with the control pyramid peaking in the hands of two or more successors.

This single-family ownership and control structure in Korean chaebol is partly due to their short history as first-generation products of a single driving entrepreneur. Even in the second generation, however, they remain rigidly single-family hierarchical operations, and this may be in part due to the Confucian cultural heritage. Another possible factor is the source of original capital. The financial history of the chaebol has been completely different from that of big business groups in other countries. There were few historic concentrations of rural or mercantile wealth; these had been wiped out by the Japanese colonial period, the Korean War, and an effectively confiscatory land reform. Chaebol did not grow by tapping accumulated wealth, but by starting small, generating a surplus, and reinvesting it with tremendous lever-
age by borrowing from government-controlled banks. Korean entrepreneurs stood on their own feet (albeit on the back of the government) rather than leaning on one another as seems to have been the case in Latin America.

It is well known that Korean chaebol groups have many affiliated enterprises under their control; but not many of them are listed on the Korean Stock Exchange. Therefore, it is necessary to obtain business operation reports directly from the closed corporations to analyze the ownership structure of chaebol. As table 5.1 shows, the ratios of family ownership of chaebol are much higher than those of non-chaebol. The family ownership of the chaebol groups averaged 33 percent in 1982 and 39 percent in 1986, while those of non-chaebol groups averaged 24 percent in 1982 and 33 percent in 1986. When we see the composition of family ownership of chaebol groups, interlocking ownership among affiliated enterprises is larger than the direct ownership by family except 1982.

Table 5.1 Distribution of Ownership (percentage)

<table>
<thead>
<tr>
<th>Date</th>
<th>Classification</th>
<th>Family and relatives</th>
<th>Affiliated enterprises</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 1982</td>
<td>Chaebol</td>
<td>17.7</td>
<td>15.0</td>
<td>32.7</td>
</tr>
<tr>
<td>(Hattori)</td>
<td>(top 10)</td>
<td>(13.4)</td>
<td>(19.0)</td>
<td>(32.4)</td>
</tr>
<tr>
<td></td>
<td>Non-chaebol</td>
<td>21.0</td>
<td>3.0</td>
<td>24.0</td>
</tr>
<tr>
<td>December 1986</td>
<td>Chaebol</td>
<td>17.2</td>
<td>21.9</td>
<td>39.1</td>
</tr>
<tr>
<td>(Lim)</td>
<td>Non-chaebol</td>
<td>24.1</td>
<td>8.5</td>
<td>32.6</td>
</tr>
<tr>
<td>April 1989</td>
<td>Top 5 Chaebol</td>
<td>13.7</td>
<td>35.7</td>
<td>49.4</td>
</tr>
<tr>
<td>(Lee)</td>
<td>Top 10 Chaebol</td>
<td>14.7</td>
<td>31.7</td>
<td>46.4</td>
</tr>
</tbody>
</table>


However, in non-chaebol groups, direct ownership is much larger than interlocking ownership. Furthermore, when we compare the family ownership of the top 10 chaebol between 1982 and 1989, the proportions of direct ownership are similar, while the interlocking ownership in 1989 increased by about two times that of 1982. This shows a gradual increase of the interlocking stockholding. The tendency is that the large chaebol results in larger share of the family ownership, especially interlocking ownership.
The concentration of ownership has resulted to a great extent from the peculiarities of the Korean financial environment. The rapid growth of large business groups requires a tremendous amount of capital. In general, a firm can raise funds by tapping internal reserves, by issuing stocks, or by borrowing. In an economy where the general income level is low, inflation is rampant, and other profitable speculative investment opportunities exist, it is extremely difficult for a firm to raise its required capital by issuing stocks to the general public. Furthermore, only rarely are the internal reserves of a firm sufficient to finance new investment projects, especially in capital-intensive industries. Hence, that firms are inevitably highly dependent on external financing. Because of this financing method, ownership of chaebol groups was not dispersed in the course of their growth but was aggravated by the intercompany shareholding practice mentioned earlier (K. Lee 1990).

In addition, the loan policies of banks provided an incentive for intercompany shareholding. To deal with the chronic excess demand for funds, the banks relied on a rationing system that allocated total available funds in proportion to the amount of capital of each potential recipient. Under this system, business groups connected through intercompany shareholding had better access to bank loans, because the capital of an individual subsidiary firm was thereby fictitiously increased. A subsidiary of a chaebol group thus had stronger bargaining power than an independent firm of the same size. This may be an additional factor in explaining the relatively rapid growth of business groups compared to other firms.

There are a number of ways for an individual to control a chaebol group. The most obvious is to hold a majority share of each component firm, but this method is limited by its high capital requirements. The second is a pyramid-like control of firms through a holding company, which is forbidden in most countries. In Korea the Act on Monopoly Regulation and Fair Trade of 1980 (hereafter, the Anti-monopoly Act) was revised in 1986 to include a new clause to the same effect.

A more general method of control is intercompany shareholding, which can take either one or all of the direct, radial, circular, or matrix forms. Among these, direct cross-ownership between a parent and a daughter company is prohibited by the 1986 amendment to the Anti-monopoly Act. At any rate, this method has limited or little effect in consolidating a large number of firms into a single chaebol group, and indeed, was rarely used even before it was legally prohibited.

It is difficult to disentangle the complicated web of cross-ownership
that can comprise a chaebol. In an attempt to restrict intercompany shareholding, therefore, the amended Anti-monopoly Act stipulates that any subsidiary of a business group beyond a specified size may neither obtain nor hold shares of other domestic firms in excess of 40 percent of its net assets. In 1984 when no such restriction existed, the average intercompany shareholding ratio for the 30 largest chaebol groups was 46.5 percent. More specifically, this ratio was 50.9 percent for the top (i.e., the 1st–10th) bracket of chaebol groups and 41.8 percent and 26.3 percent for the second (11th–20th) and the third (21st–30th) bracket of chaebol groups, respectively. In other words, the higher the bracket of the chaebol groups, the higher the average ratio of intercompany shareholding.

With the enforcement of the amended Anti-monopoly Act, however, chaebol groups have taken various measures such as increasing the issue of shares in the stock market and internal reserves to adjust to the new restrictions. Such measures are optimal for chaebol groups that do not want to disinvest substantially from their subsidiaries, but still wish to meet the legal requirements. Consequently, their capital bases have expanded and their ownership has dispersed, at least to some extent. It is possible that some imprudent investment in other firms that might otherwise have been better used could have been discouraged. The Anti-monopoly Act may be said to have been effective in this respect, since in 1989, when the act still permitted some grace period, the average ratio of intercompany shareholding decreased substantially to 31.5 percent. However, table 5.1 shows that in the case of the top 10 business groups, an average of 46.4 percent of total company shares are owned by particular individual shareholders and the firms they control. At the same time, less than 30 percent of their subsidiaries have gone public in the stock market, and account for less than 60 percent of business groups' total equity, on the average. We may therefore say that the chaebol still maintain quite a closed ownership structure (K. Lee 1990).

The family ownership of chaebol could be classified into three types (Hattori 1989). Type I is direct ownership, in which the owner or his family directly owns the chaebol group companies. The Hanjin group is a typical example of Type I. Type II is a holding company ownership, where the owner or his family owns the holding company, which, in turn, owns the group's companies. The Daewoo group is a good example of Type II. Type III is mutual ownership, in which the owner or his family owns the holding company or intermediary organization such as a cultural foundation, which has interlocking mutual ownership with affiliated companies (see Figure 5.1). The Samsung
Figure 5.1 Ownership Structure of Chaebol

a Type I: Direct Ownership Structure

b Type II: Holding Company Structure

c Type III: Mutual Ownership Structure

group is an example of Type III. There is a tendency for chaebol to develop from Type I to Type III as they grow. The transition is slow but relatively smooth from Type I to Type II, but some sort of a mechanism to unify and consolidate ownership interests needs to be worked out between Types II and III.

To quantify the owners' influence on the chaebol groups' management, Hattori (1989) used a 10-point scale. According to this scale, if the owner or one of the family members is chairman or president that person is given 10 points, the vice president is given 5 points, the representative director is given 4 points, the executive director is given 3 points, and the director of the affiliated company is given 1 point. Based on this power index score, the power score of owners' families in 41 chaebol groups averaged 29.7. The score varied depending on the size of the chaebol. The average score of the largest one-third was 20.6, the middle one-third was 29.4, and the smallest one-third was 39.2. These results are interesting, for they suggest that the share of family ownership is inversely related to management control; that is, the larger the size of the chaebol group, the greater the share of family ownership with weaker management control; and conversely, the smaller the size of the chaebol group, the smaller the share of family ownership with stronger managerial control.

The control structure of the chaebol became one where the owner held the top managerial position in many firms or employed family, friends, or founding members in such positions; thus, the group was controlled by interpersonal relations. The structure of the chaebol group, without interorganizational links and connected by personal ties of the owner, shifted in the middle of the 1970s to the multidivisional structure to effectively control the new affiliated companies and avoid organizational inefficiency. For example, Samsung has controlled affiliated firms by using a staff organization called the Secretarial Office. In 1978 it added a corporate planning office and fortified its multidivisional structure. Hyundai added a General Planning Office in 1979. This phenomenon signifies that to minimize the loss of control within an individual firm arising from the expansion of divisions, such firms are set up as independent companies and controlled on a par with other affiliated firms.

Chandler (1977) noted that in the early 1920s, several large functionally organized American corporations developed multidivisional (M-form) internal structures in response to the increasingly complex administrative problems encountered as firm size and diversity increased. In extending Chandler's analysis, Williamson observed that firms encountered two major problems as they expanded radially: cu-
mulative control loss and the confounding of strategic and operating decision making (Teece 1981).

A multidivisional organization is one response to such difficulties. A pure M-form involves control systems that induce appropriate goal pursuit by divisions and consists of semi-autonomous divisions operating under the surveillance of a general office. Control loss associated with increasing size is contained because expansion is accommodated by adding divisions rather than by deepening the hierarchy. Informational and decision-making economies are achieved by changing the nature of information flows between the upper and lower levels of the enterprise. The divisions are responsible for operating decisions, while the headquarters assumes responsibility for strategic decisions. The headquarters obtains the requisite control through the design and manipulation of incentive machinery, internal audits, and capital allocation.

For a large enterprise, the M-form structure is superior to other alternatives because it reduces the scope for management to pursue objectives other than maximizing the value of the firm. Furthermore, the M-form creates its own internal miniature capital market, thus replicating external capital market functions and economizing on transactions cost. The M-form hypothesis implies that large firms that adopt this structure will be more efficient than firms that retain their functional structures or fail to implement the M-form correctly.

The Korean chaebol's structure is multidivisional, but the M-form structure like a general office tends to be relatively small. This means that the structure of the chaebol group may be close to a U-form, rather than a pure M-form. The U-form is a traditional structure with a functional organization based upon centralized divisions. In fact, some large chaebol do not have any general office, secretariat, or staff to serve the president and his retinue. Among 218 large firms surveyed by the College of Business Administration, Seoul National University (SNU), as many as 30 percent of the firms had no general office. Among the 200 or so firms (large and small) that did have general offices, the functions that they regularly undertook were limited. Most functions were undertaken centrally only when the need arose, in which case managers operating at the group or company level were pulled together to form a temporary task force. Such task forces, for example, executed decisions about entering new industries (Amsden 1990).

A small or non-existent general office is a key characteristic of the Korean chaebol and is indicative of how decision-making power is distributed between owners and professional managers. Decisions at the
Characteristics of the Chaebol

...top tend to be made by owners autocratically, rather than bureaucratically. Most decisions, however, are not made at the top. According to SNU's survey, professional managers made decisions about production, research and development (R&D), and marketing, and these managers were assigned where their skills were needed most, whether on the shop floor, in the plant, or at the company level. Firms concentrated more than half their efforts on production and R&D (which in the mid-1980s typically concerned the absorption of foreign technology), with marketing taking up much of the remainder of their time. This picture of the distribution of power—which shows strategic and financial decisions in the hands of a single individual or family, and decentralized decision making in other areas—is supported by statistics on the growth and composition of Korean management.

A study by Lee and Yoo (1987) shows that 31 percent of the executive officers of the top 20 chaebol in Korea are the owner's family members. Based upon this information, we may conclude that the owner's or his/her family members' influence on management is very strong. However, the power structure of each chaebol may be different, based upon the number of family members and the owner's management philosophy. While the ratio of family ownership is higher for the larger chaebol, the owners' influence on management is stronger in the smaller chaebol. If the structure of ownership is sole possession by the owner, the owner's or family members' influence on management is enormous. Even though some non-family members (such as professional managers) may take higher management positions in chaebol groups of the other two ownership types (i.e., Type II or Type III), the most important posts usually belong to the owner's family members.

Considering the short history of Korean chaebol, it is understandable that many companies are still managed by the founder-owner. As the companies grow and mature, however, many companies will face a shift in generation. The handing over of an enterprise is not a simple matter, since it is not simply a transfer of wealth but the inheritance of a living organization. Thus the success or failure of the transfer often determines the future of the company. The success or failure of the transfer is often determined by the method of inheritance. Succession in Korea usually has been based on the Confucian tradition of hierarchical order within the family, with the highest priority being given to the eldest son in the family. In Korea, according to Shin (1985), the first son inherits, on average, 65.9 percent of the family holdings; family members other than the first son receive 24.4 percent; and non-family members receive 9.7 percent.
In Korea, although convention holds that the eldest son should take over the family business when the father steps down, family wealth and property are distributed upon the father’s death among all sons, albeit unequally in favor of the eldest son. This division of property among family members threatens the longevity of the chaebol as a single entity responsibly managed. Thus, Won Suk Kim, the youthful second-generation successor of the Ssangyong group, noted that no chaebol ownership is going to last three successive generations. As of 1989, only two of the top nine chaebol were still chaired by their founders. The other seven were all headed by second-generation familial successors. In anticipation of the centrifugal tendencies of property-inheritance norms, the complexities of multifirm management, and state policies designed to separate ownership and management, the chaebol have taken measures to assure familial succession and chaebol longevity. Many of the chaebol founders established foundations to which they turned over much of their personal assets. Ostensibly charitable organizations, these foundations have provided a convenient institutional method for circumventing cultural norms of succession and inheritance and passing on assets outside the scrutiny of government policy makers and tax authorities (Fields 1991).

Hyundai’s Asan Foundation is to receive some 90 percent of founder Ju-Young Chung’s wealth. Chung’s passing of the chairman’s responsibilities to his younger brother Se-Young Chung in 1987 is seen as an effort to create a period of transition while the elder Chung determines which of his seven surviving sons should ultimately become the long-term successor. Although many predict that Daewoo’s founder and chairman Woo-Choong Kim will select his successor from among the ranks of Daewoo’s professional managers, Kim has in the meantime given all his personal assets to the Daewoo Fund.

Samsung’s founder Byung Chul Lee, intent upon preventing the division of his chaebol, broke with Confucian tradition by passing over his two eldest sons and selecting his third son, Lee Kun-Hee, as his successor. Hattori (1984) notes that under the atmosphere of Korean familism, making such a selection could lead to social friction. To minimize the friction, Lee transferred a large proportion of family stock to two foundations, Samsung Foundation and Samsung Mutual Aid, during this period of succession uncertainty. This, Hattori argues, allowed the two institutions to play the symbolic role of a united Samsung. After Lee determined his successor, the function and, hence, the stockholdings of these two institutions decreased accordingly.

The Hyundai and Kumho groups divided at one point because ownership in both cases was shared by two brothers, but the econom-
ic costs of separateness prompted both chaebol to opt for reunification. In addition to orchestrations by the chaebol owners to keep them intact, the synergistic advantages of integration and diversification have overcome divisive tendencies. Thus, familial dominance of ownership and top management positions, at least in the short run, is likely to persist.

In addition to the transfer of control, recruiting also becomes an important issue for the growth of a company. During the rapid growth of the economy, the company needs to recruit capable managers. Much of the recruiting has been done, not on the basis of ability, but on various connections such as family ties, relatives, common hometown or school, or political ties. One study shows that 31 percent of the executive officers of the top 20 chaebol in Korea are family members, 40 percent are recruited from outside, and 29 percent are promoted from within. Another study shows that 25.4 percent of presidents of Korean companies are founders, 18.4 percent are the second generation of founders, 21.2 percent are promoted from within, and 35.0 percent are recruited from outside. Even though more than 50 percent of chief executive officers are not family members, the core positions usually belong to the owner's family (S. Lee 1989).

Hattori (1989) finds some general patterns of ownership and control in chaebol groups based on case analyses. First, the nature of the ownership structure is closely related to management control. When the owner and his family retains a large share of ownership as in Type I, it is almost impossible for professional managers to assume actual management power and control. However, ownership under Type II and III does not necessarily mean professional management, although, most Korean chaebol under the Type II and III ownership structure employ relatively more professional managers than those under Type I. The extent to which professional managers are employed seems to be related to the size of the chaebol groups: the greater the size of the chaebol, the more professional managers are employed relative to the owner's family members.

Second, the number of professional managers who are tobagi managers is also an important aspect of professionalization in Korean chaebol. It is clear that, compared to Types I and II, Type III ownership shows a higher percentage of tobagi managers and a higher percentage of tobagi representation in the power structure. In addition to these quantitative measurements, various forms of ownership control need to be examined to make more accurate comparison of professionalization. In the case of Lucky-Goldstar, more important than the high professionalization ratio is that much of the owner family stock-
holdings are under joint ownership, making it difficult for individual owners to dispose of their shares. This joint ownership is somewhat similar to the ownership method used by Japanese prewar zaibatsu.

The form of ownership control has important implications not only to the ownership structure but also to management control and professionalization of management in chaebol. Korean traditional culture provides for the unequal distribution of family wealth favoring the eldest son. Because the Korean concept of family is strictly based on blood relationship, family ownership of business requires certain mechanisms so that chaebol businesses are protected and perpetuated. Samsung's mechanism was to confine business succession to a single successor, thereby encouraging employment and development of many professional managers to support the successor. Lucky-Goldstar's mechanism is a joint ownership among family members to restrict arbitrary disposition of ownership shares. This forces the family members to become professional managers rather than owner-capitalists. Since the owner's family members are limited in number, this mechanism also requires extensive employment and development of professional managers as the business grows. Such a mechanism to restrict arbitrary disposition of ownership shares is an important element facilitating professionalization of the management structure especially through development of tobagi managers in the chaebol. Such a mechanism is not of course feasible without a strong commitment by the owner to preserve the chaebol business as a whole, rather than simply dividing it among succeeding sons.

Based on the analysis of ownership and control in Korean chaebol, we can formulate several hypotheses. First, chaebol, to maintain and further increase their power and influence in the industry and society, should restrict division of ownership and preserve chaebol businesses as a whole. Second, because Korean inheritance and succession systems require dividing ownership among direct or indirect family members, some kind of special mechanism must be instituted to restrict the ownership division; this in effect requires employment of professional managers. Finally, those who will make such a mechanism work are the tobagi managers; and as the tobagi managers control management, arbitrary disposal of ownership shares will gradually disappear with increased professionalization of the management structure in chaebol (Hattori 1989).
Management Style

Along with managerial values, objectives, and strategies, management style is an important aspect of business behavior. The style of management has to be changed in accordance with a firm’s strategy and its managerial values. As a result, management style of the chaebol groups are as diverse in their organizational structures as in their managerial values, objectives, and strategies.

One of the most striking features of chaebol is the underdevelopment of professional management. Although the proportion of professional managers has been increasing steadily, their role is still relatively limited, primarily because of the family ownership and control structure. In addition we have to consider the special circumstances throughout Korea’s late industrialization and economic development to understand the underdevelopment of professional management.

According to Chandler (1977), the successful development of the particular industry and the domination of that industry by certain companies that take the lead is a result of the integration of production and distribution around a product market as the industry emerges in its modern form. Despite the leadership role of entrepreneurs, and the occasionally strong role of financial backers who provide the capital in the early stages of industry and company development, in all cases the successes have been due to the elaboration and competitive success of large organizations in which professional managers have risen to play preeminent roles. In other words, Chandler (1977) finds that the professional managers eventually surpass the power of founding entrepreneurs of financiers in influencing business decisions and direction. He identifies capital market institutions and financiers as one source of pressure on business organizations that could influence the development of managerial power and could also compete with managers for decision-making power (Moskowitz 1989).

To the extent that the relationship with financiers and access to capital markets have influenced the course of development of Korean enterprises and the emergence of professional management structures and managerial power, there has been continuity since the beginning of modern business in Korea. Capital resources have been controlled by the government and by certain families, and the scarcity of capital resources has acted to increase the relative power of capital even more. More than ever before, the key relationship required to obtain access to capital resources in the 1960s and 1970s was the entrepreneur’s relationship with the government. An indispensable entrepreneurial
skill, which has not yet become routinized into a management function that can be separated from individual or family control or that can be delegated, again for political and social reasons, has been the management of relations mainly with the government authorities. A recent interview with Ja-Kyung Koo, chairman of the Lucky-Goldstar group and one of Korea's foremost business leaders, reveals how important this function is and how it is not yet routinized as a management function.

Although the institutions of private capital markets have developed in Korea, the large capital resources required for significant industrial investment are supervised by the government, or can only be mobilized by using family-controlled wealth. By Chandler's criteria, therefore, in Korea the power of the capital-provider to determine policies and strategic direction of enterprises has been overwhelming, and the independent power of professional management in these decisions has been extremely limited.

Technology had little effect on the emergence and power of professional managers in Korea. In assessing the roles of technological forces in the development of Korean management, we can go back to the late Chosun dynasty for lessons that apply to the 1960s and 1970s. The most important point to understand is that Korea was a late developer. This was true in the late Chosun dynasty, just as it was true in the 1960s and 1970s. Most modern industries have not evolved independently in Korea, nor have they been introduced at the embryonic first stage of industry development and evolved simultaneously in Korea and other markets. Instead, modern industries have been introduced to Korea as established systems.

The textile manufacturing industry represents the best example for this analysis, because representative large firms were established by Koreans early in the Japanese occupation period. The first large-scale Korean manufacturing establishments, such as Kyungsung Spinning, were founded with imported machinery and technology learned from abroad by Koreans. The point is that because Korea was a late developer, these industries did not evolve and consolidate in Korea through competition and market interaction. Therefore, the forces of growth of managerial power were lacking in Korea. Instead, market interaction involved the capitalist-owner-entrepreneur who defined a market opportunity in Korea for a product or industry that had already been developed abroad and who then imported the system. Therefore, during the late Chosun dynasty and Japanese occupation periods, the late-developer phenomenon favored the power of the owner or entrepreneur because managerial power could not emerge
through the evolutionary process of an industry. In fact, the potential for the development of the power of professional managers was further limited because often the founders of a new company tried to contain the required technical expertise within the family.

In the 1960s and 1970s the types of industries introduced to Korea were different in sophistication and scale, but the late-developer characteristics were the same. That is, they were large-scale industries that had already evolved and matured elsewhere. Therefore, the entrepreneurial or developmental act lay in gaining the capital and introducing the industry to Korea. In fact, many of the more capital-intensive industries introduced to serve the domestic market were protected from competition and market interaction, the very forces that might have led to further competitive evolution. Therefore, in Korea the late-developer phenomenon was disadvantageous to the development of managerial power through the process of industry evolution and competition. On the other hand, the late-development effect increased the power of the entrepreneur-founders because of the importance of government relations and capital.

In addition to the late-developer phenomenon, Korea’s unique pattern of export-led growth also tended to give advantages and power to the owner-entrepreneurs. This distinguishing characteristic of the market environment of Korea’s modern economic growth is virtually the opposite of the market environment of the growth of the industries in the United States. American companies took shape within the large domestic market and came to dominate the world markets—i.e., they became global oligopolies—in these industries, such as sewing machines and cigarettes, that were quick to advance abroad.

By contrast, in Korea most of the important and fastest-growing industries have been export-dependent from their inception. Though there has been intense competition among Korean companies in some of these industries, such as textiles and apparel, the dependence on external markets has tended to limit the development of independent managerial power in two ways (Moskowitz 1989).

The first is the limiting effect on innovation of passive dependence on trade channels and distribution systems dominated by other companies. Korean companies produced for export to foreign buyers; thus, it was the buyers who experienced the direct market interaction and competition. Despite the development of the Korean general trading company (GTC) system from the mid-1970s and the advance of many larger Korean companies abroad to build their own distribution system, many Korean industries still interact with the markets of their products only indirectly because of the role other firms play in
the trade channels and distribution systems for their products. Even the advent of Korean GTCs does not change this situation, as the Korean companies have now come to depend on these GTCs to sell their products. One consequence is that the managerial functions and structures that develop to provide the trade and distribution function, and interact and compete in the ultimate markets, have been retarded. Even in the latter 1980s, the number of Korean companies that had taken control of their own international distribution and who participated directly in the market was limited. The second limiting effect is intervention and supervision by government authority. Korea has managed its international economic relations with a high degree of government supervision and intervention in private enterprise decisions. The export-promotion policies, and heavy and chemical industrial policy led to interference as a matter of course. These policies, which were led aggressively by government, are indispensable for early entrepreneurial skill but are an obstacle to development of professional management. Not only does this reality serve to strengthen government influence in managerial decisions, but to the extent that the owner-entrepreneur’s role in managing relations with the government remains critical, it also serves to further strengthen the position of the owners. Needless to say, quota arrangements tend to cartelize and limit certain types of competition among Korean firms.

Another striking feature of chaebol management style is the high degree of formalization and centralization. Decision-making is concentrated in upper levels of managerial hierarchies, and major decisions, especially those requiring expenditures, go through a formal procedure (kyuljae, meaning approval from upper levels of management). The formal approval process can be a means for discussion and consultation among employees and various levels of managers, similar to the ringi system in Japan. But in the case of Korean firms, the approval process is considered more a means of authority and control than consultation and participation (Hak Chong Lee 1989). In a Korean organization, important decisions are made at the top level of management, and they are then filtered down to lower levels; there is little evidence of consensus decision making. However, there is no visible resistance to this decision making system, primarily because of the Confucian ethic system, which entails paternalism, loyalty, and respect for elders and seniors.

Along with vertical and hierarchical control, Korean chaebol generally exercise strong functional control of staff departments such as planning, finance, and personnel. Korean firms tend to emphasize functional specialization; hence planning and finance departments
usually exercise great functional control under the direction of the chief executive. Large chaebol have a planning and coordination office under the chairman; this office controls major allocations of internal resources (i.e., people, money, and information) throughout the group's companies. Thus Korean chaebol generally have an organizational structure of vertical concentration of decision making at upper hierarchies and horizontal concentration of functional control in staff departments.

Although the organizational structure is centralized and its functions formalized, individual jobs are not formally structured in Korean business firms. Korean firms usually do not have job descriptions or job specifications, and job tasks and work responsibilities of individual employees are largely determined by the supervisor as the jobs are performed. Although the absence of job descriptions may cause inefficiencies of work duplication and unbalanced workload, it may also increase flexibilities in work assignment and organic adaptations to changing conditions. Under this system of an unsystematic job structure with a high degree of centralization and formalization, individual or departmental performance depends greatly upon the individual's or supervisor's ability to get things done through the support of other people.

In terms of organization, most Korean firms do not have clear job assignment criteria. Usually, middle- or lower-level management do not have much authority to perform their job effectively (more than 80 percent of the authority resides at the upper management level). Most Korean firms have a people-oriented organizational structure. Korean corporations are organized based upon hierarchies with a clear-cut order. Nevertheless, there is no clear description of the relationship between authority and responsibility. Thus a top-down decision-making style has become typical in Korean firms. The top-down decision-making system, many operational rules and procedures, and strict hierarchy of authority and control represent the bureaucratic organization. On the other hand, less specialized and separate tasks show a low level of formality and standardization in the organization. As a result, Korean firms have a mixture of characteristics of both the mechanistic and a matrix-type organization (Lee and Yoo 1987).

Authority in chaebol firms is not only centralized at upper levels of management but in many cases is also concentrated in a few key executive positions. The concentration of authority and power is partly due to the fact that ownership and management are not separated in most chaebol groups. Family ownership is prevalent in Korean businesses. The basic leadership style in the Korean management system
is authoritarian and paternalistic. The company is interpreted as an extension of the family, and relationships in the company are similar to that of a family. However, there is no father-son type relationship between a superior and his subordinates in Korea as there still is in Japan. Loyalty of an employee to his superiors and the company comes naturally because of the Korean norm and value system, which is based on Confucian traditions and heritage.

Professional executives and managers also constitute power groups in Korean management. In some Korean companies, the career managers who have been working for the company for a long time form a strong power group. They are called *tobagi* (which literally means the natives or aborigines) and are able to exercise great influence on company management via the interpersonal relations they have cultivated throughout their long tenure with the company. These *tobagi* were selected through open competition during the initial hiring period from an elite *gong-chae* (which literally translates to the selection of employees through open competition) group. A survey of 108 business groups revealed that *gong-chae* executives constituted about 16 percent of all top management personnel, 21 percent in large chaebol and about 13 percent in smaller companies. Most Korean companies have been using the *gong-chae* system since the 1960s, and as each year passes, the proportion of *tobagi* managers and executives increases (Hak Chong Lee 1989).

Management power groups are also formed on the basis of common geographical and school ties. Owners bring in their hometown or school friends just as they bring their relatives into management. In some Korean companies, the top management group is dominated by executives who are all from the same geographical area, like Seoul, Yeongnam (a southeastern province), Honam (a southwestern province), or whatever the owner’s home region may be. In some Korean companies, the executive group is dominated by graduates of certain universities (Seoul National, Yonsei, or Korea) or high schools (Kyunggi, Seoul, or Kyungbook). In Korea, if the relationship with the owner is based on kinship, it is called *hyul-yun* (literally, blood related); if it is based on geographical background, it is *ji-yun* (region related); and if it is based on school background, then it is referred to as *hahk-yun* (school related).

*Hyul-yun*, *ji-yun*, and *hahk-yun* work not only in power group formation at the top levels, but also in the formation of informal relations, groups, and cliques at all levels throughout the Korean organization. *Hahk-yun* is a particularly strong factor in informal relationships, giving common identities and a feeling of belonging. *Hahk-yun* places
much attention on the year of graduation, as older employees are in
the position of sun-bae (a senior) and the younger employees are in
the position of hoo-bae (a junior). These relationships work as impor-
tant factors affecting employees’ behaviors. Similarly, ji-yun gives
those from the same region a feeling of a common background and
compatibility, and it likewise affects personnel decisions and the em-
ployees’ social interactions.

All of these relationships are important factors affecting the power
structure and informal groupings in Korean business firms. The fami-
ly ownership based on hyul-yun is the most important factor underly-
ing the power structure of Korean firms where ownership and man-
agement are not separated. Although the power and the influence of
tobagi executives and managers are growing with professionalization
of management, concentration of power based on family ownership is
still the dominant factor in Korean firms. Ji-yun and hak-k-yun are also
important factors underlying informal groupings and social interac-
tions among Korean employees. In an organizational culture domi-
nated by harmony and stability among employees, forming interper-
sonal relations based on common background and mutual compati-
bility may be a natural tendency.

There are several distinct characteristics of personnel management
systems of Korean business firms. First, lifetime employment is evi-
dent in many Korean organizations. Once a person (typically a male)
is employed by a company, he is guaranteed lifetime employment un-
til he retires, unless he commits a serious crime or managerial mis-
take. An employer will seldom lay off employees, even in times of re-
cession. However, some of the more talented employees will volun-
tarily quit the company to obtain better positions or opportunities
elsewhere, especially in the high-tech industry. This can be expressed
as a high degree of mobility in comparison to the immobility of
Japanese. As a result, the concept of lifetime employment in Korea is
flexible.

Most Korean companies hire employees through a reference (docu-
ment) check and a written test of English, knowledge in the major
field, and/or common sense. They prefer new college graduates and
people with career experience. Once they hire new people, they usu-
ally assign the elite group to such core departments as planning, fi-
nance, and accounting after a short training period (usually 7–10
days). Korean corporations adopt uniform training systems for all
employees using on-the-job training and experts’ lectures. The educa-
tion and training program is not at all systematic, as it does not close-
ly relate to job assignment, job rotation, and promotion. Thus, em-
ployees do not devote themselves to pursuing new knowledge during the education and training period. Naturally, maximum effectiveness of the education and training program is not to be expected. Job rotation in Korean corporations is usually done on an ad hoc basis (Yoo and Lee 1987).

Reflecting Korean firms' emphasis on employee training and development, much of employee development in Korean business firms takes place through in-house training programs. Many large chaebol groups have their own employee training centers, and some chaebol group companies devote as much as 5 percent of work hours (the equivalent of two weeks each year) to formal training. The emphasis on employee training is consistent with traditional Korean culture, which places a high value on formal education. Many Korean firms also utilize joint ventures and international cooperation with business firms in advanced countries to train and develop skilled and technical manpower.

Korean corporations lay off less important employees (regardless of core, basic, or temporary status) when they face an economic slump. Korean employees retire once they reach a certain age, usually 55, whereupon they receive a lump-sum retirement allowance. They do not usually receive such compensation as a part-time job or consulting position at the company after retirement. In Korea, labor unions have been patterned after the industrial union system. The principle of harmony and paternal authority is emphasized to resolve labor disputes. Labor unions have been kept on a tight leash by law, which forbids outsiders from intervening in a dispute between an employer and his/her workers. These laws make it virtually impossible for a union to help workers bargain with their employers, and regulations on arbitration effectively outlaw strikes.

Second, the reward system in Korean firms is traditionally based on seniority. However, with the growth of Korean business and the advancement of Korean management, Korean firms are gradually moving toward the consideration of performance as a factor in reward decisions. According to Jung (1987), Korean firms generally combine seniority with performance in making their reward decisions. The selection of a criterion depends on the type of reward decisions. In promotion decisions, seniority tends to be more important in lower levels of the organization. At higher levels, especially at the general management and executive levels, performance is usually more important than seniority.

In compensation, basic wages are largely based on seniority. However, certain bonuses—especially the one paid at the end of the
year—are distributed according to performance in many Korean firms. Although an increasing number of Korean firms are applying the performance factor in reward decisions, the relative importance placed on performance varies from company to company, with high-growth firms generally emphasizing performance more than low-growth firms. On the whole, however, seniority is still the most important factor in reward decisions in most Korean business firms (Hak Chong Lee 1989).

Most Korean companies compensate based on seniority. They determine an employee’s base salary after considering the level of education and seniority of the employee, and then add some allowances for gross salary. There is a salary difference between college graduates and high school graduates. In addition to a monthly salary, Korean companies pay seasonal bonuses (such as for New Year, vacations, the Korean Thanksgiving Day, and Christmas). However, most Korean corporations do not yet have complete welfare systems.

Third, in appraisal systems, most Korean business firms not only emphasize performance but also stress ability and job attitude. Consequently, subjective judgments can play a large part. Many Korean managers are also reluctant to evaluate their subordinates negatively. This reluctance can be attributed to culture, because Koreans generally prefer to avoid difficult interpersonal problems rather than directly confront them. Under inhwa-oriented culture, Korean managers tend to stress harmony with their subordinates, and a critical evaluation may damage harmonious relations. As a result, most Korean managers evaluate their subordinates leniently.

Because of these problems, appraisal systems in Korean business firms do not generate much useful data for personnel decisions. Evaluation data are primarily used in reward decisions, but because of the questionable credibility, their real value is limited. In many cases, seniority or the top manager’s personal evaluation plays a large part in the reward decision. Most Korean firms do not have appraisal interviews, and there is no feedback or discussion between the superior and the subordinate. As a result, appraisal data are more used for reward decisions. Therefore, although performance evaluation emphasizes past achievements, employees in Korean companies are promoted largely based on seniority, dedication, and relationship with top management rather than on contribution and achievement.
Diversification

Amsden (1989) argues that learning (as opposed to invention or innovation) is central to the process of late industrialization. Insofar as business groups in late-industrializing countries lack the technical or marketing expertise of advanced industrial enterprises, they cannot grow by developing new, related product lines or by moving into higher quality niches in their existing markets. Thus, to diffuse risk or utilize slack resources, they diversify widely, producing at the bottom end and middle level of many unrelated markets.

Large chaebol groups in Korea appear to have followed this pattern and pursued diversification strategies in the past three decades. In the case of Korea, diversification strategies have been pursued as part of the national economic policy. Both chaebol and the government have strived to create world-class big business that can effectively compete in the international market, create an industrial basis on which future economic expansion becomes possible, and provide employment opportunities for the growing population. With governmental support, chaebol were able to pursue an "octopus-arms" diversification strategy.

Diversification of products and expansion of market areas are necessary processes of growth in any business. In Korea rapid business growth began in the 1960s, led by large businesses. Chaebol groups, in particular, played an important role in the growth of Korean business and economic development. A study of the 108 largest chaebol reveals a close relationship between the size of the business and diversification strategies (see Table 5.2). Using the framework used by Rumelt (1974), Jung (1987) finds that, while the largest chaebol pursue the strategy of unrelated product diversification, smaller businesses generally follow the strategy of having a single or dominant product structure (Hak Chong Lee 1989).

<table>
<thead>
<tr>
<th>Chaebol group</th>
<th>Single</th>
<th>Dominant</th>
<th>Related</th>
<th>Unrelated</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 largest (213)</td>
<td>0</td>
<td>1 (10%)</td>
<td>1 (10%)</td>
<td>8 (80%)</td>
<td>10 (100%)</td>
</tr>
<tr>
<td>11-20 largest (123)</td>
<td>0</td>
<td>2 (20)</td>
<td>3 (30)</td>
<td>5 (50)</td>
<td>10 (100)</td>
</tr>
<tr>
<td>21-50 largest (206)</td>
<td>0</td>
<td>9 (50)</td>
<td>14 (47)</td>
<td>7 (23)</td>
<td>30 (100)</td>
</tr>
<tr>
<td>51-108 largest (246)</td>
<td>12 (21)</td>
<td>21 (36)</td>
<td>19 (33)</td>
<td>6 (10)</td>
<td>58 (100)</td>
</tr>
<tr>
<td>108 largest (788)</td>
<td>12 (11)</td>
<td>33 (31)</td>
<td>37 (34)</td>
<td>26 (24)</td>
<td>108 (100)</td>
</tr>
</tbody>
</table>

Numbers in parentheses indicate total subsidiaries of chaebol.
Source: Jung (1987).
According to Rumelt (1974), corporate diversification can be classified into 4 categories: single, dominant, related, and unrelated. This categorization depends upon the relative degrees of specialization, vertical integration, and relatedness. Specialization refers to the degree to which a firm's revenue is generated by a dominant business unit. Vertical integration refers to the degree to which a firm controls the various stages of the production process. Relatedness measures the degree to which a firm's core technology is shared by its business units.

The single-type firm concentrates on a limited business line, whereas diversified firms run multiple product lines. Diversified firms are further divided into dominant, related, and unrelated types. The dominant type concentrates on a few dominant product lines with some diversification and shares some management resources such as research and training facilities. The related type is the firm with multiple product lines that share similar technology or markets along with various managerial resources. The unrelated type runs multiple product lines with little dominance or relatedness. This is the most highly diversified form of corporate configuration.

In between these extremes are medium-sized businesses that tend to follow the strategy of related product diversification. As shown in Table 5.2, the most dominant strategy among the 10 largest chaebol is that of unrelated diversification. Of the next largest group businesses (11th through 50th), 17 groups or 43 percent follow the strategy of related product diversification, and 12 groups or 30 percent follow the strategy of unrelated product diversification. Of smaller group businesses (51st through 108th), 33 businesses or 57 percent pursue a single or dominant product strategy, and 19 businesses or 33 percent pursue the strategy of related product diversification.

The types and degrees of diversification strategies vary considerably from industry to industry reflecting the differences in their nature. For example, the related strategy is popular in the food and beverage industries as their products serve the same or similar markets and distribution facilities. In the metal and non-metallic industries, the dominant strategy is preferred because it allows management to concentrate on a few dominant product lines using the same organizational resources.

The number of large chaebol groups following strategies of related and unrelated product diversification increased steadily during the 1970s and 1980s. The total number of group businesses increased from 87 in 1974 to 108 in 1984. The percentage of group businesses employing the related business diversification strategy was 16 per-
cent in 1974, but increased to 34 percent in 1984. This indicates that large chaebol have been depending on diversification strategies, both related and unrelated, to an increasing degree. Unrelated product diversification especially is an important growth strategy for the largest chaebol. The dependence on diversification for growth in Korea is substantiated by a comparative analysis of various countries, which shows that Korean businesses tend to employ unrelated product diversification much more than do Japanese or U.S. businesses.

Besides the standard reasons for diversification of the firm—such as growth, risk aversion, and heightening of the entry barrier—the diversification of chaebol groups was strongly influenced by two environmental factors. First, the market imperfections faced by Korean firms increased transactions costs, and second, the aggressive export-oriented development policy of the government provided various support and subsidies to the chaebol groups, further inducing diversification (Chang and Choi 1988).

Leff (1978) pointed out that the business group is a common phenomenon in the developing countries and interpreted it as being intrafirm organization resulting from market imperfections. First, it is an organizational structure for appropriating quasi-rents that accrue from access to scarce and imperfectly marketed inputs such as capital and information. Second, the business group is an alternative to portfolio diversification resulting from the absence of markets for risk and uncertainty, inducing diversification of production lines. Third, the business group is a form of vertical integration to eliminate problems arising from bilateral monopoly or oligopoly.

The Economic Development Plan pursued by the Korean government in the 1960s gave preferential treatment to larger firms in specific sectors in such ways as channeling foreign and domestic loans with lower interest rates, amidst high inflation. A typical example was the support for the export industries and the heavy and chemical industries. The economic plan and the accompanying inducements made diversification even more attractive to firms. There exists an important difference between diversification on the group level and diversification within affiliated companies. Vertical integration or diversification into unrelated areas take the form of creation or acquisition of firms, whereas diversification into related areas takes the form of adding a new product line within an affiliated company.

In a developing country with a small domestic market, there is a higher probability of bilateral monopoly or oligopoly arising between demanders and suppliers of intermediate goods, increasing uncertainty faced by firms. Therefore, an upward integration by a business
Characteristics of the Chaebol

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group can be interpreted as an effort to reduce transactions costs arising from uncertainties of market transactions; on the other hand, the general trading company works as a form of downward integration aimed at the export market, showing economies of scale and scope.\[11\]

Williamson (1975) viewed vertical integration as evidence of intermediate market failure and the conglomerate as evidence of capital market failure. The conglomerate contains a miniature capital market substituting the capital allocation function of the market. The multidivisional organization forms a pool of funds from affiliated companies (divisions) and reallocates them in order of profitability of investment. Because the conglomerate can circulate funds among different divisions, it can maintain a stable capital flow and can more easily shift funds to those divisions showing higher profit.

Why diversification brought divisionalization can be illustrated as follows. The number and complexities of the decisions required to coordinate, monitor, and allocate for the production and distribution of several lines of products overwhelmed the middle managers in each of the functional departments in the centralized organization, which was originally created to handle a single or dominant product business. As a result, the top managers (i.e., the heads of the departments, the president, and the chairman) became so involved in operating decisions that they had no time to plan for the continuing long-term health and growth of the enterprise. The M-form structure solved this problem by assigning the decisions for monitoring and coordinating the operations of each full line of products for much the same markets to a single integrated division (Chandler 1982).

Furthermore, the adoption of the M-form encouraged further diversification both by direct investment and by acquisition and merger, for new product lines were easily incorporated into that structure. Diversification by direct investment usually called for the setting up of distribution and research as well as production organizations. Here the challenge was building a new division. When growth came through mergers and acquisitions, the major challenge, in addition to rationalizing and reshuffling the activities and boundaries of the divisions, was to build an effective general office. Both routes to growth led to the same result, i.e., a group of industrial enterprises operating in related industries and administered through an extensive corporate office.

This aspect has an important significance in relation to the Korean capital market, which is underdeveloped and distorted to a high degree by government intervention and credit rationing. Firms have to account for the possibility of not having sufficient funds when they
want to invest in fields with lower policy priorities, or in case of emergencies. The involvement of the chaebol group in finance industries (including insurance and stocks) and retailing such as department stores, which have high cash availability, can be viewed as an attempt to secure an internal capital market and circumvent the established financial system.

The most conspicuous feature of chaebol groups is the very pervasiveness of their activities across all sectors of industry. Korea's leading chaebol tend to be highly diversified, with operations ranging from shipbuilding to the manufacture of musical instruments, from petroleum refining to the processing of dairy products, and from building construction to air transport services (Zeile 1989). As of 1983, the top 10 chaebol controlled more than 200 legally independent firms. Within manufacturing, most of these groups include at least two or three large-scale enterprises (generally in the heavy industries) and a number of smaller firms with diverse product lines. For the leading 10 chaebol, there is an average of 11 manufacturing firms per group, while the average for the top 50 chaebol is six manufacturing firms per group. The top 10 chaebol groups, especially, have also diversified into finance, trade, construction, and other non-manufacturing industries.

Zeile (1989) measured the level of diversification in 4-digit manufacturing sector for the top 50 chaebol using four indices that reflect both the number of industries in which the chaebol is active and the degree of equality between the shares of the different activities. The index S* is the complement to the group's specialization ratio, indicating the degree to which a chaebol is active in industries distinct from its major manufacturing activity; H* (i.e., a modified Herfindahl index) captures the entire distribution of a group's manufacturing activities. Thus, S* focuses exclusively on the upper tail of this distribution.

A third measure of diversification, Sw*, is the complement to the group's specialization ratio based on manufacturing industry employment. To the extent that a group's manufacturing activities differ in factor intensity, this measure may present a distorted picture of group diversification because it gives undue weight to industries which are labor-intensive. A final measure of diversification has been constructed that lumps together industries that are vertically integrated or otherwise very closely related. The index V* indicates the degree to which a chaebol diversifies into manufacturing lines completely unrelated to its primary manufacturing activity. It thus serves as a lower bound for our measures of group diversification.12

Taken together, the measures show a considerable amount of diversification in manufacturing activities for most of Korea's top 50 chae-
Examining the figures reported in table 5.3, we see that the average chaebol has firms operating in 5 different manufacturing industries, with secondary activities accounting for 28 percent of its total manufacturing sales and 32 percent of its total manufacturing workforce. Even when we consider vertical linkages between manufacturing activities, a full quarter of the average chaebol’s manufacturing workforce is employed in industries altogether unrelated to its primary manufacturing activity. As one might expect, manufacturing diversification tends to increase with chaebol group size. For the top 10 chaebol, the average diversification indices are one-and-a-half to two times as large as the averages for the top 50 chaebol.

Table 5.3 Indices of Manufacturing Diversification for Korean Chaebol, 1983

<table>
<thead>
<tr>
<th>Chaebol groups</th>
<th>Number of manufacturing activities</th>
<th>H*</th>
<th>S*</th>
<th>Sw*</th>
<th>V*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average for top 10</td>
<td>8.6 (3.86)</td>
<td>0.581 (0.280)</td>
<td>0.453 (0.213)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average for top 20</td>
<td>6.6 (3.81)</td>
<td>0.472 (0.283)</td>
<td>0.351 (0.238)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average for top 50</td>
<td>4.7 (3.16)</td>
<td>0.384 (0.254)</td>
<td>0.277 (0.220)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Numbers in parentheses indicate the standard deviation.

At the 4-digit level of industry classification, only 10 chaebol have activities in fewer than two manufacturing sectors. A number of chaebol, however, have manufacturing firms operating almost exclusively in industries that are vertically (or otherwise very closely) related. For example, Kolon, whose major manufacturing activity is textile fiber spinning, also has firms producing made-up textile goods and ready-to-wear apparel, and a firm engaged in the bleaching, dyeing, and finishing of textiles. Vertical integration of this kind is reflected in a low value for the index V*. Altogether there are 24 groups (out of the 49 active groups in manufacturing) for which the value of V* is less than 0.20. Only six of these groups, however, rank among the top 20 chaebol in terms of total sales. Amsden’s assertion (1990) that business groups in late-industrializing countries diversify widely into unrelated product lines thus appears to hold true for Korea’s top 20 chaebol, but cannot be accepted as a blanket characterization of all Korean business groups.
The distribution of the subsidiaries of the top 30 chaebol groups by 2-digit industrial classification codes in 1987 is shown in table 5.4. It is apparent from the table that most of the subsidiaries are in heavy and chemical industries, textiles and apparel, and food and beverages. The top 5 chaebol groups have a high number of subsidiaries concentrated in fabricated metal products and in machinery and transportation equipment, while the top 30 chaebol groups as a whole show a relatively even distribution of subsidiaries throughout other industries as well. As the diversification of chaebol groups has proceeded, the number of markets that they have entered has also greatly increased. In particular, they have participated heavily and simultaneously in industries with large market size and strong growth potential (K. Lee 1990).

Table 5.4 Chaebol Groups' Subsidiaries by Industry, 1987

<table>
<thead>
<tr>
<th>Chaebol group</th>
<th>Industriesa</th>
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<tbody>
<tr>
<td></td>
<td>31</td>
<td>32</td>
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Note: a. 31—food and beverages, and tobacco; 32—textile, wearing apparel and leather; 33—wood and wood products; 34—paper and paper products, printing and publishing; 35—chemicals and petroleum, coal, rubber and plastic products; 36—non-metallic mineral products; 37—basic metal; 38—fabricated metal products, machinery and equipment; 39—others.


The effects of corporate diversification on the Korean economy and society are complex and diverse. While these diversification strategies have contributed to the expansion of the Korean economy, they have also created a host of social problems ranging from an uneven distribution of income to a close relationship of business and government. Even though these are important issues, there has been a lack of systematic investigation into the effects of corporate diversification.

Cho (1989) examines the effects of diversification on corporate performance with data collected from 113 large companies listed on the Korean Stock Exchange between 1976 and 1983. Results of the analysis suggest that diversification generally has a positive effect on
growth and profitability to a certain point, but beyond that point it can be negative. It was initially hypothesized that diversification reduces risk, but the hypothesis was not supported by the data. The effects of diversification vary from industry to industry. In general, however, growth occurs when a firm diversifies into unrelated businesses, whereas profitability is higher when the firm diversifies into a few selected businesses. Risk tends to be smaller when a firm adopts the single-type or unrelated diversification strategy. Therefore, diversification strategies do not always have positive effects on corporate performance.

If an analysis is done on the basis of chaebol groups rather than on individual units, the results will be much clearer. Furthermore, as the effects differ according to the types of industries, managerial decision makers should be attentive to the selection of appropriate strategies relevant to their industries. It is suggested that chaebol should pursue diversification strategies selectively to maximize their corporate goals, rather than pursue the "octopus-arm" style of expansion. In addition, rather than reproach diversification as a social evil the general public is advised to encourage chaebol groups to diversify selectively.
Notes

1. For example, in 1963, 169 of the 200 largest non-financial U.S. corporations were manager-controlled.

2. In the 1986 amendment to the Anti-monopoly Act, banks and insurance companies that were considered subsidiaries of business groups were exempt from this restriction. They were required only to abstain from exercising their voting rights in the companies in which they invested. In the 1990 amendment, however, these same banks and insurance companies were made subject to the restriction like other subsidiaries.

3. In analyzing the chaebol group as a multidivisional structure, a division corresponds to an affiliated firm.

4. What in essence occurs is that operating decisions that require immediate attention displace management attention from less immediately critical strategic planning and capital allocation decisions. Because there are always immediate operating decisions to be made, the strategic planning process is characteristically neglected.

5. It is assumed for simplicity that middle- and top-level managers differentiate themselves by their assignment either to the company or to the group level, respectively.

6. Exceptionally, even though Keumho group belongs to Type II, the power index score of the owner’s family members is 47.3 which is much higher than that of other chaebol groups under Types II and III.

7. In many cases, the Korean market had already been developed by imports, and the introduction of the manufacturing industry to Korea fit the import-substitution model or import-competition model. For example, when Kyungsung Bangjik was established, the market for machine-made textiles had already been developed by imports from abroad.

8. For more detail, refer to Jung (1987).


10. For detailed data on the preferential industrial policies, see Jones and Sakong (1980).

11. As of 1981, about 50 percent of sales of nine general trading companies were products of their group-affiliated companies.

12. Definitions of the diversification indices are as follows:

\[ H^* = 1 - \sum_{i=1}^{h} \frac{S_i^2}{S} \]

where \( S_i \) = \( \frac{\text{Sales by group in manufacturing sector } i}{\text{Total manufacturing sales by group}} \)

\[ S^* = 1 - S \]

where \( S \) = \( \frac{\text{Sales in group’s leading manufacturing sector}}{\text{Total manufacturing sales by group}} \)
Sw* = 1 − Sw
where Sw = \( \frac{\text{No. of emp. in group's leading manuf. sector}}{\text{Total no. of emp. in group's manuf. activities}} \)

V* = 1 − V
where V = \( \frac{\text{No. of group emp. in all sectors vertically related to group's major manuf. sector}}{\text{Total no. of manuf. emp. in group}} \)

13. Four indices of diversification are highly correlated with each other across the sample of 49 groups active in manufacturing. The two measures most closely correlated with one another are H* and S*, with a correlation coefficient equal to 0.983. The measures least correlated with one another are H* and V*, which have a correlation coefficient equal to 0.708.
CHAPTER 6
NEXUS WITH GOVERNMENT

The government is largely responsible for the concentration of economic power in Korea. Because strategic industries emphasized by the government required a huge capacity in technology, capital, manpower, and organization, the chaebol were favored over other firms. It was then natural that the benefits of the tax, credit, and trade policies should accrue primarily to these chaebol groups. In other words, the growth of chaebol groups through diversification, attributable to the original advantages provided by their business capabilities, was further aided by the growth-first policy of the Korean government.

Since many chaebol owe their success entirely to government support, a close relationship between government and business has been inevitable. For example, a close relationship with the government has been essential for chaebol to receive the basic benefits that have been critical to their success. These benefits include preferential disposal of government-vested properties during the period of confusion (1945–Korean War); preferential allotment of foreign aid and grants during the period of reconstruction (after the Korean War to the late 1950s); preferential treatment in obtaining loans during the period of development (the 1960s to the early 1970s); preferential treatment of taxation and financing; and inclusion in the five-year economic development plans of the government.

In addition, the government’s control of the banking system since the early 1960s has made it possible to direct big chaebol into industries that the government wanted to develop. Consequently, chaebol could not help but maintain a close relationship with the government if they wanted to be included in the targeted growth areas.

The close government-business relationship in Korea is often referred to as “Korea, Inc.” However, there are distinct differences between “Korea, Inc.” and “Japan, Inc.” For example, Japan, Inc. connotes a government-business partnership in which the government’s policy reflects a consensus between equals. Korea, Inc. means some-
thing very different. In Korea the government sets the policies and businessmen follow, more or less. In this way, Korea is an unusual blend of free enterprise and state direction. The government's strongest weapon is its control of credit. The Korean government announced banking liberalization plans in 1983, yet the government still does not permit domination of banks by individual chaebol (S. Lee 1989).

The Role of Government

Factors that contribute to the emergence of large chaebol groups include special ties with the government, preemptive control of scarce managerial resources, the limited availability of entrepreneurial skills, and the protection of domestic markets from import competition. Among them, the role of government seems to have had a dominating influence over Korean business in the last 30 years.

Business and government interact in many different and diverse ways. The government acts as a regulator, supporter, competitor, customer, and money extractor of business. Among these various government roles, those of regulator and supporter tend to characterize the relationship between business and government in Korea. At one extreme, a government can maintain a hands-off policy, minimizing its role as a regulator and supporter of business. This type of relationship can be termed a laissez-faire policy. In modern times, very few governments follow such a policy, with the possible exception of Hong Kong. At the other extreme, a government can play a dominating role in a country's economy by allocating resources, fixing prices, and owning and controlling enterprises directly. This type of relationship is found in centrally planned economies.

Between these two extremes is a spectrum of relationships. Closer to the laissez-faire policy in this spectrum is the arm's-length relationship between business and government, as is found in the United States. Closer to the planned economy, one can find a relationship characterized by very close communication and coordination between business and government. Japan is often referred to as a model of such a relationship, and thus the term Japan, Inc. is often used in this regard. One can always find many exceptions to this generalization, but it is not too difficult to place a certain country, in relative terms, in this spectrum of relationships. Korea certainly is very near to one end of this spectrum, with the Korean government being heavily involved in markets and business operations (Jung 1989).
There are various views about the role of government in Korean economic development, especially related to the chaebol. One view sees the government as a general office in a quasi-internal organization composed of the government and the chaebol groups, much like a private internal organization. Alternative views of the role of government in Korean development are the government as strong state, as entrepreneur, and as a principal in a principal-agent relationship.

Quasi-internal Organization

In Korea large chaebol groups have played a critical role in export expansion and economic growth.¹ Since the government has influenced the decisions of these enterprises with various policy instruments, most importantly with its control over credit allocation, finding out what the relationship has been among the government, the financial system, and large chaebol groups is key to understanding Korea's economic development. In Korea the financial system was used as an instrument for allocating credit and consequently the effectiveness of government policy in dealing with large chaebol depended crucially on the effectiveness of this instrument. Thus, how the government used the financial system to achieve its policy objectives and how it maintained its effectiveness as a policy instrument are important questions we must deal with in understanding the government-business relationship in Korea.

To analyze this relationship and its contribution to economic development, we propose that the government and the large chaebol group be regarded as constituting an internal organization. Although prices as well as administrative processes were used to influence the decisions of the chaebol, the relationship between the government and business was hierarchical and was a nexus for a set of implicit contracts. Thus, for instance, as long as the chaebol achieved the export targets assigned by the government, they were favored with preferential loans.

The boundary of this internal organization was not, however, legal and was not clearly delineated as its constituent enterprises changed from time to time. For these reasons and to differentiate it from the private internal organization, the internal organization composed of the government and large chaebol is referred to as a quasi-internal organization. In an economic system where this organization exists, the government is not merely an outsider to the market system controlling at most parametrically its environment, but is a member of the most important internal organization inside the system. This organi-
ization thus defines the relationship between the public sector and an important subsector of the private system.

One of the salient characteristics of Korea's private sector is its dual nature: that is, there is a relatively small number of large enterprises, many of them belonging to chaebol groups, and a relatively large number of small and medium-sized firms. For instance, in 1982, of 35,971 firms in the manufacturing sector, 271 manufacturing firms belonged to large chaebol groups; these 271 firms accounted for more than one-third of the value of shipment, value added, and capital of the entire manufacturing sector. The expansion of large chaebol groups during the 1960s and 1970s paralleled that of the Korean economy, and given their importance in the economy, the success of the Korean economy is, in effect, the success of these enterprises.

Given this dual structure of Korea's manufacturing sector, the government's relationship with large chaebol groups needs be distinguished from its relationship with the numerous small and medium-sized firms. Even in Korea the relationship between the government and these firms has been at an arm's length with its control over market parameters as a key instrument. Its relationship with large chaebol, however, has been quite different, being more direct and intimate as in an internal organization. In fact, this relationship has been described as a partnership where the government is a senior partner and the private enterprises are the junior partners (Jones and Sakong 1980). Such a relationship between the government and business was maintained through such channels as "deliberation councils" and "discussion groups," which facilitated the exchange of information more directly than would be possible through markets.

However, the relationship between government and the larger chaebol has involved more than meetings, and the government has used various measures such as auditing the balance sheets of targeted enterprises. But the government's most important instrument was its control of the financial system and the access to subsidized credit by these enterprises, or "preference and selectivity" in the allocation of financial resources. By controlling their access to credit, the government controlled the chaebol's decision over resource allocation and thus the pattern of industrial development.

A developing country suffers from the underdevelopment of its capital markets, and the role that the government has played in Korea can be interpreted as a second-best solution for this problem. As pointed out by Stiglitz (1989), capital markets even in a developed country do not operate as described in textbook models of perfect capital markets because the problems of adverse selection, moral
hazard, and contract enforcement are inherent to these markets. Consequently, credit rationing and equity rationing are innate characteristics of capital markets.

Credit rationing by banks may occur because of the asymmetry of information and because banks are risk averse; financial liberalization may thus lead to an inefficient allocation of credit in the absence of well-functioning equity markets. Equity rationing occurs because the firm is reluctant to offer new equity issues to raise capital because such issues will result in large decreases in its market value. Unwilling to see its net worth decrease, the firm is reluctant to issue new shares and thus is unable to divest itself of the risks it faces. Consequently, it may rely more on a decision that internal financing for capacity expansion, a decision that may result in a less efficient allocation of resources.

There are reasons why the problems of an imperfect capital market are more serious for developing countries. In developing countries, the capital markets are less developed and the economy is subject to greater changes and uncertainty. Furthermore, these countries are not likely to have developed private institutions capable of coping with the problems of imperfect capital markets. Hence, the effect of credit and equity rationing is more serious for developing than developed countries. Stiglitz (1989) notes that in more-developed economies, large firms have developed internal capital markets, so they can reallocate funds among units that are the size of many firms in LDCs. The LDCs are thus at a double disadvantage: not only are there informational imperfections, which lead to credit and equity rationing, but these informational imperfections are likely to be more significant because the process of change itself leads to greater informational problems.

It should be noted here that although Stiglitz's observation regarding the double disadvantages of developing countries is generally correct, it does not apply to Korea. In Korea, two institutions have developed to compensate for the disadvantages of underdeveloped capital markets and the limited size of individual enterprises: the quasi-internal organization and the chaebol, the multiunit business group. Because of these two institutions, Korea has developed an internal capital market that is large even in comparison to that of a multiunit enterprise in developed industrial countries and is therefore able to overcome the scope and size limitations of typical individual enterprises in a developing country.³

It can now be readily seen that the quasi-internal organization can overcome the problems faced by the developing countries mentioned
by Stiglitz (1989). First of all, the quasi-internal organization is an internal capital market where the government allocates credit among the large chaebol. It is a well-documented fact that the chaebol were given, especially during the 1970s, large sums of preferential credit to develop certain product lines that were targeted by the government. Although such a practice is commonly called financial repression, it differs little from the way an internal capital market operates within the multiunit enterprise. There may be, however, a difference between the objectives of the quasi-internal organization and those of the multiunit enterprise, and this difference in objectives may explain whatever difference there may be in the performance of the respective internal capital markets.

The similarity between the quasi-internal organization and the modern multiunit enterprise is clear. Activities of their component units and transactions between them are internalized, and these units are monitored and coordinated by salaried employees (i.e., bureaucrats) instead of by the market mechanism. Given this similarity and given that the modern multiunit enterprise is an efficient institution, it follows that the quasi-internal organization can be efficient in achieving its objectives. Stiglitz (1989) has also noted that informational imperfections that lead to credit and equity rationing are more serious for developing countries as the developmental process itself leads to greater informational problems. Again, the quasi-internal organization can be viewed as an institutional adaptation designed to overcome these problems.

In discussing the efficiency of internal transactions relative to that of market transactions, Williamson (1975) points out two characteristics of the internal organization that make it better able to handle informational imperfections. First, because of its hierarchical structure, which allows the specialization of decision making and economizes on communication costs, the internal organization is able to extend the bounds of rationality. Second, the internal organization is able to reduce uncertainty by coordinating the decisions of interdependent units to adapt to unforeseen contingencies.

The quasi-internal organization in Korea has had the advantages of these characteristics. Because of the direct contact maintained through channels such as deliberation councils and discussion groups, the government and large chaebol groups were able to share information that would otherwise have had to be conveyed indirectly through prices. Thus, decisions over the allocation of credit could be made before price changes could signal the direction of credit allocation and private agents could respond to these signals. Also, by coordinating
these enterprises, the quasi-internal organization could adapt to unforeseen contingencies. For example, the government-established KOTRA (Korea Traders Association), which collects economic and trade information virtually all over the world, evaluates the data and disseminates it to the members of the quasi-internal organization.

It needs to be pointed out, however, that the fact that the quasi-internal organization could function as an internal capital market does not necessarily mean that funds would be allocated efficiently. Even the reduction of informational imperfections does not mean that the quasi-internal organization would utilize the improved situation for developmental goals.

Clearly, the quasi-internal organization must be committed to developmental goals for it to allocate resources toward achieving these goals. But efficiency in allocation does not necessarily mean efficient allocation in achieving developmental goals. It is, in fact, possible that the quasi-internal organization is efficient in achieving its own narrow objectives at the expense of the rest of the economy.

Will the quasi-internal organization allocate resources efficiently if it is committed to developmental goals? In the case of a firm with its own internal capital markets, the choice of a wrong product or technique may lead to bankruptcy and thus to its dissolution. Furthermore, market competition ensures the survival of only those firms that on average choose right products and production techniques and thus the survival of efficient internal organizations.

Because the quasi-internal organization is the only such organization in the economy, it does not face the competition that private firms face in the marketplace. Is there then any mechanism that will correct an inefficient credit allocation it may make? Whether such a mechanism exists or not depends on the setting in which the quasi-internal organization operates. If it is committed to an outward-oriented development strategy, there is such a mechanism; on the other hand, if it is committed to import-substitution policies, there is none.

For a small developing country committed to an outward-oriented development strategy, prices are parameters determined in the rest of the world. The government cannot thus arbitrarily change prices to cover the consequences of an inefficient allocation of credit. Because of this constraint, an inefficient internal allocation of credit that supports wrong projects will result in financial losses for the large chaebol undertaking the projects. While they may be able to survive with subsidies from the government, their losses are, nevertheless, financial losses for the quasi-internal organization. Thus, whether subsidized or not, the quasi-internal organization will suffer financial
losses, and it will be eventually forced to correct its pattern of credit allocation.

In contrast, a small developing country that has adopted an inward-oriented development strategy can alter prices to cover the consequences of a wrong internal credit allocation. Potential losses of the large chaebol can be made to disappear by changing prices with little noticeable effect on the government treasury. The quasi-internal organization can avoid making losses resulting from an inefficient allocation of credit, and there is, at least in the short run, little or no incentive or compulsion to correct the existing pattern of allocation.

As market competition is necessary to ensure the survival of efficient private internal organizations, so is competition necessary to ensure that the quasi-internal organization committed to economic growth efficiently allocates credit. For the quasi-internal organization, such competition exists only if it is exposed to competitive forces in world markets. For this reason, it is essential that the country is committed to an outward-oriented development strategy.

The above discussion provides an additional reason why a developing country should adopt an outward-oriented development strategy. The standard neoclassical argument in favor of this strategy is that because of its neutrality of incentives between exports and import-substitutes, it brings about efficiency in resource allocation. The argument, however, fails to recognize that even with the neutrality of incentives, a developing country may not achieve such efficiency because of informational imperfections and the limited size of firms. The quasi-internal organization can overcome these problems of market failure, but only when it is subject to international competition.

Another reason why the quasi-internal organization in Korea could have contributed to economic development is that it has made possible the efficient implementation of policies. In a market economy of the neoclassical mold, government intervention is indirect, implemented through taxes and subsidies and through arm’s-length regulations. Here the cost of policy implementation (ignoring the cost of policy formulation) is the cost of collecting taxes on appropriate activities, ensuring that subsidies are used for predesignated activities, and ensuring that regulations are abided by. This method of policy implementation works essentially by controlling market parameters and thus by modifying the decisions of market agents. For this reason, we may call this approach the market mode of policy implementation.

An alternative to this market mode is what has been observed in Korea (and also in Japan), which we may call the internal mode of policy implementation. Because policies are implemented within the
quasi-internal organization, policy implementation is an internal transaction and does not rely solely on changes in market parameters and because these transactions parallel those within a private internal organization, they would also be efficient for the same reasons that private internal organizations are efficient relative to markets. That is, because of extended bounded rationality, reduced opportunism and uncertainty, reduced small-number indeterminacies, better information, and a group-oriented atmosphere, the internal organization reduces transactions costs.

Direct and continuous contact between the government and large chaebol permits a sharing of information that would have to be done indirectly through prices with the market mode of policy implementation. The government possesses non-price as well as price incentives and control techniques to be brought upon agents in a selective manner. Thus, it can coordinate interdependent enterprises to adapt to unforeseen contingencies, and it can resolve with fiat small-number bargaining indeterminacies among enterprises to the benefit of the public good. Thus, with better information and with various incentives and control techniques, the government can see to it that its policies are effectively carried out by the private system.

Korea's response to the oil crises, the development of the heavy and chemical industries, and the promotion of construction service exports are a few cases that clearly illustrate the way the government has implemented its policies. In all these cases, the government used discretionary as well parametric manipulation to achieve its policy objectives. It made decisions quickly, often in consultation with private enterprises, but changed policies when they were shown to be inappropriate. Even if one argues that some of the policies were wrong, one would be hard-pressed not to admit that they were effectively implemented.

It was noted earlier that credit diversion could have subverted the effective implementation of policies. It is now clear that in addition to the export ideology, which may have restrained the individualistic calculus of costs and benefits, the quasi-internal organization would have made credit diversion very difficult. Since preferential loans went by and large to enterprises constituting the quasi-internal organization, they were subject to internal scrutiny and would have found it difficult to engage in opportunistic credit diversion. In other words, because the relationship between the government and the recipients of subsidized credit was that of inside an internal organization and not an arm's-length relationship, it would have been difficult for credit diversion to take place.
Alternative Views

Strong State

Regarding the economic role of the state, scholars have drawn attention recently to the state as an autonomous actor in the processes of development rather than simply an arena for class struggle or a more neutral representative of a variety of major interest groups. The foil for such interventionist, aggressive economic direction by the state remains the weak or soft state. Myrdal (1968) examined the ineffectiveness of "soft states" in the economic development processes of recently decolonized societies of Southeast Asia, where policies decided on are often not enforced, if they are enacted at all, and where authorities, even when framing policies, are reluctant to place obligations on the people. Directly opposite to Myrdal's soft or weak state constrained by anxieties over domestic political consensus, the Korean government proved itself a strong state in economic development.

Because of the overwhelmingly influential role of the state in fostering the development of chaebol, the Korean government deserves particular scrutiny. Having examined the role of market and sociocultural factors in the formation and development of chaebol, Fields (1991) analyzed the Korean government's role as manifest in its policies toward chaebol groups with the concept of the "strong state." He demonstrated that the success of the Park and Chun regimes in creating a favorable environment for the rapid growth of the chaebol as junior partners in the Korean political economy brought about changes in this environment. While the social, political, and even economic costs associated with the pro-chaebol policies have increasingly tempered the willingness of the state to continue its support of big business, the sheer size and dominance of the chaebol have undermined the government's ability to alter the institutional supports of this previous strategy. Ironically, in this "strong" state where free markets have been sacrificed on the altar of developmental policies, external pressures for market liberalization may succeed in stemming the chaebol where state policy is now failing.

In all late-industrializing countries, the state deliberately subsidizes domestic industry to distort relative prices in order to stimulate economic activity. The Korean government has differed from most other late-developers not in providing subsidies, but in being able to impose performance standards on private firms who are the recipients of these subsidies. What then are the sources of this state power? While this state dominance of and autonomy from societal interests is often attributed to the personnel and policies of the Park military
regime, and juxtaposed to the weakness of the Rhee regime that preceded it, in fact, many of the traditional norms and institutional means for a strong state authority were already in place when Rhee came to power in 1948.

Much has been written about the Asian cultural proclivities toward a strong, centralized authoritarian state. While some of this analysis is simply too general to be of much comparative utility (even if it is accurate), Korea's specific "situational motivations" have made Korean society particularly conducive to an authoritarian political tradition. Korea's ethnic, cultural, and linguistic homogeneity combined with its territorial compactness were factors leading to its strong-state tradition.

Even after the invading North Koreans and, following them, the U.S. advisers, implemented thoroughgoing land reform, the Rhee government remained penetrated by superannuated landlords (who retained political influence) and remained incapable of the autonomy to direct growth. While certainly authoritarian in its draconian domestic policies, the regime became increasingly beholden to the nascent capitalists who skillfully played on the urgent need for political funds on the part of politicians and the prevalent corruption of high-ranking bureaucrats to ensure the continuation of government policies guaranteeing their windfall monopoly profits.

Capitalizing on the corruption of the Rhee government and the disorder that followed the toppling of his regime, General Park upon seizing power in 1961 quickly sought to assemble both a mandate and the means to assure an autonomous state capable of guiding economic development. Answerable only to the military, Park was not dependent on support from either the landed or capitalist class as his predecessor had been. And while Park never gained real popular support for his authoritarian rule, he was able to develop strong support from big business by the time he stood for civilian election.

After taking power, Park moved swiftly to institutionalize the state's autonomy and capacity both generally and in terms of pursuing economic development. For directing the economy, Park concentrated virtually all state economic powers in a newly created superministry, the Economic Planning Board (EPB). Its director, given the rank of Assistant Prime Minister (now Deputy Prime Minister), became the highest ranking economic policymaker answerable directly to the President. Park also formed the Council of Economic Ministers, composed of the prime minister, the deputy prime minister, and the ministers of finance, commerce and industry, agriculture and fisheries, transportation, communications, and foreign affairs. Any decisions
that could not be agreed on at their twice-weekly meetings were referred directly to Park for arbitration.

The Park government nationalized banks, confiscated ill-gotten private assets of big business, and gained control over virtually all resources vital to business. From this position of sheer dominance and remarkable institutional capacity, the Park regime engineered Korea’s export-oriented industrialization with the private chaebol as the chosen instruments to carry out this strategy. The chaebol learned quickly that “to go along with the state was to get along” and thrived with government support in successive strategic industrial sectors.

Predictably, the chaebol have grown into large and powerful economic and political interest groups that have challenged the autonomy of the Chun and Roh regimes that succeeded the Park government. Moreover, like the Park government, both the Chun regime, and to a lesser extent, the Roh government as well, have lacked legitimacy when coming to power and have faced increasingly strident demands for democracy. In addition to this erosion of Park’s hard-fought autonomy, the size and complexity of both the economy and the chaebol have limited the Korean state’s capacity to dictate the country’s development path. The shifting of the government’s chaebol policy objectives and the declining degree of chaebol compliance with these policies indicate a move from state dominance to a symbiosis with the chaebol.

Given the dominant position of the Korean state during much of the period of the chaebol’s rapid growth and development, there is much evidence that the government is largely responsible for this particular development path. Why then did the state choose development as its primary goal and the chaebol as the instrument to achieve it? Clearly, without such a strategy, the chaebol would not have grown and prospered as they did. In a late-developing country such as Korea, it is necessary to examine the ideology and objectives of the government and its key political leaders in order to understand economic outcomes. During the Park and Chun periods, the dominant role of the president at the apex of power has made the personality of the ruler extremely important to policymaking. However, this was no less true during the Rhee regime. While Rhee’s regime had relatively less autonomy and capacity than its successors, Rhee’s motives and goals still proved consequential. Obsessed with the task of ushering Korea into the ranks of the developed nations, Park pursued his goal relentlessly and achieved considerable results. For Park, growth took precedence over other claims, including democratization or social equality.

Thus Park explicitly chose economic growth as his regime’s highest
objective as an end in itself and as a means to maintain external sovereignty and achieve internal legitimacy. Park and his technocrats saw creating jobs and increasing exports as the critical factors in economic growth and fostered the chaebol and channeled their profit-making activities to obtain these ends. Over the course of Park’s rule, legitimacy became inextricably tied to the fate of the economy, and the fate of the economy increasingly depended on the burgeoning chaebol.

Coming to power after Park, General Chun also had legitimacy problems. However, early promises of taming the chaebol, promoting economic stability, and developing a welfare state quickly gave way to a similar pro-growth strategy and reliance on the chaebol as the engine of growth when economic slowdown threatened the Korean economy with shrinking jobs and exports. Despite his democratic mandate, President Roh has also had to renege on his pledges to curb the growth of chaebol for fear of the sociopolitical costs of an economic downturn in the chaebol-dominated economy.

Many of the so-called strong-state development studies have argued that the state is the most important actor in bringing about economic growth in the late-comers. Such studies thus attributed Korea’s miraculous economic development solely to the government, with only passing mention of chaebol. The chaebol was portrayed as being entirely created, maintained, and managed by the Korean state and was therefore treated as an enterprise similar to a public one with limited autonomy.

Although such state-centered approaches do correctly portray the significance of the Korean state and its tight control of the chaebol, they often fail to analyze the chaebol as separate entities that are ultimately private enterprises taking risks and making decisions. Recent changes in the government-business relationship in Korea suggest that the chaebol are gaining even more autonomy (Kim 1989).

Entrepreneur

The defining characteristic of entrepreneurship is planning, or deciding what, when, and how much to produce. Entrepreneurship becomes especially meaningful from a social standpoint when planning involves a new product or process. In the Schumpeterian conception, the fundamental function of the entrepreneur is innovation. Innovation, in its classic definition, is absent in late-industrializing countries, yet entrepreneurship is present: entrepreneurs in late-industrializing countries introduce products or processes that, while not path breaking, are novel in the context of the learning environment (Amsden 1989).
According to this definition, entrepreneurship in Korea has had two identities: one associated with the small firm, and the other with the large firm. In the case of the former, the entrepreneurial function of planning still remains privatized. The initiative to undertake minor investment projects with relatively small capital requirements appears to rest with the private entrepreneur. In such cases, the private entrepreneur is also responsible for the coordinating function, or for arranging all necessary inputs including capital, for the completion of a project. In the contrasting case of large chaebol groups, the entrepreneurial function of planning has primarily fallen to the government. So too has the coordinating function, insofar as the government has controlled all capital other than short- or medium-term credit available at high interest rates in the curb market.

Virtually every study bearing on the subject of industrialization in Korea has in some sense recognized that big businesses have had to come to terms with the expanded role of the government. Thus, Jones and Sakong (1980) argued that the crowning function of the private entrepreneur is “lenticular,” meaning “the pure Schumpeterian function of combination,” and the functions the entrepreneur must combine or coordinate include that of dealing with the government.

The initiative to enter new manufacturing branches has come primarily from the public sphere. Ignoring the 1950s, when economic policy in Korea was for all practical purposes under foreign control, every major shift in industrial diversification in the 1960s and 1970s was instigated by the government. The state masterminded the early import-substitution projects in cement, fertilizers, oil refining, and synthetic fibers, the last greatly improving the profitability of the overexpanded textiles industry. The government also kept alive some unprofitable factories inherited from the colonial period, factories that eventually provided key personnel to the modern general machinery and shipbuilding industries, which the state also promoted. The transformation from light to heavy industry came at the state’s behest in the form of an integrated iron and steel mill, which the state pushed for in the early 1960s and then presided over from the late 1960s onward.

The government played the part of visionary in the case of Korea’s first colossal shipyard, and it was responsible for the big push into heavy machinery and chemicals in the late 1970s. It also laid the groundwork for the new wave of import substitution that followed heavy industries beyond the simple stage of assembly. The government enacted the Automobile Industry Protection Law as far back as 1962, as part of its first five-year economic development plan. In con-
junction with this decision, it promoted the oil-refining industry. Thus, major milestones in Korea’s industrialization have been decided by the government.

Unilateralism on the part of the government probably reached its apex at the time of the second five-year plan, in 1967, after which government and business gradually worked more closely together. The second five-year plan was prepared by the government amidst exuberance over the economy’s good performance and confidence in the government’s planning function. The EPB used an input-output planning model, supplemented by industry studies that were, in fact, project studies that provided profiles on projects in the manufacturing sector for the government to promote by using its industrial, trade, and credit policies.⁶

Furthermore, the Korean government as investor spent about one-third of all foreign loans between 1967 and 1979. Then, in the economic contraction of 1980–1983, its share rose to over half the total. Nevertheless, the dividing line between a public and private loan is not always clear-cut, particularly in large-scale projects where the government and the chaebol closely interact with one another. Thus, the government’s share of foreign borrowing may be understated.

Most of the government’s deficit has been accounted for by public corporations despite the fact that almost all major investments in heavy industry, with the exception of integrated ironmaking and steelmaking, are in private corporations. Public corporations, however, have been important in infrastructure projects, including electricity, gas, railroads, highways, irrigation, and subway systems in the Seoul and Pusan areas, and investments in infrastructure have been massive.

Principal-Agent Relationship

During the period of rapid economic development, the Korean government explicitly and implicitly favored large chaebol groups. One theory of the increasing concentration of economic power in a rapidly growing economy is that economic concentration is a natural result of economic growth. Economic modernity means taking advantage of economies of scale in technology, organization, and marketing. It requires placing resources in the hands of those entrepreneurs who have shown themselves most capable of survival in the international arena.⁷ The rapid rise in business concentration is thus merely one inescapable facet of the transformation of a growing economy from a primitive economic structure to one that is modern and internationally competitive (Y. Lee 1990).
In this respect, it seems that the increased economic concentration or rise of large chaebol groups may in part be a requirement for rapid economic growth. X-efficiency in terms of organizational and entrepreneurial advantages possessed by chaebol may have been particularly important in their moving into new, large-scale, capital-intensive areas requiring modern technology, such as heavy and chemical industries. This theory may provide the grounds for the government’s tendency to rely on large chaebol groups to achieve efficiency through economies of scale, especially in the heavy and chemical industries, and to promote exports by setting up general trading companies.

In this respect, the interaction between the government and large chaebol groups can be thought of as a principal-agent relationship. One may view the government as playing the role of a principal body in designing economic development programs. It achieves growth targets by using the private sector as its agent for investment, production, and export. For the successful implementation of industrial programs, the government has exerted considerable influence over business activities by providing various incentives and subsidies to private industries complying with government plans.

However, not only are there agency problems between the government and the large chaebol groups, but there are also inter-chaebol agency problems. As the chaebol groups grow, the agency problems are more complicated. The Hyundai group’s recent scandal for tax evasion is a typical example.

The most powerful tool in directing the private sector was the allocation of scarce financial resources such as bank credit and foreign exchange. Underpriced credit was channeled predominantly into target industries and thus into the hands of a relatively small number of chaebol groups. This behavior may be attributable not only to political favoritism toward chaebol but also to the government’s belief in the chaebol’s proven record of performance and efficient use of resources. The government often rescued troubled firms, mostly large ones, in order to avoid massive unemployment and the consequent collapse of the financial system that would result from bankruptcies. The government bailout practices substantially reduced the downside risk of business ventures and thus encouraged entrepreneurs to launch high-risk, high-return, large-scale projects. The government thereby contributed greatly to the emergence of large chaebol groups in Korea.
Government Policy

*Industrial Policy*

Korean industrial policy is notable for the prominent role of the government in the economy, the boldness of policy changes, and, not least, the extraordinary results. Korea’s industrial policy history can be roughly divided into three phases: (1) the takeoff phase between 1962 and 1972, (2) the heavy industry promotion phase between 1973 and 1979, and (3) the liberalization phase since 1980.

During first phase the Korean economy successfully eliminated widespread poverty and laid a foundation for continued growth, based on an export-oriented industrialization strategy. In 1962, Korea launched its first five-year economic development plan. The plan adopted an outward-looking development strategy and identified the development of basic infrastructure, the modernization of the nation’s industrial structure, the development of several key raw material supplying industries, and the growth of exports as its major goals. To achieve these objectives, interest rates and the exchange rate system were realigned to more correctly reflect market values, incentives were provided for export activities, and foreign loans and direct investments were sought.

The most important incentives provided to encourage exports included exemption of import duties for intermediate goods, parts, and components to be used for producing export product\(^8\), reduction of corporate taxes for exporters (abolished since 1973); and preferential financing for export activities (abolished in 1982). These incentives were available to all export activities regardless of the industry (Koo 1986). While Korea’s export takeoff started from an unusually low base and was supported by a general expansion of world trade, it would not have been possible without decisive and innovative policies. These included a rationalized exchange rate regime, strong export incentives, selective import liberalization, directed credit, and a host of finely tuned export-promoting instruments.

In the early 1970s, the Korean government began to feel a need to develop the heavy machinery and chemical industries. Korea’s dependence on imported machinery remained very high, the prospects of maintaining a stable supply of raw materials from the international commodity market had deteriorated, and Korea’s comparative advantage position in the international market was changing rapidly. Furthermore, the advent of the Nixon Doctrine in the United States, which emphasized greater efforts for defense on the part of individ-
ual countries and the partial withdrawal of U.S. forces from Korea in 1971 forced the Korean government to promote the development of its own defense industries.

Thus, in January 1973, the Korean government issued an urgent call for the development of the nation's heavy and chemical industries (HCI). Accordingly, protection was strengthened and incentives expanded for the so-called strategic industries, actions that eventually resulted in an overadjustment of the industrial structure. Import protection was reinforced for the strategic industries. Starting in 1974, entry restrictions were reinforced in the form of controls on the extent of foreign ownership and export requirements in the field of direct foreign investment as well.

In addition to protection from foreign competition, incentives were provided to domestic producers in strategic industries in the form of preferential financing and tax exemptions or reductions. Long-term loans by public finance institutions such as the Korea Development Bank and the National Investment Fund were directed heavily toward these industries, and even the allocation of commercial lending was strongly influenced by the government in the direction of providing maximum financing for these strategic industries.

Domestic tax incentives were also provided for the naphtha cracking, iron and steel, non-ferrous metal refining, machinery, chemical fertilizers, shipbuilding, electronics, aviation, defense, and power generation industries. Firms that made investments in these industries were allowed their choice of one of the following tax incentives: (1) exemption from corporate taxes for the first three years after the establishment of the plant and a 50 percent reduction of corporate taxes for the following 2 years; (2) tax credits of 8–10 percent of the investment amount; or (3) accelerated depreciation of up to 100 percent of the normal depreciation allowances.

Thus, during this period the government was deeply involved in the allocation of resources to promote the development of specific industries. Partly helped by such strong promotion by the government, and partly because of an inevitable maturing of Korea’s industrial structure, heavy and chemical industries grew rapidly during this period.

The HCI drive involved more typical sector-oriented, import-substituting kinds of initiatives. Designed in part to accelerate changes in Korean comparative advantage, the HCI drive provided extensive support to large-scale, capital-intensive industries. Some of the production and export objectives of the plan were eventually realized, but its dominant effects—i.e., underutilized capacity, crowding out of
traditional export industries, and a sharp decline in the incremental capital-output ratio—were unfortunately reminiscent of experiences elsewhere.

Coming into the 1980s, the Korean economy faced severe structural difficulties. The massive investment in the heavy machinery and chemical industries was completed just at the outset of the global and domestic economic downturn, leaving many plants with severe overcapacity problems. The international competitiveness of Korean export products also began to weaken, as a result of abnormally high growth of domestic wages during the late 1970s, overvaluation of the domestic currency, and underinvestment for the development of technology and the training of skilled manpower by both the government and the private sector.

Furthermore, a sudden change in the nation’s political leadership in 1980 created considerable social and political unrest, and an unusually cold summer sharply reduced the harvest of rice, Korea’s major crop, necessitating large imports. Externally, the second oil shock almost doubled Korea’s oil import bill in 1980, and the ensuing recession in industrial countries reduced demand for Korean products.

Faced with these extremely adverse internal and external conditions, the Korean government began to critically reexamine its role in the nation’s overall economic development. This self-examination by government planners led to a series of comprehensive institutional reforms to promote a greater role for the market mechanism and reduce government intervention. The exchange rate was substantially lowered in early 1980 to compensate for the artificial overvaluation that had occurred; and since then it has floated in line with fluctuations in the values of the currencies of Korea’s major trading partners. To introduce more foreign competition into the economy, liberalization of imports and direct foreign investment was carried out; and to promote more efficient allocation of resources, preferences for specific industries have been reduced, competition-limiting activities have been banned, and financial reform has been carried out.

The third phase has been a period of eliminating protection for the previously heavily protected domestic industries through the introduction of foreign competition. It has also been a period of reduced tax and financial privileges, which in the past were provided to domestic producers to promote the development of specific industries.

Since 1980, Korea has pursued a slow but deliberate policy of liberalization. In contrast to the liberalization experiences in South America, there is little urgency or drama to this effort. The government is withdrawing slowly, although unevenly, in the policy areas of
domestic finance, import barriers, and direct export promotion. So far, the experiment is yielding positive results. If current policies remain on track and work, Korea's economic policies will eventually become as much a model for successful liberalization as its past policies are for successful export promotion.

In sum, the key elements of Korean industrial policy included exchange rate and trade policy (since these fundamentally affect incentives across different branches of the economy), financial policies that governed the allocation of capital, and direct government actions that affected industrial structure and infrastructure, and especially technology.

It is necessary to analyze concretely the interaction between the above industrial policies and the chaebol's growth. A critical time in the development of the chaebol came in 1962, when the first five-year economic development plan called for drastic and fundamental changes in the Korean economy, with rapid economic development to be based on exports of light manufactured goods. Before 1961, the Korean economy had been basically agrarian, with relatively few manufacturing firms and a small number of mercantilist businesses. Three drastic changes were ordered by the government: (1) a transition from agriculture to industry, (2) a transition from mercantilist activities to industrial manufacturing, and (3) export (Kim 1989).

Export was a major risk factor for Korean businesses; there were virtually no exports of manufactured products prior to the 1960s. Local firms lacked not only the expertise to produce goods targeted for Western markets, but also the marketing technology to export goods. Under such conditions of uncertainty, it was a given that Korean businesses would continue to develop the chaebol as the dominant industrial organization, rather than inventing or adopting some other type of industrial organization.

The preference for large, existing firms over small and medium-sized firms was intended as a way to attain development in the most rapid way by achieving the economies of scale necessary for exports. However, there is little evidence that the Park regime actually preferred the chaebol in its earlier years over other types of industrial organization. This situation changed, of course, by the early 1970s, when the government-chaebol relationship had become interdependent and symbiotic.

When the Park regime nationalized banks in 1961, credit was placed under government control, effectively making chaebol and private firms dependent on state officials. Moreover, foreign loan capital and foreign direct investment were also tightly controlled and closely
monitored by the state. Distribution of both domestic and foreign capital thus rested in the hands of the government, which could then easily implement its economic development plans and control the private sector.

The government used the nationalized banks to reward companies that conformed to government policies and to attract firms into sectors in which they otherwise saw too little profit and too much risk. One example of the first policy was the low-interest-rate, no-strings-attached export loan given to firms that were successful in exports. This policy was prevalent in the 1960s. The next decade was dominated by the second policy. An example of that policy, begun in the early 1970s, was the loan provided to firms to invest in government-targeted, heavy manufacturing industries such as automobiles, shipbuilding, chemicals, iron and steel, non-ferrous metal, and electronics and electrical appliances. Therefore, the adaptability of the industrial organization to the changes in government policy appears to have been crucial to the growth of the chaebol. Chaebol that followed the state’s push for heavy manufacturing in the 1970s are the ones that grew most rapidly in the 1970s and early 1980s. All of this evidence points to the enormous power that the government wields over the chaebol.

The rapid growth rate of heavy manufacturing in the Hyundai, Daewoo, and Ssangyong chaebol coincided with the shift in the emphasis of government policy from light to heavy manufacturing in the early 1970s, with the beginning of the third five-year economic development plan and the 1973 Pronouncement for the Development of the Heavy and Chemical Industries. However, those chaebol that did not adapt to the government-policy shift did not grow as fast. Lucky-Gold Star, which has already been mentioned, is one example. Another example is Samsung. Although this chaebol did decrease its light manufacturing share somewhat over the years, it is still largely invested in this area and in other consumer durables, such as electrical appliances. As a result, Samsung grew relatively less compared to the other three chaebol groups mentioned.

A more extreme case is that of Kukje, which took a direction totally opposite to that suggested by the government and moved from heavy to light manufacturing. Kukje had been a shoe manufacturing firm for more than two decades and could not be defined as a chaebol until the mid-1970s, when it rapidly expanded its business. Its share in light manufacturing increased sharply, from 0 percent in 1975 to 11 percent in 1980. This move contributed to Kukje’s high debt rate and thus to its bankruptcy in 1985.11

The chaebol responding to such control developed the vertically in-
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tegrated and diversified huge conglomerates that could better withstand changes in government policies and that could one day become self-sufficient in both capital and technology. A fully diversified chaebol—with such broad-ranging companies involved in sugar, flour, textiles, toys, department stores, automobiles, shipbuilding, construction, insurance, and computers, for example—would be fine no matter which way government policy turned. The industrial organization of the chaebol is thus a unique combination of the remnants of the pre-war zaibatsu and of the responses of Korean business to the constraints and challenges of the Korean government and the international context.

Institutional Relationship

All late-industrializing countries intervene in their economies through the use of subsidies. By building a meritocratic element into its system of awarding subsidies, the government extracted from the chaebol—which was an institution of possibly unprecedented power—a growth rate of output and productivity that may also have been unprecedented. This accountability was vigorously curried and enforced through the use of both carrots (i.e., preferential loans, access to foreign exchange, tax concessions, import rights) and sticks (i.e., tax penalties, revoked import licenses, calling in of loans). In fact, the very success of these policies in achieving their intended goal has now jeopardized the state’s ability to continue to significantly shape the development of its former protégé. This evolving relationship between the Korean government and the chaebol groups can best be illustrated by examining several of the government’s major policy initiatives toward the chaebol and the chaebol’s responses to these measures (Fields 1991).

The Law for Illicit Wealth Accumulation

By the early 1960s, the Korean people were frustrated with the Rhee regime for two intertwined reasons: corruption in politics and economic stagnation brought about by an extreme concentration of wealth among a few chaebol with close ties to politicians. The well-connected recipients of these windfall profits became fitting targets for those seeking to replace Rhee. The short-lived Chang regime announced a policy to clean up the “illegal and unfair profiting” of these chaebol entrepreneurs. On February 9, 1961, the Law for Illicit Wealth Accumulation was announced; the Chang regime, however, lacked the power to implement it.
After enacting this law on May 28, 1961, the Park government immediately arrested prominent chaebol leaders and other company heads and ordered them to return all profits gained through unfair and illicit activities. Genuinely cowed, many of the accused voluntarily agreed to pay the fines with cash or by turning over their assets to the government. Because of this submission, and also because the government quickly realized that these entrepreneurs were the only viable economic force for developing the country, the Park government backed down. In August, the government reduced the total fines by 90 percent and then cut that amount in half in January 1962. Further, instead of requiring the charged individuals to pay these reduced fines, some were allowed to build strategic factories (with government financing), which were then donated to the state.

In implementing this measure, Park sought to achieve several objectives. First and foremost, it was an effort to gain popular support for a regime that had come to power through military coup and not popular mandate. Park moved swiftly to make a clean break with the corrupt and unpopular Rhee regime and its chaebol accomplices. Second, it gave Park a means to firmly establish the state in a superior position and assure the chaebol’s subservience to the government and its developmental plans. Finally, it gave the Park regime control of a large amount of valuable and productive assets.

It should be noted, however, that even at this time of seeming government dominance, the chaebol hardly surrendered. These entrepreneurs exploited factionalism and disagreements within the ruling elite and utilized the proven methods of bribes and kickbacks to assure political favors. It was at this time too that these businessmen organized “a self-defense interest and lobbying organization” for the chaebol that would eventually become the powerful Federation of Korean Industries, equivalent to the Japanese Keidanren.

By the mid-1960s, the Park regime was firmly in place and had probably reached its “apex of unilateralism” vis-à-vis the chaebol. By this time, the government had firm control over capital and other resources, had identified friendly and effective entrepreneurs, and had developed the institutional means to channel those resources to them. By far, the most important subsidies came in the form of preferential interest rates on commercial bank loans and chaebol access to scarce foreign exchange and the government’s own substantial development funds. Compliant chaebol grew dramatically during this period as recipients of this financial backing and other government favors.
Special Measures in the 1970s

In the 1970s, changes in the relationship between the government and the chaebol were becoming apparent. The government began to show concern for the rapid expansion of the chaebol relative to the rest of the economy. At the same time, however, the Park regime launched a strategy of industrial deepening and import substitution in heavy and chemical industries, once again upon the backs of the chaebol groups. Moreover, as opposition to Park's rule increased in the latter half of the 1970s, the regime used rapid economic growth in an effort to obscure its political shortcomings. The government was not really in a position to regulate the chaebol groups, which were the workhorses in the achievement of its economic goals. As a result, while the government's HCI promotion goals were achieved, concurrent measures designed to correct the imbalances of overconcentration and other chaebol excesses during this period in fact had little effect on their professed targets (Fields 1991).

The first of these measures was the President's Emergency Decree for Economic Stability and Growth, which was announced in August of 1972. The primary purpose of this decree was to improve the highly leveraged financial situation of Korean businesses by freezing loans on the informal or curb market and turning them into bank loans with considerably more favorable (i.e., state-subsidized) terms. While the decree was intended to assist firms of all sizes, in fact, the chaebol, as the dominant borrowers, received the bulk of the benefits. In addition, some chaebol were privy to the plan and were able to take out huge amounts of curb market loans just prior to the decree and then reap windfall profits as a result. The consequence was an even further concentration of the economy and a solidifying of ties between the government and chaebol.

A second policy measure, the Special Presidential Directives of May 29, 1974, was designed to induce the tightly held chaebol and other family firms to go public in order to separate ownership and management and limit the concentration of business assets in the hands of a few individuals or family groups. As noted above, despite an impressive package of carrots and sticks, the chaebol have largely resisted these efforts to give up family ownership and control of the tightly held chaebol.

However, an additional Measure on Bank Credit and Business Concentration, issued by the Ministry of Finance (MOF) in conjunction with the Special Presidential Directives, proved to be an effective institutional means of government control. As part of the measure,
the MOF introduced a bank credit control system known as the Prime Bank System in which one bank was assigned to each overindebted chaebol. This streamlined the government’s ability to call in the loans of non-compliant groups, a “stick” that proved fatal for at least one chaebol, the Kukje Group, which was dismantled by the Chun regime in 1985.

Another policy measure implemented in 1974 in the wake of the first oil crisis was the Act Concerning Price Stabilization and Fair Trade. The purpose of this act was to control prices and assure fair trade practices through the prevention of monopoly practices. However, among 100 cases of alleged unfair trade investigated between 1976 and 1979, no one was charged with undue restriction of competition. In fact, the law was even used to legalize a cement cartel on four different occasions. Thus, a measure ostensibly designed to insure free competition in fact endorsed chaebol collusion, revealing the government’s pro-chaebol bias.

The consequences of these measures need to be examined from two perspectives—political and economic. Politically, the measures seemed to have solidified the ties between the government and chaebol. Unlike the 1960s when the state preferred the entire private sector over the public sector in its drive for economic development, the government clearly favored chaebol over small and medium-sized firms in the 1970s.

The economic consequences of the measures were to expedite and further the oligopolization process in certain key industrial sectors (i.e., the heavy and chemical industries). Chaebol were left free to expand without competition from small and medium-sized firms. Capital had been effectively reallocated within each industrial sector in favor of the chaebol. This differs from the 1960s, when capital was reallocated between industrial sectors. In the short run, the measures solidified the support from the chaebol and maintained the level of economic development by eliminating competition to a handful of chaebol. However, in the long run, the chaebol were able to amass economic as well as political power that would later challenge the government.

Policy Measures in the 1980s

The 1980s show a continuation of the good relationship between the government and the chaebol, but with the government significantly losing its power. The Chun regime inherited a weaker state and also had legitimacy problems because it assumed power through a mili-
tary takeover of the Korean army. Two incidents—the Monopoly Regulation and Fair Trade Act and the Reorganization of the Heavy and Chemical Industries—will be studied to examine the changing relationship between the government and chaebol.

Stepped-up domestic and foreign demands to liberalize the Korean political economy seemed to give the Chun government a convenient and politically popular alternative to government intervention for regulating the increasingly unpopular giant conglomerates. In adopting the Monopoly Regulation and Fair Trade Act (MRFTA) in September 1981, the Chun regime hoped to gain popular support and chaebol respect by disciplining the business groups as Park had in 1960, though using market competition rather than explicit state intervention to achieve this end. Unlike American anti-trust legislation, however, MRFTA preserved gaping exceptions. While restricting horizontal and vertical integration, the act does not cover conglomeratization (i.e., mergers between firms in unrelated business lines), which is the typical Korean method of concentrating economic power. Thus while it may limit market concentration, it does nothing to limit the overall concentration of the Korean economy. In addition, even vertical and horizontal mergers are permitted for purposes of strengthening international competitiveness. Given these loopholes, the chaebol remained virtually unfettered (Fields 1991).

The growing power of the chaebol was also evident in the Reorganization of the Heavy and Chemical Industries, which was announced in May 25, 1979. One of the targets for reorganization was the electricity generator industry, which had been excessively invested in by four firms. The reorganization ordered the Hyundai chaebol to take over Hyundai International to form one company and Daewoo and Samsung to consolidate and form the second company. This plan received many objections, not only because it was difficult to force two rival chaebol, Daewoo and Samsung, to join forces, but also because the takeover of Hyundai International by the Hyundai chaebol presented many difficulties (Kim 1989).

The government ordered the chaebol to continue their efforts to reorganize the industry. The plan went through a few more revisions but finally fell through because the state lacked the ability to implement the original plan and to negotiate the terms of the plan with different companies. The inability of the government may not have been solely due to the growth of the chaebol’s leverage power; it may also have had something to do with the political chaos arising from President Park’s assassination and Chun’s accession to power.

The government’s plans for reorganizing the electric generator in-
industry shows the changes in the government-chaebol relationship. First, the government invited major chaebol to participate in its initial decision-making process. This indicates that the state is keenly aware of the power and influence of the chaebol. Second, when it was made apparent by the proposal from Daewoo that normalizing the electricity generator industry would require massive state funding, the government reversed its initial plan under the influence of the other chaebol, which criticized the preferential treatment of Daewoo. The establishment of a state enterprise was a compromise solution.

Although there is no direct evidence that the government is subordinate to the interests of the chaebol, the fact that the state cannot or does not formulate major policy choices without recognizing the chaebol is a strong indication of a change in the relationship.

How did chaebol become so powerful in the 1980s, such that the authoritarian state had to negotiate its policies with them? This question can be addressed by understanding the domestic and international political economies of that time. First, under the auspices of the government, chaebol have grown into large, powerful political and economic interest groups that can no longer be taken lightly. Second, the Chun regime was experiencing legitimacy problems. Decreased political autonomy undermined the government’s ability to actively and effectively intervene in the economy and regulate the chaebol. Third, changes in the international political economy affected the state’s autonomy and its ability to intervene in the economy. It also implies that the government is no longer in complete control of the domestic economy and has allowed chaebol to become more vocal in the economy.

Changes in both the domestic and the international political economies were critical in undermining the state’s ability to intervene in the economy. Political turmoil in the domestic polity presented some difficulties in formulating coherent economic policies as well as in implementing such policies. In the midst of such confusion, it was relatively easy for chaebol to become more powerful (Kim 1989).

In fact, these and other liberalization efforts initiated by the Chun government have actually opened the way for chaebol to increase their economic clout and financial autonomy. The growing economic power of the chaebol during the 1980s should not, however, be overestimated. The government still had the means and, on occasion, the will to humble even the biggest of chaebol. As noted above, in 1985, the Chun government brought down and dismantled the Kukje group, then the country’s sixth largest chaebol. This and other rationalization measures—most prominently in shipping and construction—demon-
strate that the Chun regime was far from willing to abdicate its developmental role. But decisions counter to the interests of the chaebol became increasingly difficult to make stick, despite the predilections of economic policymakers (Fields 1991).
Notes

1. This section summarizes Lee (1992).
2. Although Johnson (1985) does not make this distinction in the case of Japan, logic dictates that such a distinction should be made for Japan: the Ministry of International Trade and Industry (MITI) could not have dealt directly with thousands of small enterprises however eager it may have been to control and manipulate them to achieve developmental goals. What Johnson observed in the case of Japan is the relationship between the government and large private enterprises or industry organization, and it is this relationship that sets apart the economic systems of Japan and Korea from what he calls the Anglo-American free-enterprise economies.
3. A similar organization called the Group also exists in some Latin American countries. Left (1976) has analyzed how the Group functions to overcome the disadvantages of underdeveloped capital markets.
4. This, of course, raises a political economy question as to why a country follows this strategy to begin with. Findlay (1989) finds his answer in the "relative autonomy" of the state, although he is clearly aware that autonomy does not guarantee that the state will commit itself to such a strategy.
5. The term "situational motivation" is borrowed from Johnson (1982).
6. For further explanation of the entrepreneur's role in government, see Amsden (1989).
7. See Jones and Sakong (1980) for detailed discussions on this theory.
8. This system is similar to the tariff rebate system employed by many other countries for their export activities, including the United States. Korea also changed to a tariff rebate system in 1975.
9. Heavy machinery and chemical industries include the steel, non-ferrous metals, fabricated metals, machinery, electronics, transportation equipment, precision machinery, chemicals, petroleum refining, and non-metallic mineral industries. As such, the term is much more comprehensive than is usually understood.
10. The National Investment Fund also made financing available for power generation and agriculture.
11. There have been many rumors and speculations about the "real" cause of Kukje's bankruptcy. Some argue that the unwillingness of Kukje president Yang Jeong Mo to cooperate with the Chun regime was the real cause of its forced bankruptcy by the state. There are, however, two important issues. The first is that Kukje's investment decisions since the mid-1970s represented rapid expansion efforts, resulting in high debt. The second is that all chaebol in Korea have relatively high debt to equity ratios compared to businesses in other nations. Since the banks were owned by the state until the recent partial privatization in 1981, chaebol were at the mercy of the state. That is, the government had the resources and capability to prevent a bankruptcy if it deemed this necessary. However, the
state remained passive and "allowed" Kukje to go bankrupt.

12. There are numerous accounts of these compliance mechanisms of Korean industrial policy. By far the most lucrative incentives for the chaebol were export subsidies made available to the group-affiliated general trading companies. For an account of these subsidies and Korea's policy to promote general trading companies, see chapter 7.

13. Those activities designated as constituting illicit and unfair wealth included tax evasion, illegal monopoly of contracts for construction and supply activities, unusually large and monopolistic allocation of foreign capital, misallocated foreign funds, and other capital illegally taken out of the country. It was primarily those entrepreneurs who had accumulated monopoly profits dealing in the lucrative "three powers"—flour, sugar, and cement—that were involved in such activities.

14. For detailed explanations, see Kim (1980).
Most large chaebol groups began as small shops or factories in the 1950s. Many factors have contributed to the growth and success of the chaebol, including government support, the ambition of entrepreneurs to build corporate empires, workers’ sweat, aggressive management, profits gained from inflation, distorted factor markets (especially the financial market), and the use of general trading companies to promote exports. Among these sources for chaebol growth, we examine the role of entrepreneurship, finance, and general trading companies.

**Entrepreneurship**

Schumpeter (1934) visualized entrepreneurship as the key factor in economic development because of its role in introducing innovations. An argument can be made that the shortage of this talent is particularly acute in less developed countries and forms one of the most intractable bottlenecks precluding growth. Capital can be borrowed internationally, and technology and intermediate inputs can be imported, but such actions lead only to debt if not combined effectively. This is the function of the entrepreneur.

By definition, any single-factor theory of development is myopic, but if one wishes to focus on a prime mover, then entrepreneurship is a likely candidate. With it, other factors can be found; without it, they will be squandered. This sort of consideration leads Hirschman to identify “the ability to make development decisions as the scarce resource which conditions all the other scarcities and difficulties in underdeveloped countries” (1958:27).

In principle, entrepreneurship is to be clearly distinguished from management, with the former referring to the initiation of new economic activity and the latter to the operation of ongoing activities. The critical characteristic is the formation of new combinations of
means of production. It should be stressed that Schumpeter (1934) interpreted "new combinations" in a much broader fashion than is commonly thought and argued that entrepreneurship should include the following functions:

1. The introduction of a new good—i.e., one with which consumers are not yet familiar—or of a new quality of a good
2. The introduction of a new method of production—that is, one not yet tested by experience in the branch of the manufacture concerned (this need not be founded upon a new discovery but can simply be a new way of handling a commodity commercially)
3. The opening of a new market—that is, a market into which the particular branch of manufacture of the country in question has not previously entered, whether or not this market existed before
4. The conquest of a new source of supply of raw materials or half-manufactured goods, again irrespective of whether this source already exists or whether it has first to be created
5. The carrying out of a new organization of any industry, like the creation of a monopoly position or the breaking up of a monopoly position

Jones and Sakong (1980) also introduce a variety of functions that go into the making of an entrepreneurial bundle. These functions include

1. Perception of a new economic opportunity, including new products, new processes of production, and new markets
2. Evaluation of the profitability of a new opportunity
3. Gaining command of financial resources
4. Plant design, technology, and construction supervision
5. Recruiting and training of new personnel
6. Dealing with government
7. Dealing with suppliers and purchasers

In a primitive economy, the absence of skill at any of the functions is sufficient to seriously impede the entrepreneurial act. In a more developed economy, the missing item can be hired, permitting a less heroic type to successfully bring a project to fruition. In fact, as one goes down the list, it becomes apparent that not only can any of the functions be performed for the entrepreneur rather than by him, but in principle they all could. What then is left for the entrepreneur is the pure Schumpeterian function of combination. The entrepreneur takes ultimate responsibility for seeing that all of the functions are carried out even though he performs few, or none, of them himself. Jones and Sakong (1980) call this pure and unavoidable task the "lenticular"
function because an entrepreneur is like a lens that focuses the energies of others.

Leibenstein (1968) augues that one major entrepreneurial task is "gap-filling," which refers to compensating for market deficiencies. That is, information about some inputs is either unmarketable or unmarketed, and it is the entrepreneur’s task to fill these gaps. If the economy provided a complete set of demand functions, a similar set of production functions, and a complete set of prices (including prices for obtaining the production and demand functions), then "perception of market opportunity" would be a trivial task easily performed by the average undergraduate with access to a computer. In fact, the market provides precious little information of this sort, and filling this gap is the entrepreneur’s job and the source of his reward. Such "gap-filling" must be performed for each of the entrepreneurial functions with the difficulty of each function depending on the state of the market. For example, for homogeneous commodities that are sold widely in developed economies, dealing with purchasers becomes trivial.

The various entrepreneurial functions may be performed (i.e., the gaps may be filled) in one of the following three ways: (1) by the market, (2) by an agent employed by the entrepreneur, or (3) by the entrepreneur himself. Leibenstein (1968) refers to the third way as "input completing." The entrepreneur as a gap-filler and input-completer is probably the prime mover of the capacity creation part of these elements of the growth process.

Because economic power became most concentrated during the process of economic development, one must examine the interrelationship between economic development and entrepreneurship to discover the source of such concentration. It cannot be denied that entrepreneurship of this sort is a scarce resource in a developing economy with an immature market system. Entrepreneurship becomes even more valuable as the target rate of economic growth is raised, because demand for the gap-filling and input-completing functions also increases. Although entrepreneurship is essential for business activity, its supply is not elastic. Nor is it a service that is transacted in the market. Moreover, it is not exhausted easily, despite repeated use. Because of these peculiarities, economic power is bound to be concentrated in the hands of a few entrepreneurs and their chaebol groups up to a certain stage of economic development (K. Lee 1990).

Furthermore, Leff (1978) notes that the group pattern of large-scale, diversified firms makes positive effects on entrepreneurship in the developing countries. The group pattern may help relax entrepreneurial constraint to permit pure Schumpeterian entrepreneurship to become
effective. The group organization also facilitates economies in the use of scarce entrepreneurial resources. Perhaps even more important, the group structure itself reduces the amount of entrepreneurial capacity required per unit of innovative decision making with increasing information flows and reducing uncertainty surrounding investment and production decisions.²

The very small number of Korean investments on the peninsula through 1945 reflects the difficulty for indigenous entrepreneurs in the face of strong Japanese competition. The small number of colonial entrepreneurs who survived and succeeded indicates the uncertainties and difficulties of major private enterprise on the peninsula. Unlike their Japanese counterparts, the Korean entrepreneurs in general were unable to develop financial institutions within their chaebol groups that might moderate losses and provide loan capital for innovative ventures. There was little opportunity for large-scale Korean enterprise within the highly competitive environment of strong alien investment initially in agriculture and commerce and later in industry (McNamara 1990).

The two early Korean entrepreneurs cited in chapter 2 displayed considerable innovative skills in organization, development of markets, and application of technology. One could point to Park’s chain stores project in the 1930s and the land reclamation projects of Kim’s Samyang Company during the colonial years. Their development of trading companies and of sugar and textile production through 1960 also demanded innovative skills, and in the Korean context cooperative skills as well.

In the 1950s, the only major domestic industries were basic food industries and light industries for clothing. With the uncertain social conditions following the Korean War, there was no active investment activity by entrepreneurs in the industrial sector, and incentive was focused on speculative and short-term investment in the commercial sector. In short, there were no entrepreneurs to speak of although there was a considerable number of prominent merchants (Kim 1986).

From the postwar 1950s through the mid-1960s, and particularly after the push for economic development began in 1962, both economic and non-economic factors were ripening for the emergence of the early entrepreneurs. There was increased opportunity to begin businesses that required little technology or managerial skill, a bare minimum of capital, and mainly an attitude of sincerity and devotion; a high return on investments was an added incentive. In those early years of development, entrepreneurship encompassed the immediate family, which grew to include the extended family and friends as well.⁵
During the period of rapid business growth—i.e., from the late 1960s to the end of the 1970s—the system became more complex, however, as the interrelationship of economic and non-economic factors became more complicated. Early entrepreneurship had readily affected the early economic development which, in turn, was beginning to readily affect entrepreneurship. The government's planning resulted in increased entrepreneurial risk taking in such areas as export orientation and development of heavy industries. Heavy and chemical industries began to emerge, while export emphasis was still geared to light-industrial products such as textiles.

In Korea, the functions of entrepreneurship are performed by a variety of individuals other than the chief executive. This is particularly true in large chaebol, where various managers take charge of penetrating target markets and initiating projects. In addition, the government, domestic companies, and foreign buyers and suppliers all contribute to new combinations. It may indeed be argued that the presence of these complementary entrepreneurial contributions accounts for a substantial part of the success of chaebol.

Almost all chaebol were established by self-made founders who inaugurated and managed their enterprises under great difficulties (these difficulties stemmed from a lack of capital, technology, experience, and education). Almost every self-founder has devoted his entire life to work. These difficulties and sweatshop ethics have led to such common Korean entrepreneurial characteristics as diligence, frugality, creativity, strong impellent force, sincerity and credibility, frontier spirit, preference for harmony among family members and employees, preference for stable and bureaucratic organization, top-down decision making, insensitivity to changes in circumstances, non-scientific management, preference for management by family, and lack of formal education. These common characteristics still have great impact, both positive and negative, on the management style of chaebol.

Entrepreneurial talent is required only at the margin to induce change. Ongoing intramarginal activity requires only managerial talent, which can be hired. So long as the incremental unit of expansion does not increase, returns to entrepreneurship thus need not be subject to decreasing returns. The entrepreneur starts one project, gets it running smoothly, turns it over to a subordinate, and moves on to a new project. The result is a continually growing ownership share by the entrepreneur, but constant returns to his entrepreneurial talent at the margin. Of course, the real-world entrepreneur must spend part of his time in managerial troubleshooting in the enterprises he left be-
hind, and these activities dilute his pure entrepreneurial efforts, ultimately putting a brake on growth unless he can develop the complementary entrepreneurial talents of his subordinates.

The pattern of continually shifting entrepreneurial attention certainly describes the behavior of the chairmen of many, if not all, of at least the larger chaebol. Woo-Jung Kim built up the light-industrial sector of Daewoo, then called in his brother from academia to run it as he shifted his primary efforts to a succession of heavy industrial projects. Joo-Young Chung followed a similar path at Hyundai, moving from construction to shipbuilding to autos and then to heavy industry. The entrepreneurial role of the chaebol is quite independent of its operational role (Jones 1987).

Businessmen have a variety of ambitions. Some entrepreneurs seem to be primarily interested in the profitability and growth of their firms as organizations for the production and distribution of goods and services. Their energy is directed toward improving the quality of their products, reducing costs, and developing technologies. Another type of entrepreneur is driven by the desire to create a powerful industrial empire extending over a wide range of businesses. Successful empire-building entrepreneurs must have initiative and be aggressive. They are primarily interested in extending the scope of their activities through the establishment of new firms and the acquisition or elimination of competitors. This unusual penchant for expanding operations can be loosely characterized as empire-building behavior.

Many chaebol seem to have followed "growth first" or "revenue maximization" strategies during the period of their rapid emergence in the nation's economy. In this regard, many Korean entrepreneurs seem to have aggressively sought to build business empires. Aggressiveness was necessary in undertaking risky projects such as the construction of world-class shipyards or the development of large-scale automobile factories. However, the desire to build business empires has also resulted in the excessive expansion of chaebol groups to the detriment of sound social and economic development (Y. Lee 1990).

In evaluating the role of entrepreneurship in the whole national economy, it is useful to follow Leibenstein in distinguishing between "zero-sum" and "positive-sum" entrepreneurship (1963:111–19). Traditional microeconomic theory holds that all voluntary exchange and production are positive-sum, leading to mutual gain (or at least no loss) for all parties. Leibenstein, on the other hand, argues that in the real world, there is zero-sum activity where entrepreneurs spend their time and energy in ways that may directly or indirectly increase
the personal wealth and income of some of them but that involve ac-
tivities that add little or nothing to the productive capacity of the
economy.

Even though entrepreneurship had positive effects on the growth of chaebol, it was also shown that the zero-sum entrepreneurship may have existed in the national economy. For example, entrepreneurs may spend their time in non-trading activities in order to secure for their interests a greater monopolistic position, increased political power, more prestige, etc. Such activities can conceivably lead to greater financial gains for some of them than the alternative of engaging in investment activities that lead to increases in national product. They may also use their talents and marshal wealth in order to engage in speculative trading that, in turn, need not increase aggregate resources or aggregate income. Such activities, even when entrepreneurs do not use up savings, do waste rare entrepreneurial resources. Finally, entrepreneurs may engage in activities that do use up net savings, but the investments involved are in enterprises of such a nature that their “social value” is either zero or much lower than their private value.

Finance

The financial system is a mechanism by which the savings of households and individuals are channeled into the hands of those needing investment for industry and wealth creation. In the theory of economic textbooks, this role is self-evident and uncomplicated. The financial system—in particular, the banking sector—aggregates individual savings into larger amounts which can then be lent to those firms requiring large amounts of funding to invest in new productive infrastructure and services. The primary role of the banks and other lending and investment institutions is then to assess the risk of the loans or investments being repaid with interest. For the system to work satisfactorily, these institutions must lend only to those entrepreneurs and firms capable of repaying their loans and interest charges (Cox 1986).

The performance of industry in terms of profits, competitiveness, and market share is of crucial importance. It is also of particular significance for the privately owned financial system because it shapes its willingness to invest funds in companies and entrepreneurs. If profits are low, competitiveness weak, and market share in decline, financial institutions are unlikely to be willing to act on their own to
provide funds for industry. When this occurs, the state must act and try to stimulate investment to ensure the long-term profitability and future of industry. In these circumstances, the government, like the financial system, has a range of alternative approaches from which it can choose to assist and support the financing of industrial investment.

Until the mid-1960s in Korea, the intermediary role of commercial banks was of little significance because of the negligible savings potential of the nation. The primary purpose of financial institutions was to channel aid funds to rehabilitation projects and farmers. Two special banks—the Korea Development Bank and the Korea Agriculture Bank—accounted for over 70 percent of total bank lending.

Korea started an ambitious economic development and industrialization plan in the early 1960s. In the process, the Korean government made extensive and forceful use of a wide range of incentives designed to assure private industry's close compliance with the government's plans. Among them, probably the most widely used has been differential access to credit from commercial banks as well as specialized banks under government control. In addition, foreign loans, which were an attractive source of borrowing, required government authorization, and allocation of such loans was largely controlled by the government.

The financial sector in Korea, especially the important banking subsector, was heavily regulated by the government in the 1960s and 1970s. As part of an aggressive and centrally controlled economic development process, the Korean government has controlled the access of firms to bank credit and concessionary lending as a way to ensure private industry's detailed compliance with official plans. In addition to low interest ceilings and negative real rates, the banks were burdened with various types of policy loans. The real interest rates on these loans (e.g., for export credit) were much lower than the general bank loan rate, which was itself already set far below market levels (Cho 1988).

With the adoption in the mid-1960s of an outward-looking development strategy that emphasized exports, the government has sought to allocate a larger share of investment resources to the export-producing manufacturing sector. Largely because of this industrial policy, exporters and those engaged in export-related activities have been by far the most favored borrowers of banks in Korea. Exporters have access to short-term loans tied to the gross volume of export sales (the term of which does not generally exceed 30 days) and long-term loans for fixed investment in export-oriented industries. All export loans
are subsidized and preferential in that they carry interest rates lower than the general bank lending rates and are made available only to those who generate exports (Hong and Park 1986).

The export-financing system has provided a powerful stimulus to firms to export once they begin production. This system has spread the lending activities of the deposit money banks more broadly throughout the manufacturing sector than would have been the case if the loans had been discretionary. It has also eliminated much of the cost involved in obtaining the rationed loans of the banking system.

Financial incentives in the form of availability of credit at subsidized interest rates induce domestic producers to sell abroad rather than in the home market, as the incentives increase the effective exchange rate for exports. The automatic availability of credit also encourages investment in export-oriented industries. In a regime where strict credit rationing is administered, credit availability can be a far more important incentive than interest rate subsidies. When official interest rates are often held below the expected rate of return to capital, and when banks are the major source of credit, business enterprises are highly leveraged, and their liabilities are mostly short term. Under these circumstances, bank credit can be critical for both the success and survival of firms.

In addition to the automatic availability of export-related credits, access to other types of bank credit has been better for exporters than for domestic market-oriented firms for several reasons. In line with government industrial policies designed to direct more resources to export-generating sectors, financial institutions have been explicitly or implicitly encouraged to support exporters. Therefore, exporters have been treated as preferred customers in the rationing of credit by banks. From the viewpoint of the banks, exporters are also preferred borrowers because, unlike domestic market-oriented enterprises, exporters are assured of credit so long as the export revenues grow. With a rediscounting facility at the central bank, discounting of export-related bills has been one of the major sources of bank profits. Indeed, banks have had every reason to attract exporters and then support them financially in preference to other customers.

Although all exporters qualified for subsidized working capital, only certain firms received subsidized investment capital, and without subsidized investment capital, it was hard to create the capacity needed to export. Therefore, the financing of export expansion in Korea should imply the financing of this selected group of entrepreneurs, and the export-oriented growth of Korean manufacturing should essentially imply the growth and export expansion of the same group. The sketchy
evidence suggests that large firms were, in fact, relatively more export-oriented than small and medium-sized firms (Amsden 1989).

Abundant labor and low wage rates alone may have been sufficient bases for a rapid expansion of output and exports of those sectors. Hence, whatever subsidy was given to them through low-interest loans was a windfall income transfer, especially after the initial phase of infant export marketing. For instance, low-interest, short-term trade credits have been allocated to all export activities at a uniform rate per dollar exported. As a result, there seem to have been enormous income transfers to the exporters of very labor-intensive goods. This may partly explain the phenomenal expansion of some chaebol groups that started mainly as exporters of clothing and footwear into large business groups. Furthermore, it is possible to make large profits by cheating the government and smuggling significant portions of such funds to other, more profitable projects. Such actions may partly explain the aggressive diversification into the labor-intensive consumer goods, service, and real estate sectors by some chaebol that began operations mainly as manufacturers of capital-intensive goods.

From the early 1970s, the deterioration of the external environment had serious implications for the development of Korea’s industrial policy. Given this situation, the promotion of heavy and chemical industries (HCls) was seen as critical for developing indigenous defense industries as well as restructuring the commodity composition in favor of more sophisticated, high value-added industrial goods. The industries included iron and steel, non-ferrous metal, shipbuilding, general machinery, chemicals, and electronics. Promotion of these industries was the overriding objective of tax policy, credit and interest-rate policies, and trade policy (Nam 1991).

Credit allocation by the government through the banking system was the most powerful means of supporting the favored industries. As the National Investment Fund, established in 1973 with the purpose of financing HCls, proved to be insufficient in financing large-scale investment projects, banks, which were practically owned by the government, were directed to make loans to the strategic industries on a preferential basis. During the latter half of the 1970s, the share of policy loans in domestic credit rose steadily from 40 percent to over 50 percent. A more significant aspect of the policy loans was interest-rate differentials. During the latter half of the 1970s, bank rates for export-related loans and equipment investment loans in key industries-averaged 8 percent and 13 percent, respectively, compared with 17 percent for general bank loans, 41 percent for curb market rate, and the CPI inflation rate of 17 percent (in terms of five-year average).
Table 7.1 Regulated and Market Interest Rates (year average, percentage)

<table>
<thead>
<tr>
<th>Year</th>
<th>General bank loans rate</th>
<th>Curb rate</th>
<th>Average borrowing cost (manufacturing)</th>
<th>Consumer price inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>24.0</td>
<td>49.8</td>
<td>14.7</td>
<td>15.4</td>
</tr>
<tr>
<td>1975</td>
<td>15.5</td>
<td>41.3</td>
<td>11.3</td>
<td>25.4</td>
</tr>
<tr>
<td>1980</td>
<td>23.4</td>
<td>44.9</td>
<td>18.7</td>
<td>28.7</td>
</tr>
<tr>
<td>1985</td>
<td>11.5</td>
<td>24.0</td>
<td>13.4</td>
<td>2.5</td>
</tr>
<tr>
<td>1990</td>
<td>11.5</td>
<td>18.7</td>
<td>NA</td>
<td>8.6</td>
</tr>
</tbody>
</table>

Sources: Bank of Korea (various years).

As a result of this strong and concerted support in tax, trade, and credit policies, almost 80 percent of all fixed investment in the manufacturing sector during the late 1970s is estimated to have been directed to the HCIs. Such disproportionate incentives, together with overoptimistic assumptions regarding world trade prospects, led to excessive and duplicative investment in some areas. To correct the situation, in 1980 the government had to intervene and coordinate negotiations among participating firms for relinquishing some projects or reducing their capacity.

In addition to investment inefficiency, the HCI promotion policy gave rise to serious sectoral imbalances and complications in macroeconomic management. As the government-favored HCI projects preempted limited financial resources, credit to other industries was unduly squeezed. Moreover, given the huge capital requirement and weak business position of small and medium-sized firms, the new HCI projects were granted to large chaebol groups, contributing to the serious concentration of economic power.

The National Investment Fund was neither as plentiful nor as cheap as export credit. But it was extensive enough to maneuver the financially leveraged chaebol into new heavy and chemical sectors of shipbuilding, automobiles, machine building, chemicals, and electronics. Korean favoritism toward HCIs and large firms was really sui generis. Inevitably, the economies of scale demanded by HCI could be met only by the large chaebol group firms, ergo policy loans to big business. It was not uncommon for the chaebol to triple their affiliates in the years 1974 to 1978, with new acquisitions often in the heavy and chemical sectors (Woo 1991).

The Korean government's intervention in the financial sector seems
to have been quite distortive, especially in the latter half of the 1970s, when it strengthened its control over credit allocation to favor the development of HCIs, although the interventions in the 1960s and 1970s to support export activities may have had positive aspects in the sense that they neutralized the distortive effects of other government policies such as high protection and overvaluation. Most important, the chaebol, which were the principal beneficiaries of cheap loans and other privileges, made excessive and "redundant" investments in major HCIs, further weakening their financial structure.

For example, we present a typical scenario of chaebol growth via credit access. Suppose one privately held company "luckily" obtains government approval for an industrial project. It will typically be financed by one-fifth equity and four-fifths foreign and domestic loans. So the project starts with a meager equity base but with substantial external debt and other government-provided privileges (notably tax advantages). The privately held firm may then grow rapidly if the project becomes successful. The firm then starts a new line of business with the profits accumulated from the first venture. Of course, once again the firm will not usually put up much equity but will rely heavily on external debt. The extension of this process leads to a group of firms or chaebol. Profits earned from the chaebol may be extracted for distribution to stockholders, usually family members, through legal or illegal methods, or both. This is particularly likely for a weak firm that might be bled. This process gives rise to a popular saying that "even when business goes bankrupt, businessmen survive." Even for the far more numerous prosperous firms in the group, the financial structure remains weak.

The finding that the chaebol share of industry's sales is significantly correlated with industry's capital requirements suggests an alternative explanation of chaebol dominance based on favorable access to scarce credit. During the 1960s and 1970s, the Korean government exercised substantial control over all formal sources of credit, both domestic and foreign (Zeile 1989). Government industrial policy dictated the credit decisions of Korea's major city banks, which had been nationalized in 1961 as part of the government's campaign against "illicit wealth accumulation" during the former regime. The government also operated a number of special banks and provided long-term loans for fixed capital investment through the Korea Development Bank (KDB). Foreign loans to Korean firms were subject to government control under a system whereby the Korea Exchange Bank (KEB) issued guarantees to foreign lenders (see table 7.2).
Government intervention in the allocation of credit increased considerably in the 1970s, subsequent to the major reductions in interest-rates mandated by the August 3 Presidential Emergency Decree of 1972. With interest-rate ceilings (at negative real rates) in effect, the government used credit rationing as a major policy instrument to promote the development of a number of infant industries, broadly referred to as the HCIs. The only real alternative to government-rationed credit was the informal financial sector (i.e., the curb market), where nominal interest-rates were two to three times as high as the rates charged for general bank loans. Given the heavy dependence of Korean firms on debt finance, access to government-controlled credit was critical to a company's successful growth, particularly in the more capital-intensive industries.\(^5\)

In general, the system of credit rationing in the 1970s favored large firms at the expense of small and medium-sized firms. As, under the system of interest rate ceilings, banks were not permitted to charge differential interest rates on the basis of risk assessment, they generally attempted to reduce transactions costs and potential losses from default by giving preferential treatment to large, well-established firms. Smaller firms thus tended to be more dependent on the curb market for securing needed loans. Large enterprises also received favorable treatment in the form of special policy loans (with interest rates even lower than the rates for general bank loans), which were largely directed to firms producing for export and firms in targeted HCIs.

Insofar as most of the manufacturing firms affiliated with the chaebol can be classified as large, the chaebol would have enjoyed preferred

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Table 7.2 Share of Policy Loans for Banks and Non-bank Financial Institutions (as a ratio of domestic credit, percentage)

<table>
<thead>
<tr>
<th></th>
<th>Monetary institutions</th>
<th>Government fund</th>
<th>Credit to KDB and KEB</th>
<th>Foreign currency loans</th>
<th>Non-bank financial institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td>48.2</td>
<td>5.3</td>
<td>3.4</td>
<td>6.6</td>
<td>52.8</td>
</tr>
<tr>
<td>1975</td>
<td>40.9</td>
<td>3.5</td>
<td>1.8</td>
<td>8.6</td>
<td>52.4</td>
</tr>
<tr>
<td>1980</td>
<td>49.1</td>
<td>3.0</td>
<td>1.5</td>
<td>15.5</td>
<td>43.9</td>
</tr>
<tr>
<td>1985</td>
<td>39.3</td>
<td>3.5</td>
<td>0.9</td>
<td>7.7</td>
<td>30.2</td>
</tr>
<tr>
<td>1990</td>
<td>47.5</td>
<td>3.7</td>
<td>7.9</td>
<td>8.8</td>
<td>12.7</td>
</tr>
</tbody>
</table>

Sources: National Statistical Office (various years).
treatment in terms of the cost of finance. Group membership in itself may also have given firms an advantage in securing loans from banks and development financial institutions. Such an advantage would have enabled the chaebol to benefit enormously from the government's credit subsidies by establishing new firms in industries targeted for development.

As foreign loans in the 1970s were generally used to finance imports of capital goods, this is consistent with our previous finding that chaebol dominance of Korean industries is significantly correlated with industry's capital requirements. It remains an open question whether the chaebol were able to assume a dominant role in capital-intensive industries because of privileged access to foreign loans or whether something about the organizational structure or technological capacity of chaebol groups predetermined their dominance of such industries independent of any government favoritism. Either way, one is led to the conclusion that the government's promotion of capital-intensive industries in the 1970s did much to contribute to chaebol group dominance of the Korean economy at the aggregate level (Zeile 1989).

Furthermore, as long as the government and the chaebol were strategically interdependent in the politicized market economy, the chaebol could exert a strong influence on the government's credit allocation policy. Major changes in the government's credit allocation policy appears to coincide with the diversification strategies of the chaebol. The close match between the changes in the government's industrial policy emphasis and the diversification strategies of the chaebol may be a strong indication that the government actively supported the creation of market pressures that would compel big businesses to adjust to the changing economic conditions (Choi 1991).

In other words, by controlling the allocation of credits, the government could actively support the growth sectors. Insofar as the chaebol have represented the forerunner of the industrial structural change, they could enjoy an ever greater reservoir of preferential credits. For example, even in periods of anti-inflation and economic stabilization, the chaebol could evade the harsh monetary squeeze more easily because of their diversified lines of business, as some of them always stood to benefit from special treatment.

As another example, although the commercial banks have been required to make available a minimum of 30 percent of their total loans to small and medium-sized firms, they have tended to ignore the regulations, and the government has not punished them for their non-compliance. In addition, under such political tactics, it is natural that
the number of industries that received preferential credits continued
to grow and the structure of Korea’s preferential credit system be-
came increasingly complicated over time. Such a fragmented and con-
sequently extremely complicated structure of preferential credit may
have encouraged credit diversion.

The credit market has been the most distorted and imperfect mar-
ket in the Korean economy. Capital generally has been underpriced
throughout the rapid growth period. Inflation-adjusted real rates of
interest on official loans have been negative or near zero during most
of the 1960s and 1970s. Under such conditions, the size and power of
large chaebol groups can be used to special advantage in exploiting
quasi rents accompanying loan market disequilibria. Quantitative ac-
cess to low-priced capital is a critical factor in determining the speed
of enterprise growth. Privileged access of large groups to credit en-
ables them to enjoy advantages in product markets when competing
with non-chaebol groups, including small and medium-sized firms.

The chaebol’s active participation in the financial industry has also
enhanced their privileged position in the preferential financial sys-
tem. As they have been allowed to acquire controlling shares of non-
bank financial intermediaries (NBFIs) since the 1970s and as they
could increase their equity holdings of commercial banks directly and
indirectly after their privatization in the 1980s, the chaebol could not
only borrow much of their working capital from the NBFIs but, as
large stockholders, could influence the decision making of commer-
cial banks. Moreover, it is not a secret that the chaebol utilized idle
funds through the NBFIs under their control. In particular, it is note-
worthy that the large group structure has been conducive to making
each of their headquarters, equipped with better information about
overall financial and market conditions, a focal point of each chaebol’s
internal financial market.

Since the Emergency Decree in 1972, Korea’s financial system has
bifurcated: commercial and specialized banks on the one hand, 
NBFIs on the other. Being allowed relatively greater freedom in their
asset management, the NBFIs witnessed a rapid growth in the 1970s.
But because no restrictions have been imposed, they have become the
turf of large chaebol groups. As a result, in the 1970s, 10 investment
and finance companies came under the control of each major chaebol
group. Six general financing companies, partly financed by foreign
capital, also came under their control.

Furthermore, the curb market incident in 1982 helped the chaebol to
advance their position, as the curb market became the target of a gov-
ernment crackdown. Within months after the incident, the Ministry of
Finance decided to lower the barriers to entry in the non-bank financial industry. As a result, the number of non-bank financial institutions—such as investment and finance companies and mutual savings and finance companies—increased conspicuously. Within a year, 12 new short-term finance companies and 57 mutual finance companies were chartered. Again most of them came under the control of major chaebol groups. This time, new chaebol groups, recognizing the utility of these non-bank financial institutions, also rushed into the industry (Choi 1991).

Since 1980, however, the government has begun to implement several reforms designed to liberalize the financial system in conjunction with an overall economic liberalization policy. In doing so, it has taken a gradual approach, whereby the non-banking subsector—which had been much less regulated with regard to asset management and interest-rate levels—was further deregulated, and entry barriers to the subsector were greatly relaxed. Compared to the non-banking sector, liberalization of the banking sector has been slow and limited. Nevertheless, there have been several significant reforms implemented in the banking sector. Commercial banks nationwide that had previously been owned by the government were privatized, and in June 1982, the government abolished various longstanding preferential lending rates that had selectively subsidized strategic activities (Choi 1988).

The financial liberalization was a signal that the government–chaebol relationship would fundamentally change. However, chaebol groups also favored the financial liberalization policy. During the restructuring episodes, the chaebol abhorred the situation in which they were compelled to leave their fate at the disposal of the government policy makers and at the peril of fickle political judgment. In addition, to meet their rapidly increasing fund requirements more flexibly, the chaebol felt the need to own and control financial institutions.

The General Trading Company

General trading companies are a relatively new phenomenon in the international business scene. In the late 1950s, after the regrouping of Mitsubishi and Mitsui, Japanese newspapers began to describe a group of large Japanese trading companies known as the sogoshosha. We have since come to understand sogoshosha, which is loosely translated as a general trading company (GTC), as a generic term for large trading companies in Japan.
During the 1970s, governments of newly industrializing countries such as Korea, Taiwan, Thailand, and Turkey began to develop their own GTC systems to promote exports in the face of increasing trade protectionism among the major importing countries. In 1982, even the United States, a nation with an advanced economy, established its own version of the GTC to promote its export activities (Cho 1987).

In Japan, to reduce the chronic dependence on European traders for much-needed imports, the Meiji government promoted the establishment of national trading companies. Government assistance and protection were offered to willing merchants. The House of Mitsui, known for over a century as an influential apparel dealer and banker, complied with the government’s offer, and in 1876 established Mitsui Bussan to engage in direct foreign trade. In 1870 in Osaka, Iwasaki Yataro established a shipping company called Tsukumo Shokai, later (in 1873) renamed Mitsubishi Trading Company. Other commercial houses included C. Itoh (which later split into C. Itoh and Marubeni), which was established in 1872, and Suzuki Shoten (which later became Nissho), which was established in 1877. These trading companies, which initially focused on import markets, have since developed into huge trading organizations with globally integrated activities. They are today’s sogoshosha.

After World War II, the regrouping of broken zaibatsu created trading companies that were substantially larger, stronger, and more sophisticated than before. In the early 1970s, the consistent growth of Japanese sogoshosha in the midst of the worldwide economic recession caught the eyes of policy makers in many countries. The governments of developing countries recognized sogoshosha as one of the major causes of the Japanese trade surplus. Soon other countries started to develop their own GTC systems, modeled after the sogoshosha.

The first attempt was made by the Brazilian government, which was concerned with its poor balance-of-payments position. Focusing on exports as the top priority instrument of its industrial policy, the government established Cobec in 1971 and Interbras in 1976. Financing for both companies came from Banco de Brasil, as well as from Brazilian and foreign commercial banks.

In the mid-1970s, Korea’s exports experienced a setback from the global recession and the protective trade policies of advanced nations in the wake of the energy crisis. Adding to the problem was overcompetition among small-scale manufacturer-exporters, who did not have expertise in overseas marketing. To regain the fast rate of export growth experienced in the 1960s, the government in 1975 issued an ordinance designating a Korean version of the GTC, called chonghap-
mooyeok-sangsa, which is a direct translation of sogoshosha into Korean. These GTCs were to be large enough to attain economies of scale in the world market, specialized in exportation to gain international competitiveness, and capable of overseas marketing. At the end of 1983, Korea had nine GTCs, which together handled 51.3 percent of Korea’s total exports.

Even though Korean GTCs have existed for less than two decades, their rapid growth made them a visible force in international trade. Some Korean GTCs export more than $3 billion. Their contribution to the national economy is comparable to that of Japanese sogoshosha, in that their combined exports are close to 50 percent of the national total. Given this impressive record, Korean GTCs are widely recognized as being one of the most successful adopters of the Japanese GTC model.

Changes in the international economic environment after the 1973-1974 oil shock were extremely detrimental to prospects for a continuous expansion of Korea’s exports. Overseas demand for labor-intensive industrial exports from developing economies fell sharply mainly as a result of the oil shock-related stagflation in the developed countries (Korea’s major export markets) and of the growing neo-protectionism against industrial exports. On the domestic front, general price inflation and increases in wages for unskilled and semi-skilled workers since 1973 had weakened the international competitiveness of Korea’s industrial exports.

However, because the government’s drive for export expansion had been intensified by a strong incentive system and profit earnings from export activities had begun to rise, the number of export-oriented trading firms increased tremendously, from 816 in 1970 to 1,842 in 1975. Notwithstanding the increasing number of establishments, the average size of exporting firms remained relatively small. Thus, export trading was overcrowded with small and mid-sized traders, leading to cutthroat competition in overseas export markets.

In addition, after President Park forcibly carried out the politically controversial constitutional amendment in 1972 that virtually guaranteed his continued rule, Park and his government viewed export-oriented economic growth and prosperity as the most effective means of pacifying political discontent among the Korean people. The “export target of US$10 billion” was a politically attractive goal, and the government made an all-out effort to attain this quantitative target (Jo 1991).

In short, faced with changed external and internal circumstances and out of political necessity, the government took a series of mea-
sures to expand exports that included the creation of the GTC system, which was designed to increase economies of scale and functional specialization in the overcrowded and fragmented export trading sector. Korean GTCs, generally following the Japanese model of sogo shosha, were designed to cope with problems affecting Korea's export trading activities, including (1) declining export market demand resulting from worldwide recession and rising protectionism, (2) lack of a functional division of labor between export traders and export manufacturers and among export traders, and (3) excessive competition among small-scale exporters.

By appointing the trading subsidiaries of large chaebol groups to the status of GTCs, the government hoped to use the limited resources or funds for subsidies more effectively among a small number of oligopolistic trading firms rather than stretching its resources among a large and increasing number of small and financially weak exporters.

Against this economic background and the government objectives reviewed above, the Ministry of Commerce and Industry established, by decree, a set of formal requirements for qualification of GTCs. In 1975 these requirements were (1) minimum capitalization of 1 billion won and a minimum value of exports per year of more than US$50 million; (2) exports of at least seven items each valued at more than US$500,000; (3) annual exports worth more than US$1 million to each of 10 or more countries; and (4) encouraging public ownership of GTCs through stock issue.

In 1978 the minimum level requirement of capitalization was abolished. The various requirements for specific minimum amounts of exports were replaced so that a GTC's exports had to be at least 2 percent of the country's total commodity exports. This meant that GTC export requirements would be automatically escalated by the annual growth of exports. The requirements for regional diversification of exports for GTCs were abolished in 1981. Therefore, one of the major functions originally envisaged for GTCs—namely, the development of new export markets—was no longer subjected to government control. This development opened up the possibility of increasing export concentration in existing export markets (i.e., the United States, Japan, and Western Europe). The relaxation and then abolition in 1981 of the requirements for product diversification implied that any trading company exporting a single item comprising 2 percent of the value of the country's total commodity exports could achieve GTC status.

However, the prior requirement for more than US$50 million exports of seven items or more was designed to promote product diversification. This requirement, which was especially suited to large chaeb-
bol groups with multiple product lines, triggered a wave of takeovers of small enterprises by larger chaebol groups. The incentives accorded the GTCs can be considered as the "rights" (benefits) to counterbalance the "obligations" (or costs) for meeting the requirements for GTC appointment. These incentives can be reviewed in terms of international trade, administrative, financial, and foreign exchange benefits.

More specifically, the financial incentives included eligibility for loans within the limits of past export performance for a specific period and local trade finance for finished products within the limits of one-third of the exports of the previous year. That is, the GTCs were permitted to issue a "local" letter of credit to local suppliers without receiving the "master" letter of credit from foreign importers and to use the local letter of credit as a base for loans for financing domestic purchases. This privilege, which was accorded exclusively to GTCs, was designed to permit them to accumulate the stock of exportable products ahead of actual demand.

The government designated Samsung Trading Company as the first Korean GTC on May 19, 1975, followed by Ssangyong, Daewoo, Kukje, and Hanil during the same year. In 1976, six more companies were designated GTCs: Koryo, Hyosung, Bando, Sunkyung, Samwha, and Kumho. In 1978, Yulsan and Hyundai were added for a total of 13 Korean GTCs.

The Yulsan group, which was once envied for its sales growth from a mere $4.8 million in 1975 to over $187 million in 1978, went bankrupt in early 1979, resulting in the liquidation of Yulsan Trading Company. In 1980, Hanil and Samwha failed to retain GTC status, as their respective exports in 1979 of $237 million and $195 million fell short of the critical $301 million mark, which represented 2 percent of total Korean exports for the year. Kumho failed to reach the 2 percent mark in 1983, thereby losing its GTC status in 1984. The Kukje group, which took a direction totally opposite to that suggested by the government and moved from heavy to light manufacturing, accumulated a high debt and thus went bankrupt in 1985. However, the requisites did not apply to Koryo, which was established and managed by the government for the purpose of fostering export activities of small and medium-sized manufacturers. Therefore, seven Korean GTCs owned by large chaebol groups have remained since the bankruptcy of the Kukje group.

Over the period 1975–1982, the share of GTCs in total commodity exports increased rapidly, from 13 percent in 1975 to 48 percent in 1982. The share of small and medium-sized producer-exporters de-
The rapid decline in the export share of small and medium-sized industries can be attributed to several factors: (1) a relative decline in competitiveness of the industries; (2) the shift from direct export by small and medium-sized industries to indirect export through the GTCs as unfavorable external conditions developed after the oil shocks; and (3) the tendency of actual exports by these industries to be understated in the export statistics as these industries “transferred” (i.e., sold), for a premium, part of their export records to the GTCs, which were sometimes eager to inflate their own export performance to maintain GTC status.

The relative decline in the share of the non-GTC large-scale producers in total commodity exports mainly reflects the growing tendency of large chaebol groups to export their products through their own GTCs and the corresponding decline in the share of exports by large-scale producers with no GTCs of their own. The Japanese GTCs have been active in export and import activities ever since they started operations in Korea.

Korea’s international business activities became concentrated into GTCs’ hands mainly through three routes:

1. As compared with other trading companies, the GTCs are in a relatively advantageous position to facilitate export activities, market information scanning activities, and import business through the extensive network of their branch offices or overseas subsidiaries.

2. The GTCs have made efforts to develop and expand exports of heavy and chemical industrial products supplied from the subsidiaries of their own chaebol groups. The GTCs are not only under pressure from the government to diversify products and markets but are also compelled to explore and expand new export markets for heavy and chemical products that their own chaebol groups began to produce. The size of the newly erected plants and equipment in some heavy and chemical industries has been far larger than warranted by current domestic demand. Expanding overseas markets alone could help to reduce the underutilization of their productive capacity. The GTCs have been particularly active in expanding the exports of shipbuilding, iron and steel, chemical fertilizer, electric machinery, and other chemicals to new export markets in the developing regions.

3. The GTCs have increased their share in total commodity exports by acting as export agents and manufacturers’ representatives for small and medium-sized industrial producers. The GTCs have not only act-
The Japanese Business Group: Zaibatsu

Ed as export agents for small and medium-sized export processing firms, but have also participated in equity investment in some cases, provided management assistance, advanced operational funds, and supplied raw materials to these producers.

Although it is true that the GTCs were created by the government as an expedient approach to its export drive, it cannot be overlooked that the formation and growth of the GTCs have been closely linked with the formation and growth of the country’s unique chaebol groups, which have exerted a pervasive influence over every facet of business activity in the past three decades. Chaebol groups are characterized by (1) their strong propensity to follow the government’s policy lead, (2) their external orientation through export expansion, and (3) their drive toward all-inclusive business diversification through takeovers and mergers (Jo 1991).

Table 7.3 shows the trend of Korean GTCs’ position in the Korean economy. The ratio of total sales by GTCs to nominal GNP increased rapidly, rising from 5.9 percent in 1977 to 21.6 percent in 1986. Thereafter, the ratio decreased to 15.9 percent in 1991. However, the share of GTCs in total exports rose continuously from 24.8 percent in 1977 to 42.2 percent in 1991. Even though the share of GTCs in total imports is relatively small, the share also increased gradually.

During the primary import-substitution period, business firms actively participated in government-initiated industrial development projects by taking full advantage of the strong industrial incentives

<table>
<thead>
<tr>
<th>Table 7.3 Position of GTCs in Korean Economy (US$100 million)</th>
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</thead>
<tbody>
<tr>
<td>A. Sales by GTCs</td>
</tr>
<tr>
<td>B. Nominal GNP</td>
</tr>
<tr>
<td>A/B (%)</td>
</tr>
<tr>
<td>C. Exports by GTCs</td>
</tr>
<tr>
<td>D. Total exports</td>
</tr>
<tr>
<td>C/D (%)</td>
</tr>
<tr>
<td>E. Imports by GTCs</td>
</tr>
<tr>
<td>F. Total imports</td>
</tr>
<tr>
<td>E/F (%)</td>
</tr>
</tbody>
</table>

Sources: Management Efficiency Institute (various years).
and protectionism. In this stage of early industrialization, they gained entrepreneurial and industrial experience and consolidated their base for industrial growth. As government development policy shifted from inward-looking to outward-looking industrial development, incentives were mainly given for export activities. Business firms rapidly followed the government’s lead by expanding labor-intensive, export-oriented industrial activities. In the process of ever-expanding export-oriented growth, certain business firms grew into all-inclusive giant chaebol. From 1973, when the government began to place top priority on the promotion of HCIs, these chaebol groups joined the government in developing HCIs while still maintaining their existing export-oriented industrial activities.

As a result, most of the large chaebol groups now have diverse business lines across all industries. The Samsung group, for instance, has been involved in diverse business lines including foreign trade, textiles and clothing, electronics, shipbuilding, heavy engineering, petrochemicals, food processing, construction, news media, tourism and hotels, insurance, non-banking finance, department stores, and overseas joint ventures. The Hyundai group has numerous subsidiaries in civil engineering, export and import, automobile assembly, construction, cement, shipbuilding, industrial machinery, electric generators, marine engineering, gas, and non-banking finance. The Daewoo group, starting from textile exports, has expanded into leather products, exportable sundry goods of all kinds, insurance, machinery, automobile assembly, construction, shipbuilding, and overseas joint ventures.

Of all policy loans, export credits were the most compelling for the big push. Export loans at real interest rates anywhere between minus 19.7 (1975) and minus 10.6 (1980) were not only giveaways, but were the most plentiful and easiest of all loans to obtain as exporters merely had to produce letters of credit from foreign buyers to turn on the loan spigot. Soon, an institution emerged to absorb a lion’s share of these credits: the GTCs, as these East Asian behemoths came to be known. These were really mercantilist instruments par excellence. The establishment of Korean GTCs in 1975 was decreed when the Japanese sogoshosha, in the thick of growing U.S. protectionism, avoided handling Korean exports. It proved a terribly expensive retaliation: the financial system hemorrhaged limitless credit into GTCs, which often exported at a loss but survived on credit subsidies (Woo 1991).

The chaebol, forbidden to own banks (unlike their Japanese counterparts), in turn relied on GTC export credits to finance their sprawling industrial empires. In that sense, the chaebol looks like a concentric cir-
cle emanating from a GTC at its core, with the energy coming from the government’s extraordinary policy loans. By 1979, half of the nation’s total exports were handled by the GTCs. GTCs have spearheaded diversification of exports and are credited with having promoted heavy industrial product sales such as industrial plant machinery. The proportion of heavy and chemical goods exports accomplished by GTCs rose to 68.4 percent in 1984, up from 22.6 percent in 1976. Therefore, Korean GTCs have been particularly instrumental in increasing the share of HCI exports.

The government was munificent; but it was also a harsh disciplinarian, supplying the cold bath that the market could not. Export credits were wonderful gifts to the chaebol, but to get them, one had to be deserving; otherwise, licenses were immediately revoked. Every year the government slapped stringent performance criteria on the GTCs with respect to capital, total export volume, and the minimum number of export items, destinations, and overseas branches required. GTCs meeting these requirements were allowed the dollar amount of the letters of credit (L/C) at favorable exchange and interest rates. In 1976, for instance, the GTCs might be allowed 420 won to a dollar instead of the official rate of 480 won, and at an 8 percent interest rate instead of the 17 percent for general bank loans. Some GTCs with exceptional export records were even exempted from showing L/C to receive credit and could borrow up to 1.5 months’ worth of their past export records.

The unique feature of Korea’s GTCs can be thus characterized by the following: (1) the GTCs as a group or system are receptive instruments of the government’s export-oriented policy; (2) they are almost exclusively externally oriented to the point of neglecting domestic trading activities; and (3) they act as “windows” for their own chaebol groups by exporting the diverse products produced by their own subsidiaries in many industries. In this connection, it is instructive to compare the main differences in orientation and function between the Korean and the Japanese GTCs.

First, because Korean GTCs because initiated and subsidized with various incentives by the Korean government, they have been closely controlled by the government and dependent upon it in such areas as financing and risk taking. Second, only a handful of chaebol, with their captive supply of manufactured goods for export, were eligible to establish Korean GTCs. As a result, each Korean GTC is affiliated with a chaebol, thus playing the role of an export service center for a group of companies. Third, the government initially intended the Korean GTCs operations to be geared toward export activities without concurrent
import activities, most of which are monopolized either by the government or by public enterprises.

Besides these differences, Korean GTCs have not yet developed other capabilities that their Japanese counterparts have, such as financing, information gathering, resource development, organizing, and so on. In contrast to the three structural differences mentioned above, however, the lack of these capabilities is mostly due to the inexperience of Korean GTCs. Indeed, the government encourages them to carry out these little-experienced activities. Recently a number of Korean GTCs have begun to explore such opportunities as resource development on a limited scale. Certainly with more experience, Korean GTCs are expected to play significant roles in these areas (Cho and Heo 1989).

Theoretically, trading companies can, as commissioned merchants, act as intermediaries in export trade transactions even if they have no equity interests in the concerned manufacturing activities. Alternatively, GTCs themselves can take the initiative of setting up their own manufacturing ventures to create and exclusively capture business opportunities. Korean GTCs have adopted the latter strategy in order to maximize economies of scope; Japanese GTCs have persisted in the former strategy. This has resulted in the establishment of manufacturing firms by GTCs or in mergers and takeovers of export producers, thus increasing the concentration of economic and market power in large chaebol groups.

There is no doubt that the formation and growth of GTCs in Korea have contributed to the expansion of Korea's industrial exports and the growth of chaebol groups. This argument is demonstrated in Table 7.4, which shows the sales of seven Korean GTCs owned by large chaebol groups as a share of their groups' total sales. Most GTCs have increased their share. Among the seven GTCs, the GTCs of Daewoo, Hyundai, and Samsung have a relatively large share. The ratio of all seven GTCs' sales to the total seven large groups' sales increased rapidly from 22.4 percent in 1982 to 31.5 percent in 1986; thereafter, it decreased slightly to 30.6 percent in 1990.

Although quantitative expansion has been attained, there remains room for quality improvement and product and regional diversification of exports. The government's encouragement of scale expansion of the GTCs has resulted in mergers and takeovers of export producers and excessive competition among GTCs, as well as between the GTCs and export producers. This phenomenon has resulted in excessive concentration of economic and market power of large chaebol groups, leading to sociopolitical tension. Too much emphasis has
Table 7.4 Share of GTCs’ Sales in Their Group

<table>
<thead>
<tr>
<th></th>
<th>1982</th>
<th>1986</th>
<th>1990</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sales (won 100 m)</td>
<td>Share (%)</td>
<td>Sales (won 100 m)</td>
</tr>
<tr>
<td>Samsung</td>
<td>16,842</td>
<td>30.7</td>
<td>42,754</td>
</tr>
<tr>
<td>Hyundai</td>
<td>10,574</td>
<td>15.4</td>
<td>38,759</td>
</tr>
<tr>
<td>Lucky-Goldstar</td>
<td>5,634</td>
<td>10.3</td>
<td>19,490</td>
</tr>
<tr>
<td>Daewoo</td>
<td>14,440</td>
<td>31.0</td>
<td>31,848</td>
</tr>
<tr>
<td>Sunkyung</td>
<td>11,999</td>
<td>24.9</td>
<td>17,230</td>
</tr>
<tr>
<td>Ssangyong</td>
<td>5,598</td>
<td>22.1</td>
<td>9,444</td>
</tr>
<tr>
<td>Hyosung</td>
<td>5,090</td>
<td>33.6</td>
<td>7,697</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>70,177</td>
<td>22.4</td>
<td>167,222</td>
</tr>
</tbody>
</table>

Note: a. Share (%) = sales by GTC/total sales by the group. Sources: Management Efficiency Institute (various years).

been placed on efficiency through scale economies by a small number of large chaebol groups in export and production and consequently too little attention being paid to economic equity and social justice.

If a small number of large chaebol groups are increasingly predominant in almost all industries and are competing with a large number of small-scale producers in many areas, the GTC of a particular chaebol group will become merely the “super” export department (or the export window) of all the subsidiaries of that particular group. The GTCs would tend, therefore, to compete with, rather than to complement, the small and medium-sized export producers. In other words, the GTCs cannot become neutral and honest brokers of exports for other producers and therefore cannot line up small and medium-sized industries under them for well-coordinated export promotion because of conflicts of interest, fear of takeovers and mergers, and a general feeling of mutual distrust. In short, the extreme concentration of manufacturing and economic power that currently exists in Korea—which is centered in the very companies that have been designated as GTCs—precludes the sound development of GTCs as impartial specialized exporters along the lines of the Japanese GTCs (Jo 1991).
Notes

1. The basic idea is that firms do not operate on their production possibilities frontier. In part, the internal motivational state of the firm determines the degree to which actual output is less than possible or optimal output. Thus, costs per unit of output are not minimized. The size of the difference between actual costs and true minimum costs offers opportunities for those entrepreneurs who think they can produce at lower costs.

2. In terms of decision-theory conceptualization of entrepreneurship, the reduced uncertainty caused by the group pattern of industrial organization leads to a shift of the action set toward the origin and a rise in the probability that a given profitable investment will be implemented.

3. A high degree of reliance was placed on practical experience rather than on theory, and paternalistic leadership was highly respected.

4. As of 1981, there were 221 types of policy loans out of a total of 298 types of bank loans.

5. Throughout the 1970s, loans from banks, non-bank financial institutions, foreign sources, and others accounted for between 42 and 58 percent of the total financing requirements (internal and external) of Korean corporations. The debt-equity ratio of Korean manufacturing firms gradually increased from 313 percent in 1972 to 377 percent in 1979, and then jumped to over 450 percent during the severe recession of 1980-1981.

6. Bank loans provided to the 30 largest chaebol (comprising 676 firms) amounted to 19,704 billion won or 26.9 percent of the total in 1988. Compare this figure with their share of manufacturing sales (40.2 percent), manufacturing exports (41.3 percent), and manufacturing employment (17.6 percent) in 1985. These statistics are based on Dong-A Ilbo, September 3, 1988.

7. The average amount of exports per firm increased from US$10.2 million in 1970 to US$27.6 million in 1975.

8. HCI exports arranged by GTCs increased from 39.8 percent of total HCI exports in 1979 to 57.6 percent in 1981. The growth rate of HCI exports arranged through the GTCs for this three-year period was 126.9 percent, far surpassing the 56.9 percent growth rate of Korea's total exports for the same period.

9. The Federation of Korean Industrialists had pleaded for the establishment of GTCs since 1968. Establishment was refused on the ground that GTCs would gobble up export credits, but when Daewoo and Samsung proved that their products had been boycotted by Japanese sogoshosha in the early 1970s, the Korean government allowed the establishment of GTCs.

10. Japanese GTCs are not engaged in manufacturing activities themselves but specialize in a variety of trading activities, including domestic commerce, export and import activities, and facilitating trade among Third World countries.
PART III

EVALUATION OF THE CURRENT STATE OF THE KOREAN ECONOMY
In analyzing the current position of the chaebol, we will not consider whether chaebol enjoy a sufficient degree of freedom in their market conduct. In cases where the government heavily regulates economic agents, the real issue is not the concentration of economic power but the concentration of wealth. Yet what is important in the discussion of economic power is not the actually exercised power but the potential capacity to exercise it. Next, we also have to choose the method by which we will measure economic power. We may use either a stock measure such as capital, asset, production capacity, and employment or a flow measure such as production, shipment, value added, or profits. Because each of these measures has different properties, close attention must be paid to them when analyzing statistics.

To regulate the concentration of economic power once a year, the Fair Trade Committee of Korea has defined a large business group. In the Fair Trade Act, a “large business group” is defined as one with over 400 billion won in total assets. The number of designated large business groups increased more than doubled, from 32 in 1987, the first designated year, to 78 in 1992. Furthermore, the number of subsidiaries of the large business groups also increased greatly, from 509 in 1987 to 1,056 in 1992.

The chaebol dominate the Korean domestic economy and have gained increasing international recognition as well. In 1983, the 50 largest chaebol had sales equivalent to nearly 94 percent of GNP. Among the 50 largest companies in Korea in 1986, 30 were owned by the 10 largest chaebol. That same year, these 10 largest chaebol had total sales of over $65 billion, or more than 65 percent of Korea’s GNP in 1986. Estimates for 1989 place the total sales of the four largest chaebol at US$105 billion, which is equivalent to one-half of Korea’s GNP in that year. Internationally, the 1988 Fortune 500 listing of non-U.S. industrial corporations includes eight Korean chaebol (see table 8.1).
Table 8.1 Chaebol Subsidiaries Listed in Fortune500 (non-U.S. corporations)

<table>
<thead>
<tr>
<th>Rank</th>
<th>Chaebol</th>
<th>Revenue (US$ m)</th>
<th>Net income (US$ m)</th>
<th>Employees (no.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>40</td>
<td>Samsung</td>
<td>21,148</td>
<td>250</td>
<td>160,600</td>
</tr>
<tr>
<td>68</td>
<td>Lucky-Goldstar</td>
<td>14,487</td>
<td>181</td>
<td>88,400</td>
</tr>
<tr>
<td>75</td>
<td>Daewoo</td>
<td>13,498</td>
<td>37</td>
<td>94,900</td>
</tr>
<tr>
<td>186</td>
<td>Sunkyung</td>
<td>6,812</td>
<td>91</td>
<td>19,800</td>
</tr>
<tr>
<td>206</td>
<td>Hyundai Corp.</td>
<td>6,387</td>
<td>4</td>
<td>900</td>
</tr>
<tr>
<td>320</td>
<td>Ssangyong</td>
<td>4,603</td>
<td>75</td>
<td>16,000</td>
</tr>
<tr>
<td>382</td>
<td>Hyundai Motor</td>
<td>3,972</td>
<td>113</td>
<td>29,800</td>
</tr>
<tr>
<td>434</td>
<td>Korea Explosive</td>
<td>3,526</td>
<td>NA</td>
<td>17,800</td>
</tr>
<tr>
<td>463</td>
<td>Hyosung</td>
<td>3,272</td>
<td>59</td>
<td>24,000</td>
</tr>
</tbody>
</table>


The huge size of these chaebol groups relative to the Korean economy has led to a high degree of concentration at all levels. In addition to dominating the whole economy, chaebol affiliates not surprisingly dominate most of the specific industries in which they participate as well. Moreover, the chaebol, both as a group and as individual firms, are also highly concentrated. Table 8.2 indicates that the leading five groups have been consistently more than twice as large as the next five groups when measured in terms of combined group sales for the years 1974 to 1984. Likewise, each individual group is dominated by three or four major affiliates. The four largest companies typically contribute more than 70 percent of the whole group's aggregate sales. In the case of Hyundai, for example, four companies accounted for 71.5 percent of the group's total sales in 1983, with the other 31 affiliates made up the remaining 28.5 percent.

The table also shows the extent to which concentration has been increasing over time. Every two-year period marks a shift of a significantly greater portion of economic clout (measured in aggregate sales) both horizontally to the right across the table and vertically up the table. This increasing concentration has not gone unnoticed by either the government or society at large, but it has continued despite government efforts to curb its progress (Fields 1991).

In the rapidly diversifying Korean economy, chaebol groups cannot expand sufficiently if they rely only upon internal growth. Additionally, they must not only acquire existing firms, but must also establish new ones. The 30 largest chaebol each owned 4.2 subsidiaries
Table 8.2 Combined Sales of the 10 Largest Chaebol (as percentage of GNP)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>4.9</td>
<td>4.7</td>
<td>6.9</td>
<td>8.3</td>
<td>10.4</td>
<td>12.0</td>
</tr>
<tr>
<td>2</td>
<td>7.2</td>
<td>8.1</td>
<td>12.9</td>
<td>16.3</td>
<td>19.0</td>
<td>24.0</td>
</tr>
<tr>
<td>3</td>
<td>10.0</td>
<td>11.3</td>
<td>16.9</td>
<td>23.9</td>
<td>24.6</td>
<td>35.8</td>
</tr>
<tr>
<td>4</td>
<td>10.3</td>
<td>12.9</td>
<td>20.7</td>
<td>30.1</td>
<td>35.6</td>
<td>44.3</td>
</tr>
<tr>
<td>5</td>
<td>11.6</td>
<td>14.5</td>
<td>22.9</td>
<td>35.0</td>
<td>42.2</td>
<td>52.4</td>
</tr>
<tr>
<td>6</td>
<td>12.7</td>
<td>16.1</td>
<td>24.7</td>
<td>38.2</td>
<td>46.0</td>
<td>56.2</td>
</tr>
<tr>
<td>7</td>
<td>13.5</td>
<td>17.5</td>
<td>26.4</td>
<td>41.0</td>
<td>49.2</td>
<td>59.4</td>
</tr>
<tr>
<td>8</td>
<td>14.3</td>
<td>18.4</td>
<td>27.7</td>
<td>43.6</td>
<td>52.2</td>
<td>62.1</td>
</tr>
<tr>
<td>9</td>
<td>14.7</td>
<td>19.3</td>
<td>28.9</td>
<td>46.0</td>
<td>55.1</td>
<td>64.8</td>
</tr>
<tr>
<td>10</td>
<td>15.1</td>
<td>19.8</td>
<td>30.1</td>
<td>48.1</td>
<td>57.6</td>
<td>67.4</td>
</tr>
</tbody>
</table>


on the average in 1970, but this number jumped to 14.3 in 1979 as a result of the rapid growth of the Korean economy. It is noteworthy that the number of new establishments was far greater than the number of acquisitions during this period. Generally speaking, it is more advantageous for a chaebol to establish a new firm than to acquire an existing one when it wants to enter a new market, because of its better technology, management, manpower, and financial resources. Additionally, since new markets emerge as the economy develops, new firms should be established to enter them. During the 1970s, the total number of manufacturing firms increased 1.3 times, whereas the number of subsidiaries of chaebol increased 3.4 times. The seed of the so-called chaebol issue can be found in this unbalanced growth of chaebol groups.

Because of the recession at the end of the 1970s and the consequent rationalization of chaebol, however, the number of their divestures surpassed the number of their new entries in early 1980s, and chaebol owned an average of 13.4 subsidiaries in 1982. In other words, the 1970s saw the expansion of chaebol, the 1980s, their maturity. The industrial composition of 402 subsidiaries of the 30 largest chaebol in terms of two-digit industrial classification is manufacturing, 222; trade, 18; construction, 30; service, 33; real estate and finance, 29; transportation and warehousing, 34; restaurants and hotels, 11; wholesale and retail, 15; and others, 9. However, in the mid-1980s, chaebol groups took over a number of failing firms and public enterprises, on the one hand, and began to establish new firms for industrial restructuring, on
the other. Consequently, the average number of subsidiaries for the 30 largest chaebol groups increased again to 17.1 in 1989.

The Manufacturing Sector

Bearing in mind the difficulties in measuring economic power, we have selected the 30 largest chaebol groups in terms of manufacturing shipments in 1989 for analysis. Economic power analyzed at the firm level may underestimate the extent of market power exercised in the Korean economy because a substantial number of large firms are controlled by a small number of chaebol. (The relative size of chaebol groups in the Korean manufacturing sector is shown in table 8.3.)

<table>
<thead>
<tr>
<th>Chaebol group</th>
<th>Shipment</th>
<th></th>
<th></th>
<th></th>
<th>Employment</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 5</td>
<td>15.7</td>
<td>22.6</td>
<td>22.0</td>
<td>21.3</td>
<td>9.1</td>
<td>8.4</td>
<td>9.9</td>
<td>9.9</td>
</tr>
<tr>
<td>Top 10</td>
<td>21.2</td>
<td>30.2</td>
<td>28.2</td>
<td>27.0</td>
<td>12.5</td>
<td>12.2</td>
<td>11.9</td>
<td>11.8</td>
</tr>
<tr>
<td>Top 30</td>
<td>34.1</td>
<td>40.7</td>
<td>37.3</td>
<td>35.2</td>
<td>20.5</td>
<td>18.6</td>
<td>17.6</td>
<td>16.6</td>
</tr>
</tbody>
</table>


Moreover, chaebol group firms grew substantially faster than firms in the non-chaebol group as shown by a rapid increase in their shipments share and their tightening grip on total manufacturing. Thus the size of chaebol groups is very large compared to firms in other developing countries; this is attested to, for example, by the fact that 10 chaebol groups are listed among 27 developing country firms in the Fortune 500 list of the largest non-U.S. industrial companies. However, the size of individual firms in the Korean manufacturing sector is still substantially smaller than those in the developed countries.³

In the manufacturing sector the share of the 30 largest groups reached 35.2 percent in 1989 in terms of the value of shipment and 16.6 percent in terms of employment. The striking difference between their shares of shipments and employment may be caused by their capital-intensive method of production and their market power to manipulate commodity prices to some extent. Their share of total
The Current Position in the Korean Economy

Shipments increased until 1982 and tended to decrease thereafter, while that of total employment has gradually decreased. The reason for these trends is that the chaebol groups entered growing industries such as chemical and machinery since 1977. As these industries grew rapidly, the size of chaebol groups expanded greatly. Thereafter, because of the declining price of petroleum products and a decline in the shipbuilding industry, the main-force industries of chaebol groups shrank to some degree; on the other hand, the appearance and growth of independent firms were remarkable.

We also notice that the share of total shipments of the top five chaebol groups—Hyundai, Samsung, Daewoo, Lucky-Goldstar, and Sunkyung—rose substantially from 15.7 percent in 1977 to 22.6 percent in 1982, but then declined slightly to 21.3 percent in 1989, whereas that of the remaining groups has gradually deceased. In other words, increasing economic power of the 30 largest chaebol groups was taken up mainly by the top 5 chaebol groups, which consolidated their positions in spite of the shrinking economic power of the remaining chaebol groups. This fact shows that the gap between high-ranking groups and low-ranking groups even among chaebol groups has definitely widened; that is, a dual structure among chaebol groups has developed.

The Industry

The share of shipments and the distribution of the subsidiaries of the 30 largest chaebol groups by two-digit industrial classification codes in 1987 is shown in table 8.4. The share of the shipments by industry clearly indicates the cause and phenomenon of the dual structure among chaebol groups. The 30 largest chaebol groups occupied overwhelming positions in two groups of industries—49.0 percent in the chemicals and petroleum, coal, rubber, and plastic products industries, and 49.2 percent in fabricated metal products, machinery, and equipment industries. These industries have not only made up the largest share in the Korean manufacturing sector, but have also grown most rapidly during the 1970s. The top five chaebol groups actively participated in these industries, consolidated their positions, and thus built up their foundations of economic power. This is particularly the case in the fabricated metal products, machinery, and equipment industries, where the share of shipments of the top five chaebol groups is 40.9 percent as compared with 49.2 percent for the 30 largest chaebol groups, implying therefore, that the remaining groups have only an 8.3 percent share. This fact shows straightforwardly the position of the top five chaebol groups in the Korean economy.
Table 8.4 Share of Shipment and Number of Subsidiaries by Industry, 1987

<table>
<thead>
<tr>
<th>Chaebol</th>
<th>Food and beverage, and tobacco</th>
<th>Textile, wearing apparel, and leather</th>
<th>Wood and wood products</th>
<th>Paper and paper products, printing and publishing</th>
<th>Chemicals and petroleum, coal, rubber, and plastic products</th>
<th>Non-metallic mineral products</th>
<th>Basic metal</th>
<th>Fabricated metal products, machinery, and equipment</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage / Number</td>
<td>4.9 (2)</td>
<td>6.3 (10)</td>
<td>2.8 (2)</td>
<td>5.6 (4)</td>
<td>27.4 (12)</td>
<td>6.3 (4)</td>
<td>9.9 (5)</td>
<td>40.9 (57)</td>
<td>1.4 (1)</td>
</tr>
<tr>
<td>Top 10</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage / Number</td>
<td>6.0 (3)</td>
<td>10.2 (18)</td>
<td>6.0 (3)</td>
<td>13.3 (6)</td>
<td>37.0 (21)</td>
<td>19.5 (6)</td>
<td>22.0 (15)</td>
<td>46.4 (74)</td>
<td>1.4 (1)</td>
</tr>
<tr>
<td>Top 30</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage / Number</td>
<td>26.2 (32)</td>
<td>20.4 (39)</td>
<td>6.2 (4)</td>
<td>17.2 (14)</td>
<td>49.0 (55)</td>
<td>28.9 (14)</td>
<td>39.2 (23)</td>
<td>49.2 (99)</td>
<td>1.5 (2)</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage / Number</td>
<td>7.3 (11)</td>
<td>8.9 (12)</td>
<td>0.2 (4)</td>
<td>1.2 (8)</td>
<td>26.2 (20)</td>
<td>2.9 (10)</td>
<td>9.1 (9)</td>
<td>43.7 (23)</td>
<td>0.0 (2)</td>
</tr>
</tbody>
</table>

Note: a. The total shows the proportion of each industry in total shipments of the 30 largest chaebol groups. The number in parentheses indicates the number of chaebol subsidiaries in the industry.

These characteristics can be observed from another viewpoint. Among the 30 largest chaebol groups, 20 groups participated in the chemicals and petroleum, coal, rubber, and plastic products industries and 23 groups in the fabricated metal products, machinery, and equipment industries. Furthermore, the fact that the proportions of these industries in the total shipments of the 30 largest chaebol groups are 26.5 percent and 43.7 percent, respectively, shows the importance of these industries in the concentration of economic power. In particular, only 12 chaebol groups participated in the textiles, wearing apparel, and leather industries, which were the main industries in Korea in the past, and the share of the industry in total shipments of the 30 largest chaebol groups is 8.9 percent. This fact indirectly demonstrates that the growth of large chaebol groups centered on heavy and chemical industries.

It is apparent that most of the subsidiaries are in heavy and chemical industries, textiles and apparel, and food and beverages. The top five chaebol groups have a high number of subsidiaries concentrated in fabricated metal products, machinery, and transportation equipment, while the 30 largest chaebol groups as a whole show a relatively even distribution of subsidiaries throughout other industries as well.

The Commodity Market

A fundamental source of the economic power of large chaebol groups is their share and position in individual commodity markets. In 1987, the 30 largest chaebol groups competed in selling 1,499 commodities in 837 different markets. Their market positions are summarized in table 8.5. In 103 markets, a single chaebol group had a monopolistic share of more than 80 percent and, in 232 markets, a dominant share of 40-80 percent. Although not every high-ranking chaebol has a large number of commodities, and a high position in the commodity market, the chaebol generally produce many commodities having large market shares. For example, the 30 largest chaebol groups have 335 markets with a market share of more than 40 percent, and 162 commodities, or almost one-half, were produced by the top five chaebol groups.

If we consider only the ranking in terms of market share, the number of markets in which a single chaebol ranked first was 475, or 31.7 percent of the total number of markets where they participated, whereas the number of markets in which a single chaebol ranked third or higher is 941, or 62.3 percent. Such a predominant market position is most visible for the top 5 chaebol groups, but is common for the oth-
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Table 8.5 Market Share and Position, 1987

<table>
<thead>
<tr>
<th>Chaebol group</th>
<th>Market Share (%)</th>
<th>Ranking of Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0-20</td>
<td>20-40</td>
</tr>
<tr>
<td>Top 5</td>
<td>345</td>
<td>141</td>
</tr>
<tr>
<td>Top 10</td>
<td>494</td>
<td>186</td>
</tr>
<tr>
<td>Top 30</td>
<td>873</td>
<td>291</td>
</tr>
</tbody>
</table>


ers as well. Even though the number of markets in which a single chaebol group was not ranked third or higher is 558, the share of these commodities in terms of total shipments of the 30 largest chaebol groups was only 10.8 percent. The share of shipments of first-ranked commodities (55.5 percent) exceeded considerably the share of the number of commodities (31.7 percent). This can be explained by the fact that chaebol groups emphasized the market share rather than the number of markets. Taking these facts into account, we know that chaebol groups not only have economic power in the total manufacturing sector, but a high market share in the individual commodity markets.

The Fair Trade Committee has also designated a market-dominating commodity in order to regulate the abuse of a market-dominating position. The standard criterion of the designation is the commodity that has a market scale of over 30 billion and where the market share of the largest firm is over 50 percent or the market share of the three largest firms is over 70 percent. According to this criterion, the number of market-dominating commodities increased rapidly from 71 in

Table 8.6 Market-Dominating Commodities

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of commodities</td>
<td>71</td>
<td>122</td>
<td>136</td>
</tr>
<tr>
<td>No. of 30 largest chaebol</td>
<td>45</td>
<td>84</td>
<td>102</td>
</tr>
<tr>
<td>No. of 30 largest chaebol as a share of the total</td>
<td>63.4</td>
<td>68.9</td>
<td>75.0</td>
</tr>
</tbody>
</table>

1984 to 136 in 1991 (see table 8.6). Furthermore, the ratio of the 30 largest chaebol groups in total market-dominating commodities also increased, from 63.4 percent in 1984 to 75.0 percent in 1991. The absolute amount and gradual increase of the ratio of the 30 largest chaebol groups in total market-dominating commodities directly shows the market position of the chaebol groups.

The Non-Manufacturing Sector

Chaebol also figure prominently in a number of non-manufacturing sectors. The shares of the 30 largest chaebol groups in the non-manufacturing sector in 1987 are summarized in table 8.7. The 30 largest chaebol accounted for 54.1 percent of the audited corporations' total sales in construction, 88.6 percent of total sales in transport and storage, 82.5 percent of total sales in commerce and trade, and 76.1 percent of total sales in real estate and service. In foreign trade, almost half of Korea's exports are handled by seven general trading companies, all of which are member firms of the top 10 chaebol. Since the early 1980s, when the Korean government began to privatize the major national banks, the chaebol groups have come to assume an increasingly dominant role in finance. Although government regulations restrict single shareholders to 8 percent of total ownership, the top 10 chaebol groups are reported to now collectively control from 22 percent to 57 percent of the ownership of Korea's five nationwide commercial banks.

<table>
<thead>
<tr>
<th>Industry</th>
<th>Sales</th>
<th>Assets</th>
<th>Debt</th>
<th>Loan</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture and fisheries</td>
<td>0.08</td>
<td>0.91</td>
<td>0.54</td>
<td>0.09</td>
<td>2.2</td>
</tr>
<tr>
<td>Mining</td>
<td>7.8</td>
<td>9.2</td>
<td>9.5</td>
<td>12.8</td>
<td>8.5</td>
</tr>
<tr>
<td>Electricity and gas</td>
<td>2.0</td>
<td>27.3</td>
<td>24.9</td>
<td>25.7</td>
<td>39.2</td>
</tr>
<tr>
<td>Construction</td>
<td>54.1</td>
<td>59.5</td>
<td>58.8</td>
<td>59.6</td>
<td>64.5</td>
</tr>
<tr>
<td>Commerce and trade</td>
<td>82.5</td>
<td>67.9</td>
<td>67.8</td>
<td>71.6</td>
<td>68.6</td>
</tr>
<tr>
<td>Transport and storage</td>
<td>88.6</td>
<td>72.5</td>
<td>70.5</td>
<td>63.7</td>
<td>NA</td>
</tr>
<tr>
<td>Real estate and service</td>
<td>76.1</td>
<td>30.4</td>
<td>32.7</td>
<td>36.8</td>
<td>23.7</td>
</tr>
<tr>
<td>Recreation and culture</td>
<td>85.0</td>
<td>6.4</td>
<td>9.0</td>
<td>10.3</td>
<td>NA</td>
</tr>
</tbody>
</table>

The Financial Industry

Almost all chaebol have their roots in the manufacturing sector, but many have recently expanded their activities into the financial industry as well, including banking, insurance, and stock brokerage services. It may be said, therefore, that industrial capital is, at least partially, being coupled with financial capital. Nevertheless, chaebol are in two ways unlike the prewar Japanese zaibatsu or German konzern of the past, which centered on banks. First, Korea's previously nationalized commercial banks were privatized only in 1981, and second, no single legally acknowledged "identical person" was allowed to own more than 8 percent of any bank's total stock. In other words, chaebol could only become oligopolistic shareholders of commercial banks. By contrast, there is no legal ceiling to the ownership of local banks, and each is practically controlled by a single chaebol group.

Table 8.8 Financial Institutions Owned by Chaebol, 1989

<table>
<thead>
<tr>
<th>Chaebol group</th>
<th>No. of subsidiaries</th>
<th>Financial institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 5</td>
<td>187</td>
<td>Banking: 7  Insurance: 6  Stock brokerage: 9  Subtotal: 22</td>
</tr>
<tr>
<td>Top 10</td>
<td>294</td>
<td>Banking: 10  Insurance: 8  Stock brokerage: 13  Subtotal: 31</td>
</tr>
<tr>
<td>Top 30</td>
<td>524</td>
<td>Banking: 21  Insurance: 10  Stock brokerage: 16  Subtotal: 47</td>
</tr>
</tbody>
</table>

Note: a. The top chaebol groups in this sector are not the same as those in the manufacturing sector, but are related to special control of loans to large corporations.


Even though chaebol group's participation in the banking industry was limited considerably by regulation, a number of chaebol groups have many stock brokerage companies, insurance companies, and short-term financing companies as subsidiaries. The participation in non-banking financial industries by chaebol plays the role of a fund's window for the chaebol groups as well as a form of business diversification. The financial institutions owned by chaebol groups in 1989 are summarized in table 8.8. Currently, 16 out of 27 stock brokerage companies are owned by individual chaebol groups, and by and large, the same is also true of life insurance companies. In all, the 30 largest chaebol groups own a total of 47 financial institutions. The top 5 chaebol groups, in particular, have 22 financial institutions distributed evenly in banking, insurance, and stock brokerage companies.
Table 8.9 shows data on the bank credits and loans by chaebol groups as a share of total bank credits and loans in Korea. The chaebol groups not only participated extensively in the financial industry, but occupied a considerable share of bank credits and loans. Although the share of credits and loans of the 30 largest chaebol groups decreased gradually as a result of strengthening of the credit and loan-control system, the share is still high when the following are taken into account: non-banking financial institutions and direct financing of chaebol groups, easiness of intersubsidiarial money accommodation, and loans excluded by special control loans to large corporation.

**Table 8.9 Share of Bank Credit and Loan by Chaebol**

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Share of bank credit</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top 5</td>
<td>NA</td>
<td>11.1</td>
<td>8.4</td>
<td>7.6</td>
</tr>
<tr>
<td>Top 30</td>
<td>23.3</td>
<td>19.7</td>
<td>18.3</td>
<td>16.8</td>
</tr>
<tr>
<td>Share of bank loan</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top 30</td>
<td>21.6</td>
<td>18.3</td>
<td>14.7</td>
<td>13.5</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance unpublished sources.

Reciprocal certificates of payment among subsidiaries are permitted under the present credit and loan-control system; thus, there is a difference between subsidiaries of chaebol and non-subsidiary firms in terms of opportunity. Furthermore, the industrial rationalization loans related with arrangement of insolvent enterprises are excluded from the objects of credit and loan control. We know that the real share of chaebol group's credit and loan is much higher than the statistics shown in table 8.9. Insurance and short-term financing companies also provided funds to the subsidiaries of the related chaebol groups. In short, the chaebol's share of credits and loans in non-banking financial institutions is much higher than that of banking institutions.

New loans that the 30 largest chaebol groups borrowed from the short-term financing, general financing, and insurance companies in 1989 jumped by 870 percent when compared to the previous year. This amount corresponded to 78 percent of the total new loans of the three types of financial institutions. Currently, no regulations limit chaebol's credit and loan in non-banking financial institutions. Therefore, the total loans of the 30 largest chaebol groups as a share of
total loans of non-banking financial institutions increased rapidly, from 32.4 percent at the end of 1988 to 39.0 percent at the end of 1989. Furthermore, the preponderance of credits and loans looks even more serious if loans by reciprocal trust companies are included.

**Wealth**

Another by-product of the government policy toward large chaebol groups has been the gradual concentration of land ownership. In the 1950s and early 1960s when land was redistributed to farmers under the Land Reform Act of 1949, Korea was an egalitarian society with an even distribution of land and property. However, over the three decades since then, as national wealth grew, land ownership shifted gradually into the hands of a select few. Approximately 65.2 percent of all private land is now owned by individuals in the top 5 percent income bracket. A series of intensive speculative activities have caused the price of land to increase by 840 percent over the period between 1975 and 1988 as compared with the 290 percent increase in the wholesale price index during the same period. Recently in Korea, the concentration of wealth by chaebol groups has been introduced as an important social issue. Special focus is given to the speculation in real estate by chaebol groups. Excessive investment in real estate by an enterprise raises many issues on the national economic side—for example, hampering sound management and weakening the economy's international competitiveness. In particular, the excessive investment of real estate by chaebol groups not only operated as a source of concentration of economic power by chaebol groups, but also became a target

<table>
<thead>
<tr>
<th>1986</th>
<th>1987</th>
<th>1988</th>
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<tbody>
<tr>
<td><strong>Total</strong></td>
<td><strong>Value (billions won)</strong></td>
<td><strong>Size (10,000 sq m)</strong></td>
</tr>
<tr>
<td></td>
<td>Land</td>
<td>Building</td>
</tr>
<tr>
<td>Total</td>
<td>6,348</td>
<td>36,552</td>
</tr>
<tr>
<td>Business-related</td>
<td>86</td>
<td>569</td>
</tr>
<tr>
<td>Unrelated</td>
<td>(-31.4)</td>
<td>(-15.8)</td>
</tr>
</tbody>
</table>

Note: a. Number in parentheses the growth rate compared with the previous year.
of social critics of big business from the point of business ethics. Concretely, in the past high-inflation period, real estate investments of large enterprises by bank loans at a low interest rate have enhanced the value of security of the real estate, and thus operated as an important determinant of chaebol's concentration of economic power.

Until recently, investment in real estate, and especially land, was more profitable than any business, and this tendency will continue for a while. This prospect has instigated many enterprises to invest in real estate. However, considering the present domestic situation and the housing shortage, real estate investment by enterprises has become the object of a national philippic. Thus, real estate investments by chaebol groups, which are the symbol of wealth, are considered negatively regardless of their economic logic. With this in mind and because chaebol groups have grown as a result of government support, employees' endeavors, and consumers' sacrifices, it is a necessary social responsibility of the chaebol that they have a corresponding ethics.

The investment in real estate by chaebol groups is still enormous despite various regulation measures. According to statistics from the banking supervisory office, on the basis of approval by the main correspondent bank, the proportion of real estate investments to total investments by the 50 largest chaebol groups was 53.1 percent in 1987 and 46.7 percent in the first half of 1989. Table 8.10 shows the possession of real estate by the 30 largest chaebol groups. The possession of real estate by the 30 largest groups increased 22.0 percent in 1987 as compared with previous year and 28.5 percent in 1988, reaching a book value of 10 thousand billion won. Furthermore, when taking into consideration that there is a big difference between the book value and the real value of real estate, the value of real estate possessed by the 30 largest chaebol groups is considerable.

The proportion of business-unrelated real estate to total real estate by the 30 largest chaebol groups is only 0.5 percent in terms of value, 1.2 percent for land and 0.1 percent for buildings in terms of size. The reason for this low share is not an increase in the proportion of business-related real estate, but rather the vagueness with which business-unrelated real estate is defined. In the recent period, when industrial activities were marred by violent labor unrest, income from land speculation had become a more lucrative channel for making money than normal business activity, so much so that as of 1987 the ratio of capital gains from land transaction to GNP was 35.7 percent. The Korean government is currently preparing several measures to put an end to the land speculation.
Besides the investment in real estate, the value of securities possessed by the 30 largest chaebol groups has increased rapidly with the boom of the stock market since 1980. The value of securities possessed by the 30 largest chaebol groups increased 26.5 percent, from 4,334 billion won of the end of 1987 to 5,482 billion won at the end of 1988; operational profits increased 98 percent, to amount to 703 billion won. While this kind of investment may have a positive effect in terms of profits, considering the increasing social criticism of the concentration of chaebol's economic clout, the excessive investment in securities with business funds is not a desirable phenomenon.

Ownership

Another characteristic of chaebol groups is the concentration of ownership. Although there are a number of ways for an individual to control a chaebol, a general method of control is intercompany shareholding. In an attempt to restrict intercompany shareholding, therefore, the amended Fair Trade Act stipulates that any subsidiary of a chaebol group beyond a specified size may neither obtain nor hold shares of other domestic firms in excess of 40 percent of its net assets. The Fair Trade Act may be said to be effective in this respect. The average ratio of intercompany shareholding of the 29 largest chaebol groups first designated as large business groups decreased substantially, from 43.6 percent in 1987 to 31.8 percent in 1991. As of 1991, the average ratio of intercompany shareholding of the 61 largest chaebol groups was 31.4 percent.

As mentioned earlier, subsidiaries of chaebol groups are practically owned by particular individual shareholders and affiliated enterprises they control. Table 8.11 shows the ownership structure of the 30 largest chaebol groups. Although the average ratio of total shareholding in the case of the 30 largest chaebol groups decreased slightly, from 56.2 percent in 1987 to 46.9 percent in 1991, the average share is still enormous. Especially when one considers that the higher the ranking of the large chaebol groups, the higher is the average ratio of intercompany shareholding, then the issue of concentration of ownership by large chaebol groups is clearly still serious. At the same time, as of 1991, only 28.7 percent of the 30 largest chaebol groups’ total subsidiaries have gone public in the stock market, and they account for less than 60 percent of their total equity on average. We may therefore say that the large chaebol groups continue to maintain a closed ownership structure.
Table 8.11 Ownership Structure of the 30 Largest Chaebol (percentage)

<table>
<thead>
<tr>
<th></th>
<th>1987</th>
<th>1990</th>
<th>1991</th>
</tr>
</thead>
<tbody>
<tr>
<td>Family and relatives</td>
<td>15.8</td>
<td>13.7</td>
<td>13.9</td>
</tr>
<tr>
<td>Affiliated enterprises</td>
<td>40.4</td>
<td>31.7</td>
<td>33.0</td>
</tr>
<tr>
<td>Total shareholding</td>
<td>56.2</td>
<td>45.4</td>
<td>46.9</td>
</tr>
</tbody>
</table>

Sources: Economic Planning Board (various years).

Notes

2. Hyundai Corporation and Hyndai Motor, both members of the Hyundai group, are listed separately in the Fortune 500 listing, thus giving the Koreans nine entries involving eight groups. If the public enterprises, Korea Electric (ranked 302d) and Pohang Steel (ranked 426th) are included, Korea’s entries total eleven.
3. Hyundai Motor, Korea’s largest automobile manufacturer, was only one-thirtieth and one-thirteenth the size of General Motors and Toyota, respectively, in 1987 in terms of sales volume. And Samsung Electric Company is less than one-tenth the size of Hitachi of Japan.
4. Audited corporations are enterprises with more than 3 billion won in total assets or more than 500 million won in capital.
5. Even though the Fair Trade Committee first designated 32 large business groups, three chaebol groups were excluded because of a decrease in their total assets.
The chaebol, or the Korean business groups, have played a major role in the Korean economy over the last several decades. Such business groups are not limited to Korea and are commonly found in many countries. In fact, it is not unusual to find a large share of industrial activity organized through networks of legally independent firm affiliated with one another under a common group name. A number of studies have been concerned with explaining the institutional phenomenon of business groups. Generally, there are two types of explanations for business groups. The first and most developed explanation draws, more or less exclusively, upon economic factors and generally rests upon theories of market imperfections. These market imperfection explanations treat business groups as outward extensions of firms and as organizational layers that exist between firms and markets. This allows firms to operate with greater efficiencies in market economies. With this explanation, the phenomenon of business groups is brought under the general theory of the firm and is explained by the theory (Hamilton, Zeile, and Kim 1990).

From this point of view, analysts argue that firms develop more complex organizational structures in response to market constraints. In the hypothetical situation in which markets operate with perfect efficiency, and in which market transactions allocate all resources, firms will remain small, and business groups will not develop at all. What causes firms to expand and business groups to form are imperfections in the market's ability to allocate resources efficiently. Given imperfect markets, firms and groups of firms administer the allocation process—through authoritative organizations in the case of firms and through quasi-authoritative organizations in the case of business groups. In this sense, business groups should be viewed as a type of organizational network located between firms and markets. As Goto (1982) notes, the business group is an institutional device designed to cope with market failure as well as internal organizational failure.
Under certain circumstances, transactions within a group of firms are more efficient than transactions through the market or transactions through the internal organization of the firm.

Market imperfection theories offer a bottom-up explanation of business groups that gives causal priority to a narrow range of economic variables. Businessmen seize the opportunity to reduce transactions costs between firms and thereby achieve greater allocative efficiencies and competitive advantages vis-à-vis other firms in the same market by establishing networks of firms. Firms are the basic unit of the process, and business groups represent outward extensions that allow firms to coordinate their activities in ways that neither markets nor firms are able to accomplish.

The bottom-up economic theories are in direct contrast with the top-down political theories of business groups offered by political economists. From a political economy perspective, business groups are formed as a result of collusion between political officials and business elites. In this sense they are unnatural monopolies that represent "corruption" of both the political and the economic processes. There is an argument that chaebol groups were a creation of an authoritarian government.

The political economy explanation of business groups has not been set down in a formal manner. Cumings (1984), however, gives one of the best summaries of the principal elements in reference to Northeast Asia. He argues that bureaucratic, authoritarian governments characterize many of the countries outside the capitalist core, including those in East Asia. Governments in this area, however, have been particularly successful in their attempts, resulting in "development by invitation." In East Asian countries, as well as in other newly industrializing countries, the apparatus itself directs the economic development of the society through preferential linkages between indigenous business elites and international capital. Such linkages allow business elites to develop oligopolistic control over key industrial sectors, thus creating business groups with the skewed formation of large firms and the politically supported networks linking them.

Although there is, conceivably, some overlap between the two types of explanations, in theoretical terms, they are opposed. The economic theories explain business groups from the bottom up, as a result of essential economic processes in flawed markets, and the political theories explain business groups from the top down, as a result of collusive, authoritarian, and sometimes straightforwardly corrupt political practices.

However, Amsden (1989) argues that market imperfection theories
are not altogether satisfactory. Acceptance of the theory implies that if markets were perfect, firms would pursue a strategy of specialization. In fact, there is little evidence to support this. Although the United States industrialized under fairly competitive market conditions, the upshot was the multidivisional firm—and more recently, the conglomerate—rather than the specialized corporation. Another explanation for the rise of diversified business groups could conceivably be developed from a transactions cost approach, although this approach is almost impossible to test empirically.

Chandler's (1990) study of the multidivisional enterprise in the United States, Britain, and Germany suggests that diversification by business is an integral part of expansion whatever the country. Amsden takes this historical proposition as a starting point for understanding the rise of the large chaebol group in Korea.

The Economic Effects

The economic effects of the chaebol groups will depend on the way these groups have grown, the extent and degree to which their economic power has been exercised, and the value system of the society at large. In addition, we must be careful not to confuse the issues of a non-competitive market structure with that of economic power, even though most subsidiaries of the large chaebol groups are monopolistic or oligopolistic. Economic power transcends a simple monopoly in its dimensions, and whether a firm is a subsidiary of a chaebol group or an independent one matters little insofar as the economic effects of monopoly are concerned.

There are somewhat mixed evaluations of economic effects of large chaebol on economic development. On one hand, they have provided economies of scale and managerial X-efficiency. Aggressive, risk-taking entrepreneurship was crucial in enabling the Korean economy to transform itself from an underdeveloped and primitive industrial economy to a modern, capital-intensive, and high technology-oriented one. The government has relied on and favored large chaebol groups to secure their active participation in large-scale development projects and export promotion.

On the other hand, many are becoming deeply concerned about the chaebol's increasingly dominant position in the Korean economy. Criticism is directed against their excessive borrowing, their expansion of business lines even into areas normally dominated by small and medium-sized firms, and their exploitation of opportunities to make windfall profits from imperfect markets.
The Positive Effects

The primary advantage enjoyed by the chaebol lies in synergy, or the economies of scope inherent in multiproduct activities. As pointed out earlier, entrepreneurship is an important constraint, especially in the early stages of economic development. The chaebol groups can more easily obtain the capital, technology, and managerial resources required to transform an idea into an innovation and an economic opportunity into an actual investment and production decision; in this respect, they are able to make better use of entrepreneurship. In Korea, this was particularly relevant for the export drive and industrial restructuring of the past couple of decades. The participation of chaebol groups in a number of different markets facilitates the flow of information, reducing uncertainty in decision making on investment and production. At the same time, diversification disperses risk and stabilizes the rate of return on investment for chaebol groups. This dispersion may ultimately increase the inducement to invest in the economy as a whole.

In those countries having underdeveloped markets, business groups develop to counter the absence of markets in certain products and services. According to Leff (1978), the institution of the group is thus an intrafirm mechanism for dealing with deficiencies in the markets for primary factors, risk, and intermediate products in the developing countries. He views the formation of business groups as constituting an entrepreneurial breakthrough that opens channels of inputs and outputs where a routinized market mechanism does not exist.

Kim (1987) argues that the business group is an entrepreneur's organizational invention to achieve efficiency in executing economic activities and that it is superior to competing forms of economic organizations. He conceptualizes the entrepreneur as a person or a group of persons that performs four sequential activities: perceives and evaluates opportunities, mobilizes necessary inputs, transforms inputs into outputs, and markets the outputs. To perform these activities, an entrepreneur needs various elements such as information, capital, and managerial resources. However, in the real world, not all of the elements are efficiently marketed. Some elements (e.g., intrafirm motivation) are inherently unmarketable, and others (e.g., honesty and trustworthy competence of high-level managers) are difficult to market and are frequently unmarketed.

Moreover, markets are frequently influenced or even replaced by government intervention. In many countries, important business opportunities are defined and rationed by the government, and the
government plays a vital role in mobilizing and allocating scarce resources such as industrial credit. Connection to the government is usually an imperfectly marketed input in many, especially developing, countries. Under such circumstances, a successful entrepreneur has to be able to operate well in the political and bureaucratic arena connected with his business activities. The greatest competitive advantage of a business group is its organizational capability to appropriate economies of scale and its scope in mobilizing and utilizing scarce resources that are hard to market or are unmarketed.

The business group's competitive advantage is rendered possible by its large structure with diversified activities. Of the competitive advantages of the business group, Kim (1987) emphasizes efficient mobilization and utilization of some critical inputs—i.e., managerial skills (especially entrepreneurship) in the formation of the firm and capital—and other advantages in the distribution of outputs and in bargaining with non-group parties (namely, the government). These advantages, individually and jointly, create superior group mechanisms to efficiently exploit the environmental opportunities.

Furthermore, the group pattern has helped relax entrepreneurial constraint and permitted pure Schumpeterian entrepreneurship to become effective in the underdeveloped countries because the group provides the capital and the technical and managerial resources necessary to transform "innovativeness and alertness to opportunities" into actual investment and production decisions. The institution of the group also facilitates economies in the use of scarce entrepreneurial resources. Economies of scale to entrepreneurship can be appropriated as able individuals are utilized to their full potential in the group's large and diversified activities. In addition to such "central office" effects, the groups increase entrepreneurial mobility, for they can deploy entrepreneurial resources to specific intragroup companies as opportunities arise (Leff 1978).

Perhaps even more important, the group structure itself reduces the amount of entrepreneurial capacity required per unit of innovative decision-making. Thus the groups' participation in many different activities increases information flows and reduces uncertainty surrounding investment and production decisions. In addition to entrepreneurship, the group pattern also makes a difference in terms of other positive effects on the functioning of the developing economies.

The business group's large and diversified structure facilitates economies in mobilization and utilization of scarce entrepreneurial and managerial resources. Many entrepreneurs and top managers in business groups are members of owner families. Family members
who plan early to get involved with the group also have the advantage of early acquaintance with basic activities and are thus in a better position to focus their education and contact building. This may count as a significant motivation for the development of entrepreneurial traits, because almost no such input can be acquired from the markets. The business group’s large size and diversified activities can attract actual or potential entrepreneurs and managers better than can small non-group firms because the business group can provide better career opportunities.

The needs or opportunities to use existing but not fully utilized entrepreneurial and managerial resources are greater in large and diversified business groups than in small non-group firms. Economies of scale and scope in utilizing entrepreneurship and managerial skills can be exploited because capable entrepreneurs and managers are used to their full potential in the business group’s large and diversified structure. The group structure also increases entrepreneurial and managerial mobility because such resources can be efficiently deployed to group members whenever opportunities arise.

The business group’s large structure with diversified activities increases the volume and flow of information within the group. Its participation in many different activities gives it a wide-ranging information system. Within the group structure, there is usually a unit that specializes in scanning and processing various information collected by other units of the group. Markets for information are not perfect, and this type of market imperfection is more severe in developing countries. In such instances, critical information usually flows through person-to-person channels rather than through open markets. Especially where government intervention is extensive, an effective information channel with the government is critical for private firms. Direct contact with the high-level political and bureaucratic world and effective coordination with bureaucratic hierarchy are always costly, especially when there is a frequent turnover of people in the political and bureaucratic world. Business groups with concentrated economic power can bear such a high cost of information collection, while most non-group smaller firms cannot.

Two characteristics of a capital market—i.e., market imperfection and government regulations—are relevant to the business group’s competitive advantages in the mobilization and allocation of capital. When capital market imperfections are severe and cannot provide financial services efficiently, the business group may be able to outperform the markets or non-group firms in mobilizing and allocating capital. The business group’s large size and diversification increase its
efficiency in mobilization and allocation of capital. The business group, especially in its early stages, usually draws its capital from sources that transcend a single wealthy family. Financing by these owner families can obviate high transactions costs, surveillance costs, and agency costs associated with capital market imperfection and can reduce the debt service burden. As a business group becomes larger and more diversified, it forms an internal financial pool, often in the form of banks or other financial institutions such as insurance companies, that can provide cheaper and more reliable financial services for group members than can independent financial institutions in small and imperfect markets.

Economies of scale in external financing can be exploited because the business group's good credit, track record, and reduced risk (from the portfolio effect attained from diversified group assets) enable its members to secure credit from outside sources at a lower average cost than would be possible if they operated independently in imperfect capital markets that cannot provide more efficient portfolios than diversified business groups. Even sophisticated foreign lenders in developed countries often identify the risk associated with major business groups in developing countries as the country's risk.

The business group's advantage in external financing is likely to be stronger when the capital markets are heavily regulated by government. Most bureaucrats are conservative and are not sensitive to the efficient allocation of capital. They tend to stick to such criteria as track record and historical share, criteria that business groups generally meet better than do small non-group firms. Because business groups are large, they are better known to the bureaucrats and often regarded as an integral part of the national economy. The groups are also more knowledgeable about bureaucratic decision making and can afford the high cost of maintaining close contacts with the bureaucracy. As a result, business groups usually continue to receive more benefits from the government allocation of capital. The business group's competitive advantage in regulated capital markets is self-reinforcing (Kim 1987).

The business group's well-established distribution networks and image in the marketplace offer economies of scale and scope in marketing member firms' products. Establishing an effective distribution network is often a costly task. While a non-group affiliated newcomer has to bear the full cost of setting up such a network, a business group can either increase the volume of distribution of current products or add new products or activities at a lower incremental cost. The group's dominant market power can also help member firms estab-
lish market agreements and conditions with competitors or the government to reduce competition.

**The Negative Effects**

The fast growth of *chaebol* groups has been a major part of Korea’s industrialization and economic development. Their rapid expansion, however, has also created unwanted consequences and potential problems. For example, the group pattern has created some serious distortions involving inefficiency within the group, interfirm and intersectoral distortions, and finally, political-economic effects on overall development patterns. In effect, the groups have taken factor-market imperfections in the less developed countries and transmuted them into product-market imperfections. In the process, rapid industrial growth has often occurred, but the groups have also created a special form of monopoly capitalism in the less developed countries.

As a result of the growth of *chaebol* groups in the Korean economy, increasing criticism has been raised about the concentration of economic power. Theory predicts that optimum resource allocation is fulfilled when factor and commodity markets are in perfect competition. Monopoly and oligopoly firms produce less than optimum levels of output at prices that are higher than marginal cost, thereby creating monopoly profits. Resources are used in less productive areas, causing net losses in economic welfare. In addition to these static efficiency considerations, dynamic effects of concentration on economic growth deserve due attention.

There are conflicting arguments about whether atomistic firms in a perfectly competitive market or big firms in a monopoly-oligopoly market are more conducive to innovation. But there is no doubt that big firms whose monopoly positions are protected by legal and administrative barriers have little, if any, incentive to devote scarce resources to create changes needed to place themselves in a superior competitive position vis-à-vis their rivals. Their monopoly rent is a windfall profit earned by external institutions rather than through innovations in price, quality, and marketing techniques. This description is typical of situations in which the economic activities of Korea’s enterprises are molded (Lee 1984).

It is frequently asserted that the high level of concentration was one important cause of the deterioration of the Gini coefficient in the 1970s. While this may be true, there are few empirical studies to support or deny such an assertion. Jones and Sakong (1980), for example, argued that even if the government were to tax away the entire dis-
tributed earnings of the large chaebol groups and reallocate them to the population as a whole, the redistributional effect would be negligible. On a priori grounds, the distributional effect of concentration is determined by various factors other than the degree of concentration itself.

As an example, ownership patterns and efficiency considerations are important. If ownership is not separated by stock dispersion and if dynamic inefficiencies are created by industrial and aggregate concentrations, the adverse effect on income distribution will be magnified. In this context, Korea's high concentration of ownership among a few business families and X-inefficiencies caused by a highly monopolized market structure have worsened income distribution, which had already deteriorated with the significant level of concentration.

Too much emphasis placed on the efficiency of economies of scope has resulted in the growth of large chaebol groups. Although the internal efficiency of chaebol groups might have been increased by vertical and horizontal integration of production and marketing activities, such expansion does not necessarily enhance overall efficiency from a social standpoint. Dominance of large chaebol groups inevitably reduces fair economic opportunities for smaller firms and undermines a competitive market environment. When private efficiency is achieved at the cost of reduced social welfare or increased social inequity, it is a pseudo-efficiency and is not desirable for the society.

On a priori grounds, it can be hypothesized that monopolized industries have a higher inflation than competitive ones. Three factors underlie these assumptions: (1) the monopoly firm has discretionary control over the price of its output, whereas the competitive firm is a price-taker; (2) the monopoly firm uses its control power to maximize its profit margin over cost (mark-up pricing theory); and (3) the monopoly firm is able to transfer more portions of a given change in cost conditions to the output price than can competitive firms.

One of the most undesirable consequences of the concentration of economic power, or the growth of chaebol, involves potential product market distortions. Typical market distortions caused by chaebol groups are horizontal and vertical predations. The potential for horizontal predation is large because the most common market structure for large chaebol groups is a single chaebol and many non-chaebol competitors in a single market. Group affiliation allows chaebol enterprises to behave in a non-competitive fashion. Rents accruing to chaebol in one market can be used to cross-subsidize non-competitive behavior in other markets. Such horizontal predation by chaebol reduces com-
petitiveness in product markets and endangers the existence of small and medium-sized competitors.

The structural domination by big firms is manifest in the serious imbalance between small and medium-sized firms and big firms. The growth rate of the output of small and medium-sized firms was significantly lower than the average growth rate of the economy throughout the 1960s and 1970s. The lower growth rate resulted in the relatively inconspicuous position of small and medium-sized firms in output, employment, and bank loans. Behind the numerical indicator lies the structural problem of a deficient compensatory relationship between small and large firms. Their production lines are not efficiently linked. Instead of a harmonious interdependent relationship between big firms in providing large-scale assembly lines and small firms in supplying parts, a big firm often undertakes the entire production line by itself. Moreover, chaebol groups often diversify into areas where small firms could operate more efficiently.

Cross-holding of shares among member companies within a group is one common means of interlocking member companies, thus reinforcing the controlling power of the owner. In the mid-1980s, the share of equity shares exchanged among affiliated companies within a group was, on the average, close to 50 percent of the total outstanding shares of the group. Share cross-holding inflates the capital base of the companies involved without any corresponding increase in actual investment. Since book value–based debt-equity ratios of borrowing firms are an important lending criterion used by banks, an inflated equity capital base will increase the borrowing limit of each company when lenders do not take into account that a simple exchange of stock ownership does not increase the debt capacity of the companies (Y. Lee 1990).

Share cross-holding between affiliated companies strengthens the controlling power of large shareholders or owners of chaebol groups without requiring additional equity contributions. This hurts the interests of general-public shareholders who hold a smaller share of stocks outstanding after the two companies exchange stocks. Although holding companies are not permitted in Korea, share cross-holding among affiliated group companies results in a pyramid of share ownership, which facilitates control of the economy's physical assets by a few individuals. Furthermore, capital inflation from share cross-holding can also result in excessive corporate profits or excessive product prices for consumers. Because to control prices during periods of high inflation the government often allowed firms to earn only a fair rate of return on invested capital, inflated capital bases
made it possible for firms to charge higher prices and thus earn excess profits at the consumers' expense.

When capital inflation through share cross-holding occurs among all affiliated companies within a group, the implications for the control of power, the creation of additional fictitious borrowing capacity, and price distortion can be enormous. Another negative effect often observed in the past is the bankruptcy of the entire chaebol group triggered by financial failure of a subsidiary firm. Bankruptcy can occur in any firm, but it is far more dangerous in the case of a firm within a chaebol.

Korean firms in general are highly leveraged. The debt-equity ratio of the average manufacturing firm is about 4 to 1. The larger a firm is, the higher is this ratio because of credit-financed expansion. A higher debt-equity ratio increases financial risk, amplifying the impact of business fluctuations. The excessive size of business firms, in combination with their weak financial structure, increases the overall risk to the Korean economy and reduces the allocational efficiency of financial resources.

If a large Korean enterprise gets into trouble, the whole group, which is so large that it cannot be allowed to fail, is endangered. Therefore, the existence of large groups forces the government to implicitly or explicitly guarantee group credit. On many occasions, the government has bailed out troubled firms by providing them with special loans and/or tax concessions. This practice inevitably reduces the amount of funds available to other more productive firms or industries and thus reduces the overall efficiency of resource allocation.

Economic power embeds political influence by which big businesses are able to exploit the benefits of government intervention in credit rationing, taxation, foreign exchange control, and other distribution of economic rents. This implies that government intervention worsens the market imperfection rather than improves it. Large chaebol groups also use their economic and political power to protect their own interests from macro- and microlevel economic policies. For example, they have expressed strong objections to the policies of import liberalization, tight credit and price controls, and fair trade, which essentially are designed to increase the efficiency and equity of the overall economy at the cost of certain sectors of the economy. Considering the serious imbalances of power among interest groups (e.g., large versus small businesses, producers versus consumers), the lobbying efforts of large chaebol groups often cause government policies to tilt toward excessive protection of their interests.

The case against unlimited expansion of chaebol groups through
conglomeration and concentration of economic power is not confined to economic considerations only. There is a potential danger that high economic concentration of wealth and power will dominate other interests and thus hinder the development of economic democracy. Conglomerate expansion probably confers no benefits on the economy as a whole and may well impose substantial long-term social and political costs. It undermines independent decision making as economic and political power is absorbed by acquiring firms. Thus, conglomerate expansion seriously hinders political and social progress.  

The negative image of the chaebol in Korea is generally attributed to the inequality of economic opportunity among firms, as well as to the general perception of their concentration of ownership and excessive growth. Granted that an unequal distribution of ownership is inevitable in every free-market economy, the most fundamental reason this is raised as a critical issue in Korea is that the process of capital accumulation itself has not yet been fully justified in the eyes of the general public. It cannot be denied that the general public believes that most chaebol groups have accumulated monopoly profits at the expense of consumers and other smaller firms through the help of loans, both domestic and foreign, and the protection of the government. It is also widely believed that chaebol have invested their profits in unproductive sectors such as real estate and have influenced government policy to promote private interests (K. Lee 1990).  

These negative general perceptions—withstanding the issue of whether or not they are justified—have fomented social tension, raised distrust and doubts about the “capitalistic” economic system, and further distorted the perception of economic ethics among some segments of Korean society. In conclusion, the concentration of economic power in Korea has evolved into an issue with political and social dimensions transcending the simple economic sphere; as a result, the value judgments of individuals are becoming intertwined with the objective facts, rendering the whole issue all the more difficult to solve.

**Empirical Evidence**

In the previous section, we examined both the positive and negative economic effects of chaebol groups. There are somewhat mixed evaluations of the economic effects of chaebol groups on economic development. The primary positive effects are a result of their synergy, or the economies of scope inherent in multiproduct activities. The
large and diversified structure like the chaebol group facilitates economies in mobilization and utilization of scarce entrepreneurial and managerial resources. However, the rapid growth of chaebol groups has also created unwanted consequences and potential problems. Even though the argument against unlimited expansion of chaebol groups is not confined to economic considerations only, one of the most noted criticisms is the concentration of economic power.

In short, the positive effects of large business groups such as the chaebol focus mainly on organizational efficiency, while the negative effects are generally attributed to the concentration of economic power. There are very few empirical studies that examine the economic effects of chaebol groups. Because of data shortage and difficulties involved in calculating the economic effects due to the concentration of economic power, most empirical studies about the chaebol examine organizational efficiency as it is related to the performance of the business group. Therefore, we summarize three studies—those by Chang and Choi (1988), Zeile (1989), and Cho (1990)—on organizational efficiency for positive effects, and for negative effects, we introduce the empirical study of Kang (1991), which was the first synthesized study about the economic effects resulting from the concentration of economic power, despite the fact that the study has several deficiencies, such as a shortage of good time-series data.

Organizational Efficiency

Chang and Choi (1988) use the transactions cost approach to analyze the diversification strategy and the resulting structure chosen by chaebol groups to overcome market imperfections prevalent in developing countries. Chaebol groups that have a multidivisional structure are thought to show superior economic performance because such a structure reduces transactions costs arising from organizational failure. If the strategy and the structure of chaebol groups are such that they reduce transactions costs, the ultimate effect would be to lower costs and to provide relatively higher profit for the affiliated companies of the chaebol group, compared to independent non-affiliated companies. To analyze the economic performance of the chaebol group, they use a modified model employed by Caves and Uekusa (1976) for Japan to regress firm profits against various variables, including dummies representing group membership.

Since the hypothesis of greater efficiency depends on structural characteristics, they classify the 30 largest chaebol groups into three
types by their structure. They separated out the four largest *chaebol* groups that are completely vertically integrated and have all the characteristics of a conglomerate and a multidivisional structure as Type I. The next 20 largest groups with a multidivisional structure were classified as Type II, and six smaller groups without a multidivisional structure were classified as Type III. They represent the three types by the dummy variables D1, D2, and D3, respectively. Chang and Choi expect the firms affiliated with Type I *chaebol* groups to show superior performance compared to firms affiliated to *chaebol* groups of Type II and Type III and also to non-affiliated firms. Because the consolidated financial statements were not available, they used financial statements of a total of 182 listed companies in the manufacturing sector during the ten-year period from 1975 to 1984. Among the 182 firms in the sample, 63 (18 Type I firms, 36 Type II firms, and 9 Type III firms) are group affiliated firms, and 119 are independent firms.°

To test the hypothesis of the profitability of group membership, they used two measures of profits—the average annual rate of profit after taxes on owners' equity (PE) and the average annual rate of profit after taxes but before interest on total assets (PA). Meanwhile, to separate out other factors that affect differences in profit between group affiliated and non-affiliated companies, they included in the regression equation the following independent variables that affect profit: (1) the three-firm concentration ratio, which is the percentage of value of shipment accounted for by the three largest firms in the company's principal industry (CR); (2) average advertising intensity, which is the ten-year average ratio of advertising spending to total sales (AD); (3) the ten-year average of total assets (TA); (4) the average rate of growth of sales by the firm (GR); (5) a diversification index, which is one minus the ratio of the value of shipment in the industry in which the firm has the highest value of shipment to the total value of shipment (DI); and (6) the coefficient of variation of PE (VE).

The variable CR reflects profits resulting from monopoly power. Product differentiation and entry barriers also affect profitability and are represented by advertising intensity (AD). Another factor representing market power of the firm, the diversification index (DI), reflects the increase in profit resulting from the rise in an entry barrier, economies of scope, and the reduction in risk due to diversification. The growth rate (GR) reflects windfall profit resulting from sales increasing faster than other firms' sales. For example, if during the period 1975–1984 the firm made some innovations or acquired special rent-yielding assets, sales would have grown faster and profit rates would have increased. In this fashion, GR reflects the effect of internal
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and external movements in demand faced by the firm. The variable TA, which represents scale, reflects whether a large firm can do things that smaller firms cannot to increase its profit. TA also reflects the existence of economies or diseconomies of scale. The coefficient of variation of after-tax profit rate on equity (VE) reflects risk. If stock owners are risk averse, they will require a higher risk premium, which is reflected in higher profits. The dummy variables representing affiliation reflect the residual effect of whether affiliation increases the profit rate and therefore is more efficient.

To summarize their regression results, when using PE as measure of profit, all firms affiliated with chaebol groups have higher profitability; when PA is used, Type I chaebol-affiliated companies show higher profits than independent companies. Thus it appears that the chaebol group is more efficient in terms of economic performance at the individual firm level. However, Chang and Choi could not obtain a significant result on the differences in profit between affiliated and non-affiliated companies in the regression once structural differences were taken into account. When comparing the coefficients of dummy variables, they can see from regressions using PA that the profitability of chaebol affiliation decreases as the firm goes from Type I to Type III, showing that the differences in profitability correctly correspond to their analysis of structure. Also, using only group-affiliated firms, which numbered 63, the differences in dummy variables again came out significant at the 1 percent level.

Thus we see that the chaebol groups with strategy and structure show superior economic performance. This is in line with the general result of the empirical work that has been done for the multidivisional effects on the firm level. However, the results are in contrast with those derived by Caves and Uekusa (1976) for the Japanese business groups; that study showed group-affiliated firms to have lower profits. They explained this by the fact that the banking companies, which form the nucleus of the group, take away part of the profits in terms of higher interest rates. In their words, interest payments passing to the banks may be a conduit for group-derived rents. But in the case of Korea, even with higher costs of interests for chaebol groups in general, it is worthwhile to note that the group-affiliated firms earned higher profits. This strengthens the position that the chaebol groups that satisfy their structural conditions show superior economic performance. The Japanese business groups do not show multidivisional structure and would not fit their structural conditions.

Zeile (1989) adopted the econometric model used by Encaoua and Jacquemin (1982), with some minor modifications to test an explana-
A similar test for efficiency in the pattern of relative industry dominance by groups can be constructed for the Korean case. For this purpose, Zeile (1989) uses 1983 data for 72 manufacturing sectors selected to match the categories of the Korean Standard Industrial Classification with the categories of the 1983 Input-Output Tables. The basic regression model consists of one dependent variable and five explanatory variables. The dependent variable shows the share of industry sales by the 50 largest chaebol groups (CHAESS). The explanatory variables include the capital requirements as measured by the ratio of industry to total fixed capital (KR), research activity as measured by the ratio of research and development expenditures to total industry sales (RES), multiplant economies as measured by the ratio of the number of plants in the industry to the number of firms in the industry (MLTP), plant economies of scale as measured by the average plant size of plants of minimum efficient scale (ES), and level of export as measured by the ratio of industry exports to total industry output (EXP).

In accordance with the arguments presented by Encaoua and Jacquemin (1982), the expected signs of the explanatory variables are all positive. Chaebol groups are expected to predominate in industries characterized by large capital requirements because of the large transactions costs involved in obtaining finance: the internal capital markets of chaebol groups make it possible to economize on these transactions costs, thus reducing the cost of capital. Furthermore, the existence of large fixed costs in capital-intensive industries is a source of market failure, favoring centralized management through large organizations. Extensive research and development requirements in an industry favor the group form of organization over market transac-
tions between independent firms for two reasons: first, the interdepen-
dence of research and development with production and market-
ing favors the integration of these activities within a common organi-
ization; second, the public-goods nature of technological knowledge
creates transactions costs in interfirm trading that can be avoided
through internal transfers between the member firms of a group. The
coordination of resources within chaebol groups also makes possible
the realization of scale economies, both at the level of the plant and in
the multiplant operations of firms. Finally, in industries where ex-
ports are important, the high degree of uncertainty and the high cost
of information in marketing products internationally should favor in-
ternal coordination through organizations with extensive domestic
and international operations.10

The regression results provide weak to moderate support for the
hypothesis of organizational efficiency based on industry characteris-
tics. In the basic regression equation, the capital requirements and re-
search activity variables are statistically significant, but the industry
exports variable is not; moreover, the estimated parameters for the
economies of scale and multiplant economies variables display the
wrong sign.

Some further insight on the relation between the industry sales
shares of chaebol groups and the explanatory variables of the model
can be obtained by dividing the sample into four subsets. The results
show that, for all five explanatory variables, the mean values for the
sample subset with a chaebol sales share greater than 50 percent ex-
ceed the mean values for the sample as a whole. This is marginally
the case for four of the variables (ES, MLTP, RES, and EXP), but for
capital requirements the mean for this subset is almost three times as
large as that for the whole sample.

Note, however, the absence of a monotonic increase (with chaebol
sales share) in sample subset mean values for any of the explanatory
variables. Indeed, for two of the variables (ES and MLTP), the sample
subset displaying the largest mean is that for which the chaebol share
of sales is zero. This explains why the estimated parameters for these
two variables are negative in sign. Thus, the relative degree of domi-
nance of Korean industries by chaebol groups appears to be consistent
with expectations based on industry characteristics, if one controls for
the presence of government enterprises.

The regression results definitely confirm one prediction of the orga-
nizational efficiency model: that is, chaebol groups tend to predomi-
nate in industries characterized by large capital requirements. It may
be that reductions in transactions costs, made possible by the group
form of organization, give the chaebol a major advantage in entering such industries. Amsden (1989), however, argues in reverse fashion that it was the involvement of Korean companies in capital-intensive industries that gave rise to diversified chaebol groups. According to Amsden, capital-intensive industries are distinguished by extensive learning requirements and require a large cadre of salaried managers and engineers. Through early involvement in such capital-intensive industries as sugar refining and cement production, Korea’s leading chaebol developed a technological and managerial capacity that enabled them to establish new firms in ever-more-complex industries. This contrasts with the experience of firms that started out in the light industries (such as Korea’s major textile companies) and that were never able to diversify and expand into large chaebol groups. Applying this argument with an eye to his regression results, it may be said that, in a late-industrializing country such as Korea, the learning requirements of new capital-intensive industries constitute a barrier to entry that chaebol groups are well-equipped to overcome by virtue of their previous involvement in capital-intensive industries. In adopting this interpretation, however, one should keep in mind that many of Korea’s major capital-intensive industries were actively promoted by a government that exercised firm control over the allocation of financial resources.

If chaebol groups are economically efficient, their business performance should be superior to that of non-chaebol groups. Therefore, Cho (1990) analyzes the statistically significant difference in business performance between chaebol and non-chaebol groups by use of a T-test. He used financial statements of a total of 219 listed companies in the manufacturing sector during the five-year period from 1983 to 1987. Among the 219 firms, he selected 74 firms respectively in chaebol and non-chaebol groups by three-digit industry. He used the following four measures of business performance: (1) the average annual growth rate of sales (SG) as a growth variable, (2) the average annual rate of profit on total assets (ROI) and the average annual rate of profit before interest on total assets (PA) as profitability variables, (3) labor productivity (LP) and capital productivity (KP) as productivity variables, and (4) coefficient of variance of business profits for the years 1981–1987 (CV) as a risk variable.

Cho proposed the null hypothesis that there is no statistically significant difference in the business performance between chaebol and non-chaebol groups. The results show that the hypothesis is rejected at the 1 percent significance level in the case of ROI. Meanwhile, the hypothesis is also rejected at the 5 percent significance level for LP and
at the 10 percent significance level for CV. However, the hypothesis is not rejected for the remaining variables (i.e., SG, PA, and KP).

These results can be interpreted as follows. First, chaebol groups are not superior to non-chaebol groups in ROI and are almost the same as non-chaebol groups in PA including financial costs. This means that chaebol groups diversified actively because of the growth-led strategy and invested mainly in capital-intensive industries, thus increasing financial and depreciation costs, which reduced ROI. Second, the difference between chaebol and non-chaebol in terms of SG indicates that the quantitative growth-led strategy has changed since the mid-1980s, whereas the strategy favored the chaebol's higher growth compared to non-chaebol in the 1970s. Third, the higher labor productivity of chaebol groups is ascribed to the relative capital intensity and high quality of labor forces. Fourth, the relative lower value of the coefficient of variance of business profits in chaebol groups is due to the synergy effects through risk reduction and intergroup marketing.

Cho also empirically analyzes which and how strategy and structural variables affect business performance. Most empirical studies on business performance used the logic system that argues that substituting strategy variables for behavioral variables in the basic model captures the linkages among strategy variables, market structural variables, and business performance. Chaebol groups advance into various industries, such as trade, construction, and finance, and set up the management strategy themselves; thus, the chaebol have the distinguishing structural characteristics of other firms. Taking these factors into account, Cho chose seven explanatory variables: (1) industry growth (IG) as measured by the weighted average sales growth in the industry with the chaebol's sales share; (2) a diversification index (DI) as measured by the Berry index; (3) advertisement intensity (AD) as measured by the ratio of real advertisement costs to average advertisement costs; (4) R&D intensity (RD) as measured by the ratio of real R&D costs to average R&D costs; (5) market share (MS) as measured by the ratio of the chaebol's sales to the total sales in the industry; (6) a bank loan share (BL) as measured by the ratio of bank loans to the total amount of debt; and (7) total assets (TA) as measured by the natural log of total assets. Cho also used SG, ROI, and PA, which were used in the previous study as dependent variables.

The expected signs of the explanatory variables are all positive, except for DI and TA. The sign of DI is expected to be negatively correlated with the profitability index and positively correlated with the growth index. The variable TA is also expected to have a weak negative sign with respect to both the profitability index and the growth
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index. The regression results show that using SG as a dependent variable, all variables except DI have the same sign as expected regardless of the significance level. Industry growth and R&D intensity variables are statistically significant at the 5 percent level. Meanwhile, the coefficient of DI is not statistically significant, but has a negative sign. This can be interpreted to mean that until the 1970s, the diversification strategy was advantageous for chaebol growth because of the characteristics of the Korean economy with its export-led strategy. However, since the 1980s, increasing economies of scale and a leveling up of the technology induced chaebol to advance into the high-technology industries, which inevitably face competition from advanced countries. Thus, the number of industries in which chaebol could extend its new business and the sharp competition within each industry could, in some cases, diminish growth, particularly when excessive diversification occurred.

Meanwhile, the results of the equation that used profitability as a dependent variable show that all variables except BL have the expected sign regardless of the significance level. The diversification index variable had a negative and significant relationship (1 percent for ROI and 5 percent for PA), whereas the market share variable had a positive relationship at the 5 percent significance level for both profitability variables. This means that since the mid-1980s, the business-unrelated diversification strategy—which is the typical strategic characteristic of chaebol groups—had a negative effect on profitability, whereas firms that specialized in specific or business-related industries and focused on maintaining their market share were more profitable.

In pursuing quantitative growth, the chaebol groups diversified into the less profitable and business-unrelated industries, thereby increasing the competition among chaebol groups. Furthermore, the heavy and chemical, construction, and shipbuilding industries, which had been promoted by government industrial policy and chaebol's oligopolistic incentives, became weak as a result of the recession and excessive investments; this weakness aggravated the overall profitability of chaebol groups. The positive relationship between market share and profitability can be explained by the fact that economies of scale and increasing market control power combined with high market share reduced costs, while relatively superior quality of management affected the control of costs and improved productivity. The negative effect of the bank loan share on profitability can be interpreted to mean that there were too many policy loans to insolvent chaebol in spite of lower interest costs.
Concentration of Economic Power

The concentration of economic power in Korea has evolved into issues with political and social dimensions transcending the simple economic sphere, such as hindering the development of economic democracy, unjustly accumulating capital, and speculating in unproductive sectors. Such effects, however, cannot be calculated easily and must also address the issue of the value system. Therefore, we focus our comments on the pure economic effects resulting from the concentration of economic power. Generally, the concentration of economic power produces a welfare loss as a result of allocative inefficiency, increases X-inefficiency, generates higher inflation, worsens income distribution, and affects innovation. Among these effects, we examine three effects—welfare loss, inflation, and income distribution.

"Welfare" is the happiness and satisfaction that people feel. In particular, economic welfare is the welfare related to the production and allocation of goods, and thus affects growth, equilibrium, and stability of national income. Generally, optimum resource allocation is fulfilled when factor and commodity markets are in perfect competition. Meanwhile, when competitive firms are converted to monopolistic firms, the firms having market control produce less than optimum levels of output at prices that are higher than marginal cost, thereby creating monopoly profits and decreasing the consumer's surplus. The decrease in welfare that occurs when a competitive market is changed to a monopolistic market is the deadweight loss, which is the social costs of the concentration of economic power.

Harberger (1954) estimates the deadweight loss in the U.S. manufacturing sector using the concept of consumer’s surplus. His results indicate that the ratio of the deadweight loss to GNP in the total manufacturing sector is less than 0.1 percent. From the results, he concludes that the welfare loss due to monopolization does not have an important effect on total social welfare. However, Comanor and Leibenstein (1969) argue that the social costs due to monopolization should include X-inefficiency arising from production costs as well as the deadweight loss, and they provide a new model for the estimation of social costs. Kang (1991) adopts the model of Comanor and Leibenstein (1969) to estimate the social costs of Korean manufacturing sector during the nine-year period from 1977 to 1985. He assumes a 1.5 percent price elasticity of demand and a 10.0 percent X-inefficiency rate. The results show that the ratios of social costs to GNP in the manufacturing sector are about 10 percent, which is much greater than the estimates of Harberger (1954).
Kang hypothesizes that the concentration of economic power generates social costs. To test this hypothesis, he uses a simple regression equation with the ratio of the social costs to GNP as the dependent variable (SC) and two measures of the concentration of economic power: the share of shipments of the 10 largest chaebol groups in the entire manufacturing sector CR(10) and the share of shipments of the 30 largest chaebol groups CR(30) as the independent variables. In the test results, both concentration ratios have a positive and significant relationship with the rise in SC. The results can be interpreted to mean that the increasing concentration of economic power resulting from the rapid growth of chaebol groups augment the social costs including the deadweight loss.

Meanwhile, in the Korean economy, which is excessively dependent on exports, the large chaebol groups, having the market power to manage the price, have had important effects on the price change of Korea to the extent that the rise in the import price due to external factors imputes to a higher domestic price through the higher price strategy. Generally, it can be hypothesized that monopolistic industries have a higher rate of inflation than do competitive industries. The monopoly firm has discretionary control over the price of its output, uses its control power to maximize its profit margin over the costs, and is able to transfer a larger portion of a given change in cost conditions to the output price than can competitive firms.

The theoretical framework that the concentration of economic power can affect the process of inflation is based on the administered price hypothesis by Means (1962). He argues that the inflation of the U.S. economy in the 1950s is ascribed to the voluntary price rise by large monopolistic firms having the market power to change prices regardless of the change of demand. Kang (1991) inspects the appropriateness of the administered price hypothesis in the Korean economy with its severe concentration of economic power. He proposes that the concentration of economic power causes the inflation. To test the hypothesis, he uses data of the Korean manufacturing sector during the nine-year period from 1977 to 1985. Because inflation is a dynamic process, all variables are used as the rate of change. The regression equation consists of the rate of change in the wholesale price index (WP) as the dependent variable; explanatory variables include the rate of change of the import unit price index (FC) and the rate of change of the share of shipments of the 10 largest chaebol groups in the manufacturing sector CR(10), or the rate of change of the share of shipments of the 30 largest chaebol groups CR(30).

The results show that FC has a positive and significant relationship
with the rise in WP, but both CR(10) and CR(30) have a positive and insignificant relationship. This means that since the Korean manufacturing sector depends largely upon imports, the change in price is greatly affected by foreign factors, such as the price change of basic products, intermediate goods, and parts. In addition, the concentration of economic power can elevate the price level to some degree.

Furthermore, it is frequently asserted that the concentration of economic power worsens income distribution; that is, the high level of concentration resulting from the rapid growth of chaebol groups was an important cause of the deterioration of the Gini coefficient in the 1970s. While this assertion may be true, there are few empirical studies to support or deny it. Moreover, even though the Gini coefficient is generally used as an index of income distribution, it has a number of shortcomings. Therefore, Yoo (1987) developed a new inequality index by distinguishing between relative and absolute inequality to estimate the degree of inequality in the Korean economy.

The effect of concentration of economic power on income distribution is determined by various factors other than the degree of concentration itself. Large chaebol groups also use their economic and political power to protect their own interests. This also generates inequality of opportunity (e.g., large versus small businesses, producers versus consumers, and the rich versus the poor), and thus aggravates income distribution. The ownership pattern and efficiency considerations are also important for income distribution. If ownership is not separated by stock dispersion and if dynamic inefficiencies are created by the concentration of economic power, the adverse effect on income distribution will be magnified. In this context, the severe concentration of ownership among a few business families of chaebol groups and X-in-efficiencies caused by a highly monopolized market structure have worsened income distribution. When we focus on distributional issues, wealth as well as income should be considered, and the wealth distribution is more important in some sense.

Kang (1991) also investigates the hypothesis that the concentration of economic power worsens income distribution. To test the hypothesis, he estimated a regression equation consisting of an absolute inequality index (AI) or a relative inequality index (RI) as estimated by Yoo (1987) as the dependent variable. The urban population ratio (UP) and the share of shipments of the 30 largest chaebol groups in the manufacturing sector (CR) are the independent variables. The results indicate that UP has a negative and significant relationship, but CR has a positive and not significant relationship with the rise in AI or RI. This can be interpreted to mean that urbanization deepens the dif-
ference between urban and rural areas and thus has a negative effect on income distribution. In spite of the statistical insignificance of the coefficient of CR, the concentration of economic power can be said to deteriorate income equality to some extent.
Notes

1. An implicit overlap is that successful late-developing societies require strong states to direct resources and create markets where there were none or where so many impediments existed that no market developments could occur.

2. Kirzner (1979) elaborates on the "alertness to market opportunities" as a basic nature of entrepreneurship from the neo-Austrian viewpoint.

3. This definition of entrepreneurship follows closely that of Harvey Leibenstein and thus may not fit in the classical definition given by Joseph Schumpeter.

4. The reduced uncertainty caused by the group pattern of industrial organization leads to a shift in the action set toward the origin and a rise in the probability that a given profitable investment will be implemented.

5. An increase in total factor productivity through technological innovation and managerial improvement is imperative if Korean export goods are to become more competitive in price and quality.

6. Friedman (1981) discusses the externalities of the corporate financial structure's increasing the aggregate risk of a nation's economy as a result of excessive debt financing.

7. Especially with the political democratization since 1987, calls for equity in income and wealth distribution have become more insistent. Concentration of economic power in the hands of a few individuals or chaebol groups has become a major target of public criticism.

8. The main difference between the studies by Chang and Choi (1988) and Caves and Uekusa (1976) is in the interpretation of the dummy variables and in using them to analyze the relationship among strategy, structure, and performance.

9. The total number of listed companies in the manufacturing sector, as of 1984, was 216. Thirty-four companies that were listed for less than 10 years were omitted from the sample.

10. Inclusion of the export share variable in the efficiency model is probably a misspecification for the Korean case. The rationale given by Encaoua and Jacquemin (1982) for its inclusion is the high degree of uncertainty and the high cost of information in marketing products internationally. This definitely is not the case in Korea, where seven general trading companies are responsible for marketing nearly half the country's exports.

11. The total assets of chaebol averaged 500 billion won, whereas the average total assets of non-chaebol groups was 235 billion won.

Korea's industrial development is intimately intertwined with the emerging economic power of Korean business groups, the chaebol. The Korean government has favored and heavily supported the chaebol. As a result, chaebol now command the capital and clout to make huge investments in industries such as shipbuilding and semiconductors. Each is prone to enter every important Korean industry, especially if one of the others does so. Each also aggressively uses profits from some of its businesses to subsidize new entry and growth in others. The incentives to mobilize resources and take risk are much greater than is typical of firms in most developing countries, where there may be only one or two large business groups that feel little competitive pressure. The chaebol groups have diversified using typical portfolio management strategies. Using their access to capital, management talent, and clout with the government, the chaebol entered any industry that looked promising or that the government had targeted, irrespective of its relationship to the other firms in the chaebol. This approach is in stark contrast to the strategies of leading firms from most other nations such as Germany and Japan and has led to firms that are widely diversified in unrelated fields but are still managed with a high degree of central control (Porter 1990).

The strategies of the large chaebol groups have fit the Korean environment thus far. Aggressive managers, heavy government-backed capital investment, and low-cost labor are their principal sources of advantage. However, there are real questions about whether this corporate structure, and the concentration of economic power that goes with it, will benefit national competitive advantage in the future. A final and essential underpinning of Korea's competitive advantage is the fierce and even cutthroat rivalry that characterizes every successful industry. At least four or five companies compete in every significant industry, often including a subsidiary of each of the leading chaebol. Given the goals and attitudes of Korean managers, it should not
be surprising that rivalry is intense and emotional. Because most chaebol firms compete with similar cost-based strategies, they meet head-to-head not only in the domestic market but abroad as well. This competition creates continued pressure to invest, improve productivity, and introduce new products. The presence of committed chaebol rivals mitigates any tendency for firms to compete solely on the basis of low labor costs. The rivalry among chaebol companies is so fierce that the government on occasion has intervened to prevent "destructive" competition.

Episodes of government intervention in the automobile industry, such as those that occurred in the early 1980s, threaten the long-term success of the industries involved. Repeated intervention will eventually diminish domestic rivalry and limit investment and upgrading. Fierce domestic and international competition among chaebol firms has been essential to Korean success and is one of the factors that has set Korea apart. The tendency to intervene in rivalry is a dangerous one. The proclivity of the government to intervene directly in individual industries has a more mixed record. The role of the government in channeling capital was vital when capital was short. Subsidies and loans targeted to particular industries were common in the 1960s and 1970s. Protection of the domestic market from both imports and foreign investment was common. However, domestic rivalry was so fierce that protection did not usually dull incentives. The government also sought to secure the best terms on foreign technology licenses in chosen industries, an action that lowered the cost of obtaining technology and speeded up the process by which chaebol firms developed their own technical capability.

Yet Korean targeting has been wrong as often as it has been right. A major focus on chemicals, plastics, and machinery industries consumed large amounts of scarce resources with only modest results. Government's selection of areas for cooperative R&D projects has had a mixed record as well. Government targeting distorts private expectations and incentives and can obscure the sectors with true prospects for competitive advantage. Targeting has been heavily concentrated in a relatively small number of mostly end-product industries and has resulted in a narrow economy with very shallow clusters. Heavy reliance on the widely diversified chaebol as a primary engine of economic development only accentuated these problems. Korea provides a striking example of a rapidly upgrading economy. Its competitive advantage has thus far rested largely on basic factor conditions (principally human resources), investment-oriented company and managerial goals, and fierce domestic rivalry. Korea's unique-
ness as a nation comes from its rapidly improving talent base, the presence of the large chaebol, the willingness to take risk, and the intensity of competition. The combination of skilled and productive labor with aggressive investment to acquire technology and build modern, large-scale facilities has created low-cost positions in a variety of industries and industrial segments.

Synthesizing the empirical results on the organizational efficiency in the previous chapter, Korean chaebol groups pursue a growth and stability-led strategy compared to a profitability-led strategy with diversification focusing on the manufacturing sector. The quantitative growth-led strategy with the higher degree of diversification was advantageous for chaebol's growth until the 1970s because of the characteristics of the Korean economy of a subcontracting export-led strategy. Since the 1980s, however, this strategy of the chaebol groups has confronted a number of problems. In addition, the negative effects arising from the concentration of economic power of the chaebol groups induced change in the chaebol's strategy as well as in government policies formulated to continue the chaebol's self-sustaining growth and maintain a sound Korean economy.

Beginning in the mid-1970s, the government began to pay attention to the chaebol issue and the concentration of economic power. In an attempt to restrain the rapid expansion of conglomerate groups and to promote fair trade practices, the government introduced various measures and regulations. These included special presidential directives, a bank credit control system, and the Monopoly Regulation and Fair Trade Act (Fair Trade Act). Facing ever-increasing criticism of government favoritism toward large chaebol groups and their increasingly dominant position in the nation's economy, the government issued a set of special presidential directives aimed at opening up privately held firms to public ownership and control, reducing reliance on debt to improve companies' financial structures, and prohibiting illicit wealth accumulation through socially undesirable practices (Y. Lee 1990).

An earlier effort was the measures of May 29, 1974, which proposed to induce large chaebol into going public on an extensive scale while simultaneously improving their financial structure. Another notable attempt was the measures of September 27, 1980, which aimed at preventing the corporate liquidation system, limiting real estate holdings by companies, minimizing rescue loans, and tightening supervision of bank loans. For these purposes, the government provided financial and tax incentives for companies to go public. At the same time, heavily indebted firms were directed to improve their financial structures by increasing the share of equity in financing new projects. In an
effort to enhance the public credibility of corporate reporting, an external auditing system, disclosure requirements, and a tax surveillance system were also enforced. However, changes in the economic environment and inadequate administrative support caused these measures to be terminated prematurely without any visible results.

One of the most significant steps in curbing the excessive expansion of conglomerates and in reducing their heavy reliance on bank borrowing was the introduction of a monitoring and control system for bank credit allocation, especially for a designated group of top chaebol firms. Since, as discussed earlier, privileged access of chaebol to subsidized bank loans was considered a major factor in the rapid expansion of Korean conglomerates, the government in 1974 introduced the "prime bank system," which assigned banks to monitor specific heavily indebted companies for effective credit control. Under this system, chaebol groups with outstanding bank credit above a certain amount and with high debt-equity ratios were ordered to improve their financial structures and were prohibited from establishing or acquiring additional businesses, receiving loan guarantees, purchasing stocks of other companies, or acquiring non-operating real estate.

The prime bank system has been modified and strengthened since its introduction. In 1984, for example, the government temporarily froze the aggregate amount of bank loans and guarantees extended to the top five chaebol groups. According to the new scheme, the so-called basket system chaebol groups as a whole became subject to credit limits. This change reflected the government's determination to curb the highly leveraged expansion of chaebol; the scheme proved effective in curbing the share of bank loans to top conglomerates groups. These various measures were implemented at different points in time with different intensities. As one might assume, one could not expect much from such a poorly coordinated policy. There were certain cases, on the contrary, in which some chaebol groups even benefited from government policy for industrial rationalization.

The Fair Trade Act, enacted in December 1980, attempted to encourage fair and free competition by prohibiting market-dominating power by entrepreneurs and excessive concentration of economic power. The act prohibits any business combinations that may substantially restrict market competition. When it seems likely that market competition may be compromised in a particular field of trade, companies are prohibited from acquiring stocks of or interlocking directorates with other companies unless they are granted permission by the minister of the Economic Planning Board. As pointed out earlier, a direct and specific restriction on chaebol groups was introduced
into the Fair Trade Act by its first and second amendments, in 1986 and 1990, respectively. By these amendments, holding companies are prohibited, and subsidiaries of the same chaebol group are not allowed to invest directly in each other. In practice, the limit imposed on subsidiaries of chaebol groups poses a stronger constraint, restricting their total investment in other companies to less than 40 percent of their net assets. This stipulation is also applied to banks and insurance companies that are also subsidiaries of chaebol groups. Furthermore, such companies are not allowed to exercise their voting rights in their domestic subsidiaries.

Restriction on investments by subsidiaries of chaebol groups has had some effect since the amended Fair Trade Act began to be enforced in 1987. For effective control of chaebol, however, it is necessary to simultaneously mobilize other policy tools including taxation and credit rationing. It should also be noted that the restriction on the investments by subsidiaries mentioned above does not cover the absolute amount of the investment itself, but the investment ratio in terms of net assets. Consequently, the absolute size of subsidiaries or chaebol groups may even increase as a response to the restriction because they can always justify the amount of their current investment simply by enlarging their net assets. Though this new legal measure evidently improves the financial structure of the companies concerned and serves to dissipate their ownership to some extent, it seems to fall short of deconcentrating ownership of chaebol groups in any significant way.

**Policy Implications**

The new circumstances require a change in the role of the Korean government. Direct intervention in individual industries, reliance on the chaebol as a prime development tool, widespread protection, emphasis on basic factors, and directing capital through government decisions were appropriate in the earlier stages of Korean development. But such policies must give way to a new set of priorities if Korean industry is to progress further. Economic decision making should be decentralized into a growing number of private-sector hands. The prime role of government must shift from direct intervention to providing the resource foundations for upgrading and creating a more challenging environment in which firms can compete. Rule setting needs to replace government’s direct role in decisions. Efforts to stimulate investment in advanced and specialized factors, upgrade home de-
mand, institute world-class product and environmental standards, deconcentrate economic power, and preserve rivalry are prime government roles in moving to the innovation-driven stage. The job of factor creation must increasingly fall to industry as well as to universities and research institutes with close ties to industry (Porter 1990).

**Pro-competition**

The concentration of economic power may be inevitable, so long as a discrepancy in entrepreneurial capabilities among individuals exists. At the same time, diversification of business activities, often a criticism of the chaebol, is, at least partially, a natural manifestation of profit-seeking and risk-dispersing motives. Therefore, public policy toward chaebol groups should tread the line between discouraging their inefficient or anti-competitive diversification and respecting bona fide entrepreneurship. The most effective means for this may be to expose the chaebol to competitive pressures. Faced with tight competition, a firm has to shed its excess and inefficient management. In this respect, a pro-competition policy such as removing entry barriers to firms from home and abroad is both fundamental and necessary (K. Lee 1990).

It has sometimes been suggested that the government mandate that the chaebol curtail their scope of diversification and focus on a few narrowly defined business fields. Notwithstanding the practical need for specialization of business groups, government coercion of the chaebol to select a predetermined set of specialization areas would violate the free-market mechanism. This statement should not be construed as unconditional support for laissez-faire policies, however. I merely want to draw the line between areas that should be left to the proper working of the market mechanism and those that are appropriate policy interventions of the government.

What is needed for firms in the ever-changing world is not a blind adherence to the same old market but flexible adjustment, resulting at times in diversification across different markets or in focusing on a niche in the firm’s traditional market. The characteristics of a firm are defined not by the nature of its products, but by the nature of its managerial resources. Even among firms in the same market, therefore, the pattern of adjustment, in terms of both internal reorganization and product mix, will be different when market conditions change. It is hence a matter of course that the government does not interfere in the decisions of private firms, providing instead competitive incentives for the self-specialization of firms.
The Korean economy has benefited thus far from the presence of the chaebol. They have mobilized resources, taken risks, and spearheaded success in a range of industries. Their vigorous competition with each other has been essential to Korean dynamism. At this stage, however, the chaebol’s role in the economy must not only change but must become less central if rapid advancement is to continue. The presence of more independent companies that are more focused in specialized fields will foster innovation and be a force for upgrading competitive advantage. More centers of initiative, more potential buyers for new products and services, and less political clout in the hands of a small group of firms will be essential to further Korean economic development. This is particularly true in machinery, specialized inputs, intermediate goods, consumer packaged goods, and services (Porter 1990).

As is true in any rapidly advancing economy, the vigor of domestic rivalry has been essential to Korean industrial success to date. It has fostered dynamism and set Korea apart from other developing nations that attempted to upgrade their economies via state-owned firms or protected monopolies. There are inevitable pressures in Korea to curb domestic rivalry. In addition, the ability of large groups to discourage entry is considerable, given their size and relationship with government. It is important for the government to resist the tendency to focus on the short-term “inefficiency” of domestic rivalry and miss its fundamental significance for dynamic progress. Strong anti-trust laws need to be established, as well as an orientation to prevent too much concentration in Korean industries. Mergers that consolidate an industry to one or two firms should be prohibited.

One of the policy measures toward pro-competition is to foster small and medium-sized industries (SMIs). This policy has been based on a number of objectives, including an “affirmative action” program to offset past discriminatory access to credit and prevent any abuses of credit markets by monopolistic borrowers, i.e., the large firms. These measures to overcome distortions in the credit market are “second-best interventions” and should be considered prudent and useful interim measures until capital market biases can be wrung out of the system. In the absence of these credit market distortions, however, government should be neutral in its stance on the size of production units as there is no conclusive evidence that smaller firms are inherently more efficient. Moreover, even if smaller production units have some technological or cost advantages, the ultimate ownership structure should not necessarily favor SMIs unless government has additional public policy objectives in mind.
Other objectives of an active SMI policy can include equity considerations as related to income distribution, for example, or general anti-trust goals. It is often argued that to limit the power of the conglomerate, the seeds of new conglomerates need to be spread. Thus, SMIs are seen as a political as well as economic counterweight to the chaebol. A second rationale for explicit SMI promotion revolves around employment generation inasmuch as smaller firms are more labor-intensive. Indeed, an argument can also be made that smaller firms are better able to withstand demand shocks because they have greater flexibility to adapt their production techniques and products. This flexibility is, of course, dependent on access to capital. Finally, in addition to employment externalities, there may be technological advantages to the economy of SMIs in terms of innovation; however, a distinction should be made between small industries and medium-sized industries because some minimum production levels are normally needed to sustain certain modern technological innovation.

Dissipation of Ownership

As implied by the discussion thus far, the core of the chaebol issue cannot be remedied until the ownership of business groups is shared widely by the general public. In pursuing this goal, however, the pace of ownership deconcentration must be tuned to many factors including the level and distribution of personal income, the financial structure of corporations, the sense of managerial responsibility, and the conditions in the stock market. A once-and-for-all dissipation of ownership as witnessed in postwar Japan may result in concealed ownership or a zero-sum redistribution among well-off individuals, including large shareholders of business groups. Instead, therefore, we must endeavor to attain the goal through comprehensive and long-lasting efforts. In the past, neither did the majority of the chaebol seek to go public in the stock market nor did the government eagerly enforce the Act for Promoting the Public Offering of Corporate Securities. It is therefore recommended that the government impose strong measures, such as a restraint on bank credit and the issuance of bonds, on companies that resist going public even though they meet legal requirements (K. Lee 1990).

To prevent the chaebol's monopolistic control of the banking industry, the Banking Act should be amended to (1) narrowly redefine "the legally-acknowledged identical person," (2) further reduce the limit on chaebol ownership of commercial banks, and (3) introduce a similar limit for regional banks, which have been heretofore immune from
such control. It is also desirable for the dissipation of ownership to induce firms into repaying their bank loans by mobilizing capital in the stock market. The synergistic effect expected from chaebol groups does not require a strong financial linkage between firms, while intercompany shareholdings may entail various adverse effects. Therefore, the limit on the investment by subsidiaries of chaebol groups should be lowered further. Nevertheless, this recommendation does not nullify the lesson of the Japanese experience that, as a safety valve after capital liberalization, intercompany shareholding may be promoted to the minimum extent necessary as a means of protecting domestic firms against potential takeovers by foreign capital.

Unless the concentration of ownership of chaebol groups is leveled down, the seed of discontent will remain. General policies of income or wealth redistribution can have only a limited effect on this score because they are not specifically designed against majority shareholders of chaebol groups. For example, because the property tax, income tax, and death tax are levied on all taxpayers, the upward calibration of these tax rates cannot be considered a proper measure for preventing the concentration of economic power. Consequently, we must come up with a policy aimed specifically at dissipating the ownership of chaebol groups. Such a policy must entail making subsidiaries of chaebol groups go public with the issuance of stock and concurrently inducing the general public to participate more in the stock market. This step must be preceded, however, by improvement in the general income level and distribution, upgrading of the corporate financial structure, enhancement of managerial professionalism, reductions in opportunities for other speculative investments, and betterment of the overall environment of the stock market. Consequently, we cannot jump beyond the factual constraints to reach the final goal, and we must instead make consistent, long-term efforts on a wide front. One effort in this direction is the recent proposal of the government to add to the Fair Trade Act a provision forbidding direct intercompany shareholding between subsidiaries of business groups and limiting their total investment.

Finally, although its effects are not limited to the question of economic power, the disclosure of information cannot be overemphasized in Korea. If the real picture of chaebol groups and related policies is sufficiently disclosed, then purely emotional biases and prejudices against the government and the chaebol will be eliminated. Through the analyses and evaluation of objective data, general doubts and distrust will die down to the extent that they are ungrounded, and more lessons will be learned from past mistakes. Likewise, as correct and
sufficient information is rapidly disseminated, it will function as a sort of social filtering mechanism, which itself can contribute to preventing inefficient concentration of economic power and its adverse effects. As the largest producer and distributor of information, the government must disclose all the relevant information that it holds and discuss policy options in public.

Management Implications

In view of changes emerging in Korean society, challenges lie ahead for contemporary chaebol groups. If the chaebol are to continue to grow and prosper, they must find a way to adapt to these societal changes, as well as other changes and challenges occurring throughout the world. Indeed, it is a time of decision for the chaebol. Despite significant economic progress—indeed, partly because of it—Korea today faces increased challenges on the economic front. From a macroeconomic standpoint, it needs to maintain a high growth rate so that economic development continues. However, tension is increasing between Korea and its trading partners (especially the United States and Japan) over the trade imbalances brought on by Korean economic success (Steers, Shin, and Ungson 1989).

In addition, many countries accuse Korea of failing to open its markets to foreign products and competition. Indeed, when the Korean government reluctantly reduced some trade barriers (as it did for tobacco, movies, and some farm products), "popular"—that is, highly organized—protests and boycotts were initiated until the government relaxed its efforts. To the extent that protectionism diminishes and a more open market economy emerges, the chaebol will face an increasing need for professional managers to meet the growing competition. At home, there is a need to further develop internal markets and satisfy the increased consumer demands of a more prosperous society. Korea has a growing middle class that is anxious to see the fruits of its labor, and to a large extent, political stability in the future rests with the government’s ability to fulfill these expectations. Throughout the expansion of both their internal and external markets, the chaebol will have to find new ways to secure the necessary financing for growth because government-controlled sources have diminished. Because the chaebol groups are highly leveraged (with high debt-equity ratios), many of them are in precarious financial positions.

Political changes have significantly affected the chaebol. In essence, the move toward democratization has greatly diminished—although
certainly not destroyed—the power and influence of the “old boy’s network” between corporate executives and high-ranking government officials. Such relations will of necessity continue to be a central aspect of doing business in Korea, but the previous intimacy between these two groups will be less evident. Even so, the new political climate and its resulting revised contract between business and government also mean less government-sanctioned corruption and more efficiency through increased competition. It is also beneficial for small and medium-sized companies and subcontractors that in the past have often found themselves excluded from competition by the major firms. The changes also mean that companies in the future will have to rely increasingly on professional managers to skillfully guide them through the new industrial competitiveness.

Korea faces an increasingly complex technological environment. It has found it relatively easy to acquire aging technology and compete on the international marketplace based on product price. This is largely how the chaebol entered markets such as consumer electronics, automobiles, and household appliances. Today, however, as the half-life of technology-based products declines and as labor costs escalate, it has become increasingly important for chaebol groups to develop their own technology and be first to market. This puts these chaebol squarely in competition with American, Japanese, and European companies that have far more resources to devote to research and development.

Furthermore, changes that are occurring in Korean society are also affecting labor-management relations and the nature of human resource management. Employees at all levels are increasingly demanding a greater share of the benefits of the emerging economic prosperity. The new movement toward political democracy has fueled demands for workplace democracy, with greater worker autonomy and participation. Strike activity has greatly increased, as have turnover rates. Commitment to the company, once assumed, is now seen as diminishing, and workers are demanding greater input in corporate decisions: they want work councils that have real substance. In short, Korea has reached the stage of rising entitlement, where people feel they deserve more. Such is the nature of successful economic development.

In the increasingly competitive business environment facing companies today (with fewer government guarantees, more competition, higher labor costs, and so forth), a company’s human resources become a vital asset. However, just when Korean companies need this asset most, labor’s commitment remains unclear. Hence, a major challenge facing contemporary firms in Korea is how to negotiate a new social contract that is acceptable to its workforce at all levels of the or-
ganization. To meet these challenges, chaebol groups should change the existing structures and strategies. The chaebol should pursue the core business-related diversification strategy and establish a professional management system through the separation of ownership from management.

The chaebol will increasingly focus on growth and development through logical incrementalism. That is, whereas in the past chaebol moved into new businesses based on hunches or random opportunity and often grew unwieldy as a result (called the "octopus strategy"), the emphasis in the future will be to develop more refined business lines and focus developmental efforts within these areas. This is not to say that unique opportunities will not be explored; rather, the general trend will more than likely be that the chaebol will become more conservative in their corporate strategies and tend to focus on their core businesses. In view of increased competition, increased R&D expenditures, and decreased government support and guarantees, this is simply a wise course of action.

The chaebol have become unwieldy conglomerates. Their further development as international competitors will require a shift from unrelated diversification to more integrated corporate strategies. Each group must identify a narrower range of fields, related by technologies, channels, or customers, in which it seeks to become a world leader. Selling off businesses peripheral to these core fields will allow the focusing of company resources on improving technology, developing brand awareness, mastering production skills, and solidifying foreign distribution channels. These steps are all essential to moving from cost-based competitive advantage to innovation- and differentiation-based advantage. This shift in corporate strategy will benefit not only each group but the Korean economy as a whole. Japan prospered after the zaibatsu were disbanded. Shifting strategies by the Korean chaebol will benefit Korean national advantage in many of the same ways (Porter 1990).

Because of the political move toward democratization and decentralization and because of the economic shifts requiring competitive skills, control of the major chaebol will continue to evolve toward control by professional managers instead of owners or family members. This trend will be somewhat accelerated by the increasing age or death of the original founders who once ruled with tight controls. In some of the chaebol, such as the Lotte Group, none of the founder's sons wish to be involved in the business. Because of these changes, increasing reliance on well-trained professional managers will become a hallmark of many Korean firms.
Whatever the policy may be, its intended effects will not be fully realized unless the chaebol are determined to observe the economic morality expected from them. This is true of all policies and laws, but is all the more so for a chaebol because of its economic power. As the proper working of the invisible hand of the market mechanism requires a minimum of commercial morality, the absence of social responsibility on the part of chaebol groups will undermine government policies. The more imperfect the market mechanism and the more unequal the distribution of market power, the more important is the economic morality of chaebol groups in an economy. From a purely economic viewpoint, it may be justifiable for the chaebol to emerge as an optimal response to given market conditions and to pursue profit maximization using their economic power. Nevertheless, they are strongly urged to abide by economic morality more than expected from other firms, for much of the root of the issue of economic power lies in such extra-efficiency areas such as distribution, equity, social justice, and the sense of community.

Last but not least, the importance attached to commercial morality or economic ethics of the chaebol must be emphasized. Basically, as far as the profit motive of private firms is considered legitimate in the capitalist system, their performance can be conditioned only by legal and social constraints binding their activities. Therefore, it is more logical to set up appropriate constraints than to rely upon moral persuasion if we desire a "fair" business performance. However, we can neither establish a perfect system of such constraints nor force all individuals to abide by such rules. This is where economic ethics comes into the picture. Economic ethics should be emphasized more for chaebol in light of their past evolutionary process and potential. Insofar as the "invisible hand" may not function fully without a modicum of commercial morality in each economic agent, any economic policy will be neutralized similarly if chaebol groups do not recognize their social responsibilities (K. Lee 1990).
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