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Chaebol companies as the backbone of South Korea's  
economy: Birth, growth, and later abuse of power.

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Academic Year 2020-2021

## **Abstract**

During the 19<sup>th</sup> century, chaebol business groups played a fundamental role in the growth of the Korean economy. However, they have grown into powerful monopolies able to abuse of their dominant position to the detriment of SMEs.

Through an historical overview, chaebol companies are analyzed to understand the processes that favoured their birth, excessive expansion, and later concentration. Although the Asian financial crisis called for reforms to limit their power, these family conglomerates are still dominating several industries and preventing other companies to enter and compete against them.

New businesses focused on innovation and digital markets could threaten chaebols' position. Nonetheless, without a strong and decisive government intervention, chaebols will maintain their influence and consolidate economic imbalances.

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## **Introduction**

Nowadays, South Korea is one of the largest economies of East Asia and the 7<sup>th</sup> largest exporter of the world. The capital, Seoul is not only an important part of Korea's cultural heritage but also the global city which has contributed to the country's image and economy.

Until the 1960s South Korea was an extremely poor country. However, during the second half of the 19<sup>th</sup> century, the Republic of Korea has experienced an unprecedented economic growth at an extraordinary speed. This growth and development were mainly due to the strategic and successful intervention of the government and the growth of chaebol, a business conglomerate system that generated and developed in the same years. Chaebol companies rapidly became relevant in certain industries and markets not only nationally but also internationally. They are indeed considered together with the government the main engines of the country's economic development and consequently what made South Korea such a powerful nation.

Chaebol businesses helped the country to establish itself as a leader of innovation known for its technological advancements in the automotive, mobile phones and shipbuilding industries. Nevertheless, they have today an extremely high market power. In 2020 they comprised 84% of GDP but only 10% of jobs. They are considered a threat for the health of Korea's economy as their abuse of power makes markets less competitive, especially at the expense of small and medium enterprises.

The aim of this paper is to describe the role of chaebol companies in South Korea's economy and to understand the complicated relationship between these firms and the government. On the one hand, they are an essential part of South Korea and played a major role in the country's rise after the Korean War. However, on the other hand, they have a huge power which creates imbalances in the economy.

In the first part of this paper an overview of South Korea's economy before and after its rise will be analysed. Afterwards, the focus will shift entirely on chaebol companies to understand their establishment, growth and contribution to the country's success. Some concerns relating to chaebol firms' relevant position in the economy, such as considerable political influence, economic and social issues, the financial crisis in 1997, will be analysed.

Although crucial for the development of the country, chaebols are more and more criticized, having been accused of limiting the expansion of SMEs and eroding consumers' welfare as

well as of bribery and corruption. Thus, the paper will also focus on such anticompetitive concerns. Lastly, the final part of this dissertation will explain the reforms deployed during the years and the causes of their failure including a conclusive overview on today's new players of the Korean economy, competitors which could eventually restrict chaebols' power.

# 1. THE MIRACLE ON HAN RIVER

“The Miracle on Han river” refers to an era of industrialization and massive economic development experienced by South Korea. This expression coined after “the Miracle on the Rhine” describes the sharp expansion of the Korean economy during the second half of the 19<sup>th</sup> century like Germany did after the Second World War becoming a global economic power.

Even though South Korea is nowadays well known for the giant Samsung or the automotive manufacturer Hyundai, the beginning of the last century was characterised by extreme poverty. Together with Taiwan, Hong Kong and Singapore jointly known as the “Four Asian Tigers”, South Korea economically joined the Western rich countries in the span of three to four decades. Indeed, the post-Korean war years were characterised by improvement of living while its neighbour North Korea once part of the same nation returned to a state of disease and starvation.

In this chapter South Korean history and economic policies are analysed. In the past several decades, the country not only underwent through economic changes but also political turmoil. The aim of this section is to understand the historical and cultural context in which the country developed and make the reader much more aware of the conditions under which chaebol companies emerged.

## 1.1 Japan and Korea

In 1905 the Korean Peninsula became a Japanese protectorate and then a full colony in 1910. Unlike other colonies Korea was characterised by a common ethnicity, language, and culture, with recognised national borders since the 10<sup>th</sup> century. The process of becoming a colony of Japan struck the country very hard: Japanese ruling replaced the so-called *yangban* scholar officials, namely the aristocracy who ruled the nation up until that moment, a Japanese modern education system was established and controlled for thirty-five years, and the Korean language was banned. In 1939 Koreans were even required to change their names in Japanese style surnames.

Japanese colonization tried to destroy the national identity of Korea through many prohibitions and bans which were eventually loosen after the nationwide protest of 1<sup>st</sup> March

1919. Nevertheless, Japan, having full control of the country, implemented a set of expensive policy to modernize the peninsula.

First, one of the key projects was to improve infrastructure. Some examples are the extension of railway lines and the overall improvement of roads, harbours and communication networks. Also, advancement in healthcare and public hygiene, the introduction of modern medicine, and the building of hospitals decreased mortality. Consequently, the population expanded 1,4% per year from 1925 until 1940. In particular, the population increased from 19 020 000 in 1925 to 25 120 000 in 1944 (Cha, 2012). Even though out-migration occurred on a considerable scale, the population density rose from 81 in 1910 to 114 per km<sup>2</sup> in 1945 at the end of the 35 years of colonization. (Kwon, Lee, Chang, Yu, 1975).

Moreover, the Japanese government established a central bank, development banks and financial cooperatives. Imperial Japan estimated that over 80% of total Korean households were engaged in agriculture, and therefore, the financial system was underdeveloped. Some type of financial institutions such as landlords or moneylenders already existed but were informal. In addition, there was not even a uniform currency in circulation. Therefore, during the colonisation period, a private Japanese bank Dai-ichi Bank functioned as a central bank for Korea and helped the process to establish a new monetary system.

As part of the colonisation trade-off, Japan's manipulation of educational system and economic development projects, aimed at serving strategic and economic functions, increased a sense of national identity and awareness (Toby, 1974). Throughout the years, the Koreans carried out protests which, however, were violently suppressed. Only on 15 August 1945, the country was liberated as the Japanese Emperor Hirohito announced the surrender of Japan and marked the end of WW2. The American War Department drew a line at the 38<sup>th</sup> parallel of Korea, dividing the peninsula in halves and determining the areas in which American and Soviet troops were deployed.

Nowadays, South Korea and Japan are both democracies and trading partners. However, colonization left a high degree of mistrust between the two countries especially from the older generation.



## **1.2 The Korean War & after**

The three-year long Korean War started on June 25, 1950, when North Korean troops invaded the South. An apparent civil war started out. However, as the two separate territories were occupied by world powers, the war revealed itself to be an international one between UN forces in the South, and China and USSR in the North.

With the end of the Second World War and the subsequent Korean War, the impact on both Korean economies was immense. The damages done in these three years were devastating. Major industries were strongly affected. Indeed, 70% of textile industry, 70% of chemical industry, 40% of agricultural machinery industry, and 10% of rubber industry were estimated to be destroyed. In addition, 600 000 housing units, almost 50% of railroads, a total of 500km of roads, 1453 bridges, 44% of factory buildings and 42% of production facilities laid in ruins. The destruction of electric facilities had also drastic consequences on productive activities (Lee, 2001).

The war damage amounted to a total of 41.23 billion won which are equivalent to US\$6.9 billion. In addition, foreign trade decreased from US\$208 million in 1948 to only US\$2,9 million already in 1950 (Lee, 2003).

On top of that, the Republic of Korea suffered also from serious inflation. At the beginning of the war the total money circulating increased by 72%. The government issued new money to finance war expenses which could not be covered by the temporary increase in taxes. By the end of the conflict, currency in circulation increased by 24 folds.

### **1.2.1 Economic reforms**

Although the South Korean government under president Syngman Rhee implemented two major economic reforms to lift the country after WW2, their objectives changed and were distorted to meet the war needs. The two reforms concerned were the Farmland reform enacted in June 1949 and the Enemy property privatization established in December 1949.

As previously mentioned, the reforms served war necessities rather than addressing economic objectives. Thus, the Farmland reform was executed to provide war supplies. Farmers willing to buy farmland could do so by paying 150% of the average annual product with their farm products and not with money. Therefore, the burden imposed to farmland

owners was huge, since the tax rate progressively increased from 15% to 28% and it had to be paid with products. Moreover, one-third of their production had to be sold to the government at an official price. For these reasons, there were no incentives to improve production and many of them eventually sold their land.

With reference to the Enemy property privatization reform, old landlords were obliged to sell all the farmland that exceeded three *chongbo* (1 *chongbo* = 0.993 hectares), in exchange of a voucher that could be used to purchase properties at public auction.

The main objective of the reform was to offer benefits to landlords by giving these vouchers to purchase factories and businesses. However, most of the landlords sold these vouchers as their real value declined because of inflation, apart from the difficulty to operate a business during that specific historical period. The reform ultimately resulted in 1953 in only 7% of sales of enemy properties (Lee, 2001).

### **1.2.2 The 1950s: US aid and South Korea post-war policy**

Since 1945 South Korea has been receiving aid coming from the US. Precisely, from 1945 to 1948 the southern half of the peninsula was under US trusteeship. In this period, the US provided South Korea with emergency relief aid, namely the Government Appropriations for Relief in Occupied Areas (GARIOA) aid. GARIOA assistance was provided under the control of the US Army Military Government in Korea (USAMGIK) and consisted of 70% in grains, food, fuel, clothing, and fertilizer. It definitely served its function as source of emergency relief aid to support the country after the war and the Japanese occupation.

In 1948 when the Republic of Korea was established, the country was suffering from economic and political instability. Indeed, the government lacked the capability to implement successful economic plans and therefore, could not effectively use and exploit foreign assistance. That is why, in the same year, the Economic Cooperation Agency (ECA) Seoul office was created with the purpose of building a sound economy for the country. In addition, ECA replaced GARIOA as source of emergency assistance and invested in three essential industries: coal mining, thermal power generation, and fertilizer (Kim, 2013). Therefore, between 1949 and 1953 the US continued to assist South Korea, though with a reduced emergency relief budget. Indeed, the Korean War affected and worsened the US budget deficit, which increased tremendously (Park, 2000). Consequently, the assistance

from ECA which amounted to \$201,807 million was considerably lower than GARIOA aid, which in turn amounted to \$409,394 million.

In the following years, the US continued to be the most influential donor to South Korea. From 1953 to 1960 the US provided aid focusing more on the strengthening of the South Korean Military defense. Given the position of the Republic it was crucial for the US to have control to prevent the expansion of the communist bloc.

After the Korean War, the country was able to recover quite quickly. The Korean economy achieved a 3.5% annual economic growth rate during 1954 and 1961, which is obviously higher than 2.8%, growth rate of the 1946-1953 period. The post-war inflation was also reduced to 20% compared to the 120% inflation rate of the former period (Lee, 2001).

Furthermore, the South Korean government started to be more independent and to focus more on the reconstruction of the country, by establishing the Ministry of Reconstruction, which main role was to bring national economic stability and manage foreign assistance. Moreover, the Korea Development Bank was established with the scope of providing funds to mainly large companies under the condition to use funds to rebuild infrastructure. The government was therefore responsible for the rise of big businesses as they benefited from aid materials and other advantages such as lower interest rates for their loans and other tax credits. However, one of the consequences of the government favourable behaviour towards these firms is that during the 1950s there have been no real industrial development as the value created was transferred through political connections. Moreover, companies started to form cartels and consequently monopolized the industries of cotton, wheat and sugar (Lee, 2001).

All in all, US aid helped the Republic to recover from the war, but it remained still a poor country compared to its neighbours. Special benefits given to few businesses and corruption have resulted in low economic productivity.

## **1.3 Park Chung-Hee**

The Korean war had drastic consequences on the economy. With a GDP equal to \$1.5 billion and per capita GDP of \$70 in 1954, South Korea was one of the poorest countries of the 1950s.

The rapid development of its economy has been historically associated to General Park Chung-Hee who seized power in a coup d'état in May 1961. Even though, he was certainly a controversial figure, he is also considered the man who made the Miracle begin.

After the war, Korea remained a poor and underdeveloped country. Rhee Syngman who was president of the Republic of Korea from 1948 to 1960 was not able to improve the economic situation of the country and overall dissatisfaction spread across the population.

There were several reasons for this underdevelopment. First, one of the causes was widespread corruption. A significant amount of aid was appropriated for private use and only few selected citizens could reap the benefits. Moreover, in the following years the government focused on import-substitution policies which could not generate significant growth. Confronted with political and economic instability, Rhee stepped down and resigned from his position.

### **1.3.1 Export Oriented Industrialization**

Park Chung-Hee had a different view on the role of the government for the economy. He was a strong nationalist who fought for the Japanese and was influenced by a doctrine which focus was on the centralized management of the economy.

One of the first decisions taken by Park Chung-Hee for the improvement of the country was to establish in 1961 the Economic Planning Board (EPB), a board composed by civilians who were experts in economic planning. Its function was indeed to transform the economy from being foreign aid dependent to becoming independent. In the same year, with a Special Law Dealing with Illicit Wealth Accumulation, Park secured himself that under this law entrepreneurs who undertook investments in line with him would be rewarded while the others would be penalized by confiscating their assets or even being arrested.

Going back to the EPB, in 1962, it decided to implement the first five-year plan strategy directed to improve the foundation of the economy and lead companies to start exporting.

From the early stages of Park presidency, the Korean government took the role of a “entrepreneur-manager”. The core of the policy was to help and subsidize companies that could achieve increasing exports but also those firms that could substitute domestic production for imports. Many incentives such as preferential access to foreign credit or credit extended by domestic Korean banks were given to push companies to achieve the nation’s objectives.

Although the first five-year plan prioritized both export expansion and import substitution, the government seemed to prioritize exports over import substitution. Companies that could delivered high exports were nurtured even more and entrepreneurs enjoyed rosier prospects of becoming more affluent. However, if the exports were not outstanding, then the government would not support those businesses anymore and allow them to fail. This was in fact one of the reasons why chaebol started to grow, as many of them enlarged their businesses and continued successfully exporting. In addition, another event that demonstrate the government priority for exports was the easing of some import restrictions for goods needed as inputs to exports.

In particular, the textile and apparel industry was one of the first to benefit from these policies and even though there were 15 firms engaged, competition was little as they created a formal cartel to receive loans. In 1961, 25% of exports were delivered by the textile industry, totalling \$5.7 million. After four years, total exports reached more than \$106 million of which textiles made up 41% (Graham, 2003)

During the 1960s, the government spent one-third of its expenditures for investment. Between 1963 and 1977, public enterprises indeed grew at an annual rate of 10% (SaKong, 1993).

### **3.2.1 HCI Drive**

At the end of the first five-year plan the EPB wanted to continue with exports expansion and develop industries where the Korean economy had some comparative advantage. Several trade agreements were negotiated during those years to transform South Korea into an exporting nation. Moreover, trade-related institutions such as the Korea Trade Promotion Agency (KOTRA), Korea Traders Association (KTA), and the Federation of Korean Industries (KFI) were created.

The board wanted to continue exports expansion with the light manufacturing industries. However, some divergencies raised as Park preferred to invest and develop the heavy industries. On the one hand, the EPB was against the growth of new heavy sectors since they would require high rates of capital accumulation. In addition, there was no point for foreign lenders to lend money to Korean companies that were still little and with basically no experience. On the other hand, dependence on foreign finance was seen as an opportunity for the government to guide the economy. The government would act as a guarantor and consequently foreign lenders would be more incentivized to lend money to Korean firms.

The EPB second five-year plan announced in 1967 and meant to be implemented between 1971 and 1976 was designed to have a gradual shift from investments in the light manufacturing to heavy manufacturing industries. However, in 1973, Park changed strategy and launched the Heavy and Chemical Industry (HCI) drive with the Heavy and Chemical Industry Declaration. This change in strategy also marked a change in his way of governing the country. It is from this moment that he would suppress more and more the democracy and significantly decrease the influence of the EPB for economic decisions.

Nevertheless, the shift in strategy was a reasoned one. Protectionist measures for labour-intensive products were very likely to be implemented in countries where Korean products, like textiles, apparel and footwear were exported. This belief was also claimed by the EPB together with the rising competition from developing countries in Southeast Asia.

Six industries were selected: non-ferrous metal, shipbuilding, chemical engineering, electronics, steel, and machinery. A few acts were implemented during the years to promote these six industries: The Industrial Machinery Promotion Act of 1967, the Shipbuilding Promotion Act of 1967, the Electrical Industry Promotion Act of 1969, the Steel Promotion Act of 1970, and the Petrochemical Industry Promotion Act of 1970. The goals of these acts were to incentivize companies to enter these sectors by receiving easy access to foreign and domestic credit, again tax breaks and public provision of infrastructure were offered.

For instance, one of the objectives that the government planned for the steel industry was to build a 300 000 tons' steel plant and after diplomatic agreement with Japan, South Korea received the funds to build a 1 000 000 tons' steel plant in Pohang. Pohang Steel Company (POSCO) plant is today one of the largest steel plants in the world.

Furthermore, concerning the automotive industry, the goal was to promote domestic production of parts and components. In 1967, Hyundai Motor Company was founded and

later forced to produce a model on their own. This led to the mass production of the Pony model which was the first passenger car in Korea. Hyundai is nowadays a major international player in the automotive industry and its facility is the largest automotive manufacturing facility in the world.

In addition, Samsung Electronics was founded in 1969 and the Daewoo Group joined the electronics industry in 1973 with the setting of Daewoo Electronics.

It is important to underline the fact that for instance, Samsung was born in 1939 and Hyundai Engineering and Construction Company in 1947. Therefore, Samsung Electronics and Hyundai Motor Company were part of a group which was already relevant in the past years and expanded in new sectors where they could only benefit. The main concern arising from the HCI drive was indeed the concentration of wealth in the hands of few already wealthy families.

#### **1.4 Chun Doo-Hwan**

On October 26, 1979, after 18 years of ruling president Park Chung-Hee was fatally shot by the chief of the Korean Central Intelligence Agency (KCIA), Kim Jae-Gyu, during a dinner at the KCIA House in Seoul. Park Chung-Hee was succeeded by Major General Chun Doo-Hwan, who established another authoritarian government, against people hope for democracy. The widespread dissent burst into a massive protest in Gwangju on May 18, 1980. The demonstrations which involved many university students and professors were brutally suppressed and after 10 days of protests about 200 people were killed, 4141 were injured or tortured and more than 3000 citizens arrested. The Gwangju massacre is considered today a symbol of the early years of the democratic movement.

The 1980's were characterized not only by political turmoil but also by drastic changes in economic strategies. There were serious problems that Chun Doo-Hwan had to address: the HCI drive distorted economic growth and together with the second oil shock in 1979 worsened inflation. Moreover, it is important to remember that the country had a huge foreign debt used to finance the previous significant investments on the economy.

It was earlier mentioned that some companies, chaebol firms, could benefit more than others from the HCI drive. The Korean economic structure was in fact based on these big businesses and wealth was unevenly distributed. Furthermore, South Korea could not enjoy the high

exports that had before as the second oil shock caused international recession and the consequent rise of protectionism.

#### **1.4.1 Government policies**

One of the main objectives of the government was to reduce inflation and acquire economic stability. For this reason, the government implemented a contractionary fiscal policy. It stopped providing loans to private companies and expenditures were frozen.

The government understood the inefficiency of the government-led economic policy. Therefore, it decided to liberalize the Korean economy and minimize direct intervention. Liberalization was also favoured by an approaching end of the Cold War which meant open markets.

Despite the efforts of non-intervening in the economy, it was impossible for the government not to step in. Several large companies due to unfavourable internal and external factors were on the verge of bankruptcy. Many of them were insolvent but the government could not let them file for bankruptcy as they were “too big to fail”. Indeed, their failure would induce socio-political problems like the increase in unemployment, something that was not desired. The situation, however, was much more complex. Korean companies had to appoint a bank which acted as a creditor. The 5 major banks that were chief creditors of these large companies became insolvent themselves as they had to deal with non-performing companies that the government had bailed out (Kuk,1988).

In the end, the government had no choice but intervene. Nevertheless, it also tried to restructure the economy by distributing more resources to small and medium enterprises. It tried to help these companies with a rescue package which included loans from domestic banks to restructure companies that had difficulties. This restructuring was done through acquisitions, mergers, and legal management. Nonetheless, most of the insolvent companies which were favoured with preferential treatment were taken over by some chaebol companies. Therefore, they became wealthier as they received special loans for the insolvent businesses.



## **1.4.2 Results**

During Chun Doo-Hwan years some chaebol businesses could not survive whereas others like Hyundai, Daewoo, and Samsung became stronger.

Nevertheless, the policies adopted helped the country to gradually stabilize itself. Average growth rate was 8.7% and GDP in 1987 reached \$100 billion. Economic recovery was possible thanks to low oil prices, low interest rates and low exchange rates. The Korean won value decreased and consequently international competitiveness of Korea improved, and exports started to slowly increase again.

## **1.5 Democratization**

On June 29, 1987, Chun Doo-Hwan under domestic pressure announced the end of the military regime and the beginning of democracy. Roh Tae-Woo was elected president through popular election. However, its close relationship with Chun Doo-Hwan raised questions about his position. He was indicted for serious evidence of corruption which worsen his popularity.

Only in 1992, a real democracy started with the election of Kim Young-Sam, who reopened the corruption case of presidents Chun Doo-Hwan and Roh Tae-Woo. They were eventually respectively sentenced to life prison and seventeen years in prison for the suppression of the Gwangju massacre.

### **1.5.1 Roh Tae-Woo**

Under Roh Tae-Woo government, housing policies and a national health care plan were implemented. During this period the Two Million Housing Construction program was launched as a measure to reduce citizens discontent, but also political threat (H. Lee, 2017).

Moreover, the labour strikes and disputes resulted in the improvement of wage rates, shorter work hours, and improvement in working conditions. The average income of labour workers increased by 10% in 1987, 15.5% in 1988, and 21.2% in 1989. Also, the national health care plan started by Park Chung-Hee was extended to lower income classes.

As the average wage of labour workers in South Korea went up by 46.6% between 1987 and 1989, the country's international competitiveness was reduced. Economic growth was slow and dropped to 6.4% in 1989, while in 1988 it was 11.5%.

### **1.5.2 First half of Kim Young-Sam Administration**

The early years of Kim Young-Sam administration were characterized by economic growth. In 1992 when he was elected, the country was experiencing growth recession. Indeed, real growth has been really high in the previous years and for this reason the priority of the government was to decrease government intervention and liberalize the economy through globalization.

The EPB which had a relevant position during the first years of Park Chung-Hee's government, was substituted by the merger of the Ministry of Finance and Economics.

Moreover, the Korea Fair Trade Commission (KFTC) increased investigation of large businesses and punished violations if found. The KFTC was also responsible of keeping chaebols out of industries if their entry would cause harmful effects on competition. For instance, Hyundai was denied entering the steel industry as it would have extended the group's market power.

Also, Kim Young-Sam implemented anticorruption measures by adopting a "real name" system for holding accounts. From this moment, accounts with fictitious names were banned. This measure was implemented with the purpose of stopping chaebol executives to deposit funds into these accounts held by politicians.

The growth of the first half of the 1990s was export-led. Exports were dominated by three major industries: electronics, automobiles, and ships. For example, the largest exporter, electronics exceeded in 1993 a total of \$20 billion exports; the second-largest exporter, automobiles between 1992 and 1995 increased its production capacity and exported 1.09 million units in 1995. The third-largest exporter, the shipbuilding sector dominated by Hyundai, Daewoo, and Samsung was not a large employer. However, a slew of businesses depended on them. Therefore, the shipbuilding sector had an indirect role on employment.

The first half of Kim Young-Sam administration was very optimistic. Everything looked good, the Korean economy grew, and the annual compound rate reached almost 9% in 1995. However, a foreign exchange crisis was approaching, and it would stop the fantastic growth

of the country which, even though had ups and downs, was constant throughout almost four decades. Chaebols will be one of the main characters involved in the financial crisis as their financial structure was very problematic.

## 2. CHAEBOL: RISE AND FALL

During the second half of the 19<sup>th</sup> century, the Republic of Korea was able to transform from a traditional agrarian economic structure to a modern industrial structure dominated by chaebols, large and monopolistic corporations.

Established mainly during the 1950s, chaebol businesses have played a major role in the development of the country after the Korean War. They have been agents of reconstruction, growth, and innovation. However, the public tended to overlook at their preferential status and therefore, at the relationship these businesses established during the years with the government. Indeed, up until the 1980s they had an overall strong and positive reputation.

Their influence is still today relevant to the Korean economy. For this reason, South Korea is often called the “Chaebol Republic”. Being horizontally and vertically diversified, chaebols have been able to gain and sustain a powerful position within the economy often at the expenses of smaller businesses.

The aim of this chapter is to explain more in detail the establishment of chaebol companies, their consolidation during the 1960s and 1970s and the subsequent economic liberalization of the 1980s, focusing on their monopolistic and oligopolistic position, their increasing concentration and structure which will be the focus of reforms after the 1997 financial crisis.

### 2.1 A quick overview of Chaebols

Chaebol is the English transliteration of the Korean word 재벌 which derives from the Chinese characters of wealth “chae” (財) and group “bol” (閥). A chaebol is indeed defined as a business group composed by large companies in diversified business areas under the control of a single family. Such companies usually operate in many related and unrelated industries and are characterized by a high level of money concentration. Moreover, they are generally controlled by a single *chongsu*, the “supreme” leader who makes final corporate decisions for the entire group. The *chongsu* is usually the main blockholder as well as a member of the controlling family (Murillo, Sung, 2013).

The chaebol model is often compared to the Japanese zaibatsu or keiretsu. On the one hand, zaibatsu which name comes from the same Chinese characters of chaebol, were pre-war

business conglomerates under a centralized family control, much like chaebol companies. However, the main difference lies on formal ownership and managerial control. All management decisions in the Japanese zaibatsu were made by professional managers and not by family members. On the other hand, keiretsu refers to a group of interlocking companies formed after the WW2 and still existing today. Keiretsu are horizontally or vertically integrated but in comparison Korean chaebols tend to be much more diversified. Banks and trading companies, that control other subsidiaries, are of most importance in the keiretsu model, whereas the most prominent firms in the chaebol model are focused on petrochemicals, automobiles, electronics, and heavy machines.

All in all, business groups are not unique to Korea. US conglomerates, and the Mexican groups are other examples of similar corporate structure. In the case of chaebol, however, Confucian values are strictly observed. Therefore, in their management system, relationships with the family and the government are of critical importance. It is because of these relationships that these groups have been able to survive and expand.

Nowadays, the Korea Fair Trade Commission (KFTC), the administrative organization which formulates competition policies and handles antitrust cases, classifies companies and affiliates with assets of ₩5 trillion or more as large business groups. In 2020, the KFTC reported a list of 64 large conglomerates which must comply to strict regulations and disclose their status and internal transactions. Samsung is in 2020 the largest chaebol, followed by Hyundai Motor Company, SK, LG, and Lotte.

## **2.2 Establishment**

Most contemporary chaebols emerged during the 1950s. In 1995, 21 chaebols among the top 30 were established during Syngman Rhee's government (1948-1960) and only 3 during Park Chung-Hee regime (1961-1979).

The state played a significant role when they first emerged and was responsible for their capital accumulation. With the end of the Japanese occupation, the country had to deal with a proper reassignment of property rights, the establishment of external trade, the lack of domestic capital and technology. However, the government's decisions aimed at securing political support rather than addressing the policy challenges mentioned above, and encouraged therefore, the creation of chaebols.

### **2.2.1 Three Main Factors**

Broadly speaking, three main processes favoured the establishment of chaebol companies: the convenient sale of Japanese firms, biased aid fund distribution, and the Import Substitution Industrialization (ISI) policy.

First, the Korean government started to sell Japanese properties seized by the American Military government after the end of the Japanese colonization. Korea was left with 3551 operating plants and firms, land, infrastructure, and inventories to be sold (Kim, 1965).

The government sold Japanese firms and properties at 25-30% of their market value and offered generous instalment plans for those willing to buy: only 10% of the total cost had to be paid immediately while the rest within 15 years.

The conditions set by Syngman Rhee's government favoured the politically well-connected, creating an uneven distribution of such properties (Lim, 2003). Indeed, the main beneficiaries were close associates of the Liberal Party, strategically chosen by the government to reinforce Rhee's political base.

Accumulation of capital was also favoured by the biased distribution of aid funds. The foreign aid funds allocated by the government gave the beneficiaries the privilege of building plants with only 15-25% of their own capital. The remained capital was then invested through bank loans or in the case of Samsung and other chaebols it was used to acquire controlling shares of commercial banks.

Indeed, from 1954 the government started to privatize commercial banks. Specific provisions were formulated to prevent distortion of resource allocation, something that economic experts feared as possible outcome arising from financial institutions being under the control of industrial capitalists. However, no satisfactory bids were made, and consequently the government relaxed the requirements. Ultimately, industrial capitalists were able to exploit their political connections to make bids for ownership of banks by borrowing money from the same banks. In 1957, bank privatization was completed, and all major banks were under control of primary contributors of the Liberal Party (Lim, 2003).

Another factor which encouraged the establishment of chaebols was the import substitution industrialization policy (ISI) mentioned in the previous chapter. Industries such as the sugar, textile, and wool one, were protected with tariff barriers, low domestic interest rates, and preferential bank loans. Most Korean chaebols took advantage of this policy and specialized

in these industries as exports were discouraged. Furthermore, 9 out of 10 largest chaebols engaged in import trading that required a government license, a highly profitable business.

### **2.2.2 The new class of Korean capitalists**

During the 1950s two groups of industrial capitalists were born. On the one hand, the first group is composed by former employees and minority shareholders of Japanese firms who successfully transformed themselves into large chaebols after having acquired Japanese properties. These firms produced mainly consumer goods meeting the needs of the ISI policy.

On the other hand, the owners of companies like Samsung or Hyundai represent the second group of Korean capitalists who had no background nor relations with the former Japanese firms but were able to accumulate capital. For instance, Lee Byung-Chul, founder of Samsung was the son of a wealthy landlord, who started his small business thanks to inherited money.

## **2.3 Expansion and concentration**

Already in the late 1950s some family businesses expanded and formed industrial conglomerates. However, the real process of business expansion and concentration started during the 1960s and lasted until the 1980s. In particular, during the 1960s and 1970s the government acted as a conglomerate promoter by designing economic development policies that awarded and continually supported the best performers.

### **2.3.1 Chaebol conglomerates promotion of the 1960s and 1970s**

In 1960, businessmen who have grown rich through political connection with the former president Syngman Rhee were condemned by the new government (Haggard, Lim, Kim 2003). Targeted as “Illicit wealth accumulators”, prominent owners of companies were accused of tax evasion, price fixing, speculation, and other illegal practices. The government seemed to have taken actions against the owners of family businesses who became rich thanks to widespread corruption. However, Park Chung-Hee’s economic policies of state-led industrialization, show that many of the firms that were first accused, were favoured by

the strategic economic decisions taken by the government during this industrial transition period. Moreover, as previously stated the Special Law Dealing with Illicit Wealth Accumulation guaranteed that investments were in line with the government decisions and penalized whoever did not follow the state view. Hence, chaebol businesses only had to follow the government directives to grow and keep receiving support.

During these two decades, the government acted under the principle of “economic discrimination”, where firms were evaluated on explicit performance and capacity criteria.

In 1962 with the launching of the first five-year development plan the government pushed companies into labour-intensive and light industries, and export-oriented industrialization. Due to a lack of natural and capital resources, Korea was still aid dependent and it had to rely on foreign borrowing necessary to pursue the goals of national economic development.

Hence, foreign capital was key for industrial expansion of enterprises which relied on a state which made itself guarantor. Nonetheless, only those who had connections with powerful politicians or government officials were able to easily get permission to import foreign capital, whether they had been “illicit wealth accumulators” or not (Haggard, Lim, Kim 2003).

Conglomerate promotion was taken a step further in the 1970’s with the HCI plan specifically designed to build a self-sufficient economy against the decreasing comparative advantage of light and consumption industries, focal industries of the previous years, but also against trade protectionism of developed countries. As a result of the HCI policy, from 1973 to 1978, 46 of the largest chaebol business groups grew at an average rate of 22.8% while the national GDP at 9.9%.

It goes without saying that the HCI drive required a huge amount of capital without which capitalists could not invest in the chemical and heavy industries. Thanks to the government support, chaebols experienced massive capital concentration and expanded establishing subsidiary companies in several markets. For instance, among the 191 subsidiaries of the 10 largest chaebols ranked by sales in 1984, 114 were established or incorporated during the 1970s, while only 34 in the 1960s (Kim, 1988).

To support the earlier statement on how the government adopted an economic discrimination principle, large industries which could not follow or did not want to cooperate with the state were excluded from the development plan. Conversely, large chaebols that did follow the



government lines, became faithful partners, and established a stronger and more intimate relationship. They could concentrate capital much more easily and diversify in unrelated and related areas. In 1972, the 30 largest chaebols owned on average 7.5 firms, whereas in 1979 the top 30 chaebols had on average 25.4 firms spreading into 17.6 different sectors (Kim, 2008).

It is possible to summarize chaebols' increasing economic concentration by defining three main factors. First, essential was the encouragement from the state whose policies geared towards creating large conglomerates in order to have firms competing with large foreign companies. Secondly, some chaebols, such as Hyundai, Daewoo, or Hanjin were successful in war related business during the Vietnam war. They grew threefold in construction and transport industries between 1972 and 1979. Lastly, the General Trading Company (GTC), established to promote and coordinate the diversified trading business of chaebols during the 1970s, encouraged mergers and acquisitions of other firms, favouring oversea expansion (Le, Kim, Kim, 2016).

## **2.4 Liberalization of the 1980s and 1990s**

The 1970s have been years of expansion and concentration of chaebol businesses. The government inappropriately offered incentives to pursue sales growth rather than profitability which resulted in distorted competition in key industries.

Several were the problems arising from Park Chung-Hee HCI drive. In addition to the international recession and the new trade protectionism, over- and duplicated investment on heavy and chemical industries, and huge foreign debt were at the base of the slowing Korean economy. The excessive state intervention of the previous decades had produced significant moral hazard as the government continually bailed out failing companies giving them an implicit guarantee to undertake excessive and risky investments expecting not to be let go bankrupt in the case of a crisis (Kim, 2008).

From 1980 onwards, after realizing the inefficiency of the government-led economic policy, various market liberalization policies were introduced to address the Korean sagging economy. Despite the government drastic change regarding its role in the system, Chaebols continued to grow and expand, dealing with excessive debt financing and overinvestment.

### **2.4.1 Regulatory policy of the 1980s**

After having understood some of the problems generated by the previous government, the new one opted for a transition to a more market-oriented system. Chun Doo-Hwan enacted economic policies that were different from his predecessor. A change in economic policy was indeed needed given that many companies due to the HCI incentives became insolvent (Kim, 2008). South Korea, being one of the largest foreign debtors in the world, seriously concerned the international community. For this reason, the International Monetary Fund and the World Bank pressured the president to pursue stabilization by reducing government expenditures and tightening the money supply.

The new policy directive emphasized liberalization. The government tried to be less interventionist by drastically decreasing direct investment to businesses, lowering the inflation rate, and eradicating export subsidies, leaving companies on their own, taking responsibility of their own actions (Chang, 2003).

In addition, to force chaebol companies to divest some of their subsidiaries, sell speculative real estate holding and lower their debt, anti-chaebol measures were announced. The anti-concentration policies included the “Monopoly regulation and Fair Trade Act”, also known as the Fair Trade Act, the Loan and Payment Guarantee Management system, and the Small-Medium size businesses support system.

In particular, the contents of the Fair Trade Act contained limits on banks loans, cross-shareholding, and debt guarantees for the top 30 chaebols. It also prohibited unfair practices such as price discrimination, the obstruction of market entry by rivals, and the formation of cartels. The Fair Trade Act aimed at reorganizing business groups’ structure by disposing of unnecessary subsidiaries and therefore, limit the expansion of such groups. However, regulatory policy was entrusted to the EPB, which had wide discretion over its implementation. Consequently, the policy was not as strict as it should have been. For instance, cartels were not banned or penalties for noncompliance were very light (Chang, 2003).

Chaebols were still able to grow on their own. The financial sector became less regulated and in 1983 the government started privatizing banks. Although the percentage of shares chaebols could buy was limited, in order not to rightfully end up in the same situation of the 1950s when banks felt under total chaebol control, they still purchased large blocks of stocks and could influence banks’ lending decisions.

The final goal of regulatory policy was to establish conditions for fair and optimally effective competition, achieve an effective allocation of resources, and most importantly narrow the gap between chaebols and non-chaebol sectors (Lee, 1996). Unfortunately, during this period, they blocked SMEs to develop and created oligo-monopolies in many markets. Apart from economic reasons, social and political ones should not be neglected. Korean people started to think that chaebols were morally wrong and realized that competition between firms was unfair and wealth distribution was distorted.

All in all, chaebols prospered without the government support, also thanks to the favourable external environment characterized by the “three lows”: low interest rates, low oil prices, and low exchange rates, namely the appreciation of the yen. Between 1986 and 1989 the Korean economy made a trade surplus, which somewhat justified the government having a more generous attitude towards chaebols.

#### **2.4.2 Chaebol self-finance under Roh**

Initially interested in political democratization and diplomacy with North Korea, Roh Tae-Woo did not intervene directly in managing the economy as it was still experiencing growth and surplus in international trade. Hence, in the first two years nothing was really done regarding chaebol companies. However, in 1990, the Korean economy entered a recession and economic concentration of chaebols deepened. As a consequence, Roh tried to recover political authority by restricting economic concentration. The reform measures adopted, similarly to Chun Doo-Hwan, aimed at deconcentrating ownership of chaebol firms and supporting small-medium businesses for their development. He ordered chaebols to dispose of their speculative real estate and to focus on three core business areas.

Even though some improvements were made, the measures did not fully reach the targets planned. Furthermore, under Roh regime limits on ownership of nonbank financial institutions, namely insurance, investment trust, securities, and merchant banking firms, were removed. Therefore, chaebols turned to such institutions and purchased controlling shares of stock in them. Nonbank financial institutions became a key source of capital used to secure large but not economically justifiable loans (Chang, 2003).

### **2.4.3 The 1990s and the outbreak of the 1997 crisis**

The first years of Kim Young-Sam regime were characterized by considerable optimism. However, the decisions made during the second half of his administration and the conditions to which the country was subject to, eventually led to the outbreak of the 1997 financial crisis.

In 1996, the Republic of Korea entered the OECD and became one of the members of the “rich and developed countries”. Thus, South Korea had to adhere to the Code on Liberalisation of Capital Movements, which still today provides liberalisation measures and therefore, removal of barriers to the movement of capital. The government implemented a few financial reforms to meet the obligations of the Code. For example, Koreans were allowed to hold foreign bank accounts and to purchase foreign securities, domestic firms could freely issue warrants denominated in foreign currencies and foreigners were allowed to purchase short-term won-denominated bonds.

As deregulation accelerated, chaebols were free to issue bonds and stocks in overseas markets, and banks free to borrow short-term money from international capital markets. Consequently, foreign supplies of funds, which were headed to firms and financial institutions, were ultimately collected by chaebols, which in turn made long-term investments in domestic and foreign markets (Chang, 2003).

This short-term money flow used to finance long-term investments caused a mismatch between term structure of liabilities, owed to foreign investors, and assets, financed by that debt. The mismatch created was quite troublesome: if foreign investors decided to withdraw their funds, a liquidity crisis would likely happen, as, in fact, no liquid funds were available to pay the investors.

Furthermore, the liberalization followed by the OECD entry, created another mismatch, this time between currency denomination of liabilities and assets of Korean banks. Liabilities were most of the times denominated in foreign currency, usually US dollars, while assets were held in domestic currency. Were the Korean won to depreciate against the dollar, banks would see their liabilities expressed in won grow or conversely, their assets denominated in dollars, shrink (Graham, 2003).

Even before the breaking out of the financial crisis, several chaebols went bankrupt because of excessive debt-financed capital investments. Even though economic growth during the

first half of 1997 was strong, and international lenders seemed to be confident that banks and companies would encounter no barriers to repaying short-term international loans, the possibility of problems came to surface at the beginning of July, when Thailand asked for assistance to the IMF to meet international obligations. Thailand crisis triggered a domino effect which affected Asian countries in similar conditions. Shortly after, Indonesia was also having difficulties in meeting international obligations. The rupiah value plunged and affected South Korea since Korean banks had lent significant sums to Indonesian banks. The Korean won began to depreciate and as preannounced liabilities grew significantly. Warning signs were increasing, and international investors started to withdraw their funds from Korea. In the end, in November 1997, the Bank of Korea as a last resort spent billions of dollars to keep the won from further depreciating. Eventually, the Bank asked the Ministry of Finance and Economics to seek IMF assistance (Graham, 2003).

## **2.5 Evidence of Anticompetitive Behaviour**

The South Korean economy depends heavily on chaebols' performance. When chaebols were doing great, also South Korea was growing and viceversa. Even though external factors contributed to both failure and success of the country, the relationship between the government and chaebols created strong dependence such that any change in chaebols would affect and put the health of the Korean economy at risk.

The 1997 financial crisis brought to the surface many problems arising from excessive reliance on debt financing, cross-shareholding and overinvestment. Therefore, chaebols' anticompetitive behaviour will be analyzed with the aim of explaining why they were one of the causes of the Korean economy collapse and how the government failed to develop a competitive environment which would have benefited the country and perhaps avoided the financial crisis. Analyzing chaebol conglomerates' conduct is fundamental to understand the evolution of reforms towards chaebols.

### **2.5.1 Growth strategy and monopolization**

Chaebols adopted similar growth strategies which consisted of three common elements: exploiting government policies, pursuing diversification and vertical integration, and accumulating external and internal capital.

Throughout the years the government allowed chaebols to monopolize products. In the 1950s daily products such as sugar and textile were produced 100% by chaebols. In the 1960s and 1970s with the industrial development plans, shipbuilding, automobiles, and new productive areas were monopolized. In 1978, the EPB announced that 200 enterprises monopolized or oligopolized 148 products. Moreover, in the early 1980s 88% of manufacturing and mining products were under the rule of monopoly and oligopoly (Kuk, 1988).

Monopolization was used as a tool by the state to make sure capitalists followed the government's political goals. However, by doing so, it reduced any internal competition. In addition, since the government awarded large size companies, chaebols' objective was to give priority to size expansion rather than maximizing profits. Therefore, they mainly grew because they had special treatment and could borrow funds, but ultimately, they were not profitable. The government had its hands tied because it could not let these extremely large companies fail, otherwise, they would drag the Korean economy down. Backed up by the state if they failed, Chaebols spent money on speculative venture and purchased lands and building.

The ability to raise capital both internally and externally was fundamental because the country always suffered from shortage of capital. Thanks to the economic development plans, they were able to obtain huge subsidies and accumulate large amounts of money. Political connection played a significant role to expand and benefit from additional aid. For instance, many chaebols in the 1970s were allowed or even asked by the government to take over insolvent companies in exchange of large subsidies. Furthermore, preferential treatment was also found in the allocation of foreign currency. Chaebols preferred debt financing rather than equity because it was cheaper and easier to obtain. By the end of the 1990s leverage financing was a serious problem. In 1997, listed firms' average debt ratio reached 300%, and specifically, listed manufacturer reached over 350% (Sung, Kim, 2017)

Chaebols could also expand and further obtain loans by making their subsidiaries invest in new ventures. Subsidiaries provided debt guarantees to the new entrants and helped them secure banks loans. Also, as previously mentioned chaebols took advantage of the removal of limits on ownership of nonbank financial institutions and secured even more capital during the 1980s.

Related and unrelated diversification was also a consequence of the government policies. In the 1960s and after in the 1970s with the HCI drive, chaebols entered new product areas. For

example, in the late 1960s Samsung which started as a trading company, focused on export of agricultural products, changed its focus on manufacturing. Hyundai was assigned by the government to transform into a ship-building company and Daewoo, which main business was textile, was encouraged to entry the heavy and automobile industries. Furthermore, as these industries were not well developed or even existing in the country, chaebols integrated vertically to secure parts and raw materials. Some of these companies were born as trading firms. Consequently, they eased exports to overseas markets (Chang, 2003)

Today their diversification encompasses many businesses from fashion, to healthcare, food services and many others. Samsung counts around 80 companies working in several sectors.

### **2.5.2 Internal human structure and the importance of the family**

Family prestige and relationship are of most importance in chaebol businesses. For this reason, chaebols are typically owned and controlled by their founders and direct family members.

Until the 1980s founders of the chaebols also recruited as upper ranking managers former government officials or military officers with the aim of increasing political connections and maintain good relationship with the government and leaders. In 1984 within the top 50 chaebol groups, very few were professional managers.

It is well known that members of chaebol families are one of the wealthiest people in the country. Among the top 15 Korean richest people 9 are heirs of chaebol companies (Forbes, 2021). As one can see, maintaining and improving the family social status is of critical importance. For this reason, it is not uncommon for chaebols to enlarge marriage-ties with other business groups and powerful politicians, or within members of the group subsidiaries. Even though it was much more frequent during the first generation, marriages between chaebols are still existing, and marriages between people in the corporate world are increasing.

Let us take Samsung group as an example, Lee Kun-Hee, son of Lee Byung-Chul, the founder of Samsung, married Hong Ra-hee. She was the daughter of Hong Jin-ki, chairman of JoongAng Ilbo, one of the biggest newspaper in South Korea which was founded by the same Lee Byung-Chul. Their son and heir of Samsung Lee Jae-yong married in 1997 Lee Seryung, heiress of the Daesang group, a Korean food conglomerate. Lee Jae-Yong's sister

also married the son of Dong-a Ilbo's chairman. Dong-a Ilbo is one of the top 3 daily newspaper publishing companies of the country.

### **2.5.3 Control over subsidiaries: Interlocking ownership, Dereference and Intragroup transaction**

Another characteristic of Korean chaebols is the difference between ownership and control. Even though, only a tiny fraction of total shares is owned by the founder or heir of the group, the entire business is under the control of the owner and its family. This is possible thanks to a complex ownership structure which secures control of core companies over subsidiaries even with tiny stakes.

Mutual shareholding is prohibited in the country. However, circular shareholding, namely cross shareholding between three or more firms is allowed (Sung, Kim, 2017). Today, Samsung and Hyundai still apply this system, which is however, likely to disappear. Due to external pressure and regulations, many intra-group shareholding links have been already removed and other chaebols have indeed switched to a pyramidal ownership.

An interesting phenomenon that comes with marriages between chaebol companies and subsidiaries is deferential behaviour of one firm towards the other. The cultural influence of Confucian values affects the business world and decisions made by the companies within a group or even within chaebol groups. One partner acknowledges that the other party is superior and has special rights and advantages (Han, Shipilov, Greve, 2017).

Marriages between companies translate in intra-group transactions, which are not in themselves illegal. However, chaebols provide their affiliates with capital access, offer technology development services and management services in exchange of information. Subsidiaries can be strategically important as they can provide the core company information about potential market expansion opportunities. It can support market entry and exit or even remain passive in its own market position. They can also cooperate with the core firm in attacking competitors in common markets.



### **3. REFORMS AND THE ROLE OF THE KFTC**

The 1997 financial crisis magnified several financial and industrial issues which were already known but inadequately managed by the government. As a result of this mismanagement in dealing with financial institutions, chaebols, and the labour market, South Korea had to seek help from the IMF and ask for a rescue package.

Before 1997, due to the fear of business and bank failures and political instability, former presidents held back from launching strict reforms. Problems that existed prior to the crisis were then fully exposed in 1998, when Kim Dae-Jung became the new president of the Republic of Korea and started an era of systematic reform in the financial, labour and industrial sectors. Even though, before the elections it seemed he was not willing to adhere to the agreements, he eventually as new president accepted the IMF conditions as it was necessary for the country to receive help.

South Korea was able to make a quick recovery. Indeed, the recession was deep but momentary. In 1998 GDP growth was -6.7% while in the following years remained positive: 10.9% in 1999, 8.8% in 2000, and 3% in 2001.

The aim of this chapter is to display the several reforms the government implemented to recover from the financial crisis. Financial and industrial sector reforms are analyzed to better understand the measures taken to improve the situation. Then, the focus will shift to the role of the Korea Fair Trade Commission, and what it is doing nowadays to limit chaebols' power. Finally, an overview on today's business environment will be provided.

#### **3.1 Reforms amid the crisis**

On December 3, 1997, Lee Kyung-Shik, Governor of the Bank of Korea, and Lim Chang-Yuel, Deputy Prime Minister and Minister of Finance and Economy, signed a Letter of Intent with the IMF. By signing the Letter of Intent South Korea committed itself to follow, for the following three years, the policies outlined in the attached document, namely the "Memorandum on Economic Program". Adjustments in governance, business organization and performance had to be made.

The package announced by the government and the IMF included financing for a total of \$57 billion, the sum of \$21 billion from the IMF, \$10 billion coming from the World Bank,

\$4 billion from the Asian Development Bank, \$5 billion from the US government and several other countries which contributed with \$1 billion each.

In the previous years, the government failed to undertake decisive structural changes in financial institutions and public enterprises. Moreover, because of the liberalization policies of the 1990s chaebols were able to exploit them to their own advantage. Therefore, it was crucial to restructure financial institutions and chaebols, and innovate the management system.

Reform of financial institutions and privatization of public enterprises, big deals among chaebols, workout programs for failing firms, improving the corporate financial structure, and enhancing transparency are major economic policies outlined in the agreement with the IMF. Also, the president and the owners of the five largest chaebols personally met and reached agreements such as eliminating cross-debt guarantees or focusing on core businesses and strengthening chaebols' cooperation with SMEs (Lee, Kim, Kim, 2016).

In addition, new accounting and auditing rules in line with international standards were enforced to improve and intensify the reliability of corporate financial statements. Companies were also expected to establish committees of external auditors and include external members to their executive director committee. Other policies aimed at the limitation of voting power of institutional investors and the strengthening of minority shareholders' voting rights.

Furthermore, the government realized the relevance and value of SMEs to enhance competitiveness within the Korean economy. Therefore, in 1997 the "Special Act for Nurturing venture Business" which included financial support and procurement of human resource was approved. In 1998 venture businesses were 2000, while in 2001 they totalled 11000 (Lee, Kim, Kim, 2016).

### **3.1.1 Financial Sector Reform**

The measures applied to the financial sector can be divided into three broad categories. The first group of reform measures concerned the functions of the Bank of Korea and the financial supervisory system. The second ones aimed at liberalizing the financial sector, while the third category, which measures were the most drastic, were established to restructure it.

First, the Bank of Korea was made independent from the Ministry of Finance and Economy. Supervisory responsibility was removed from the central bank and transferred to a new and independent Financial Supervisory Board (FSB), which had the authority to determine whether it was necessary to take corrective actions. (Lee, Kim, Kim, 2016). The final goal of this separation was to let the central bank focus only on monetary management and remove any other responsibility from it. Moreover, financial institutions, such as banks, insurance companies, and other nonbank financial entities were allowed to enter each other's lines of business to increase competition among such institutions. Consequently, the FSB was merged with other securities and insurance supervisory agencies.

The second category of reforms included liberalizing long-term capital accounts. Thus, the bond market was opened to foreign investors for any type of Korean bond, either private or government issued, long-term or short-term. Foreign direct investments jumped from \$6.97 billion in 1997 to \$8.85 billion in 1998, year of the recession. However, the numbers can be misleading as the increasing trend which started in 1996 was actually slowing. From 1996 to 1997 when long-term capital accounts were not available the jump in FDI was of 3.8 billion, while between 1997 and 1998 it was of \$1.88 billion.

Restructuring the financial sector was one of the main challenges the government had to undertake during the crisis. It first had to identify which financial institutions were unviable and consequently define appropriate exit strategies. The possible solutions for those banks or nonbank institutions were complete closure, takeover of unviable institutions by viable ones, or restructuring plans for the institutions considered recoverable. By early 1999, the number of commercial banks was reduced from 25 to 17.

Lastly, all Korean banks were asked to meet the Basel capital adequacy standards enforced by the Bank for International Settlements. Hence, in 1998, the government established The Financial Supervisory Commission (FSC), agency created to ensure effective and efficient supervision of banks and other financial institutions. It indeed adopted the "prompt corrective action system" to control whether quantitative risk indicators were exceeded, and if so, propose corrective action (Graham, 2003). The FSC was later reorganized and given the authority to draft and amend financial laws and regulations and issue regulatory licenses. It operates today under the name of Financial Services Commission.

### **3.1.2 Chaebol Reform**

Industrial sector reforms were necessary to rebuild the Korean economy. It was, therefore, indispensable to address issues which originated from chaebols expansion strategies. The overall financial status of Korean firms was considerably affected by the crisis. Companies were highly indebted with interest coverage ratios under the optimal 3.0, indicator of a healthy firm, not at risk of insolvency. In early 1998, among the top 10 Chaebols, only 2, Samsung and Lotte met this criterion, while 6 companies had a ratio under 2.0 which suggested poor financial health. The Ssangyong business group, which core business operated in Korea's automotive industry, had a coverage ratio of 1.0, signal of insolvency. Many other companies, ranked below the top 10, had ratios less than 1.0.

In addition, another problem which concerned different industries was low labour productivity. For instance, the Korean automobile industry labour productivity was reported to be 48% of US firms, which firms were not even international leaders. This was the result of the sector protection from imports by the government which encouraged the pursuit of growth by unreasonable and inefficient investments and the development of excessive labour.

These problems were already recognized by the government before the breakout of the Asian crisis but improperly managed. Even before his presidential inauguration, Kim Dae-Jung came to agreements with chaebols' chairmen to address the IMF requirements. Chaebols had to choose from three to six core businesses and exit all the others. This process was to be implemented through big deals among business groups: companies, after having decided which core businesses preserve, had to swap assets among each other to dispose of those secondary noncore business lines. However, these arrangements were criticized because it meant maintaining alive noncore businesses that were possibly unprofitable, but also creating and strengthening monopolies protected from domestic competition. Nonetheless, negotiations often failed and only a few transactions were successful. For example, in the semiconductor industry LG and Hyundai decided to combine operations under the control of Hyundai Electronics Industries. Thus, Hyundai Electronics became the world's largest producer of DRAMs surpassing Samsung.

In the automotive sector, a big deal transaction was supposed to happen between Daewoo and Samsung: Daewoo acquisition of Samsung Motors in exchange of Samsung acquisition of Daewoo Electronics operations. However, it never happened due to the failure of Daewoo

group. Also, Kia was denationalized, and its control was awarded to Hyundai Motor Company despite being highly indebted. Even in this period of reforms, favourable treatment to some groups such as Hyundai or Daewoo was still given. In the case of Hyundai, favours could be explained by the fact that Chung Ju-Yung, Hyundai group chairman, was a strong supporter of Kim Dae-Jung “Sunshine policy” meant to improve the relationship between South and North Korea.

Chaebol reforms included also measures such as the submission of Capital Structure Improvement Plans by the 5 largest chaebols to reduce by the end of 1999 the debt-to-equity ratio to 200%. Another requirement was to end cross-debt guarantees between affiliates. It was especially established to protect minority shareholders who often were not consulted on approval of cross-debt guarantees by an affiliate to pay back the debt of another one whenever the former was unable to do so. Lastly, the top 30 chaebols were asked to prepare balance sheets and income statements conform to international accounting principles.

By the end of 1999, four out of five chaebol groups were able to reduce their debt-to-equity ratio. The only business group that could not achieve the requirement was Daewoo, which filed for bankruptcy. It is important to note that even though the situation in Korea improved, still some problems remained unsolved. It is indeed extremely difficult to solve issues related to sectors which worked in a determined way for years. In reality chaebols did not do much to reduce their ratios as non-listed subsidiaries were excluded from the statements. Most of the affiliates were considered by the FSC nonviable. The companies instead should have sold their assets and raised new equity (Graham, 2003).

### **3.1.3 The case of Daewoo**

Daewoo is an adequate example of what went wrong with chaebols during the period of expansion and growth of the 1970s and 1980s. Even though, the recession ended in 1999 Daewoo was on the verge of bankruptcy. Precisely it was declared bankrupt on November 1, 1999, after 31 years of existence and extreme growth. Kim Woo-Choong, founder of Daewoo and then chairman of the Federation of Korean Industries (FKI) expanded his empire throughout 26 industries with 30 different affiliates, ranging from financial institutions to automotive, shipbuilding, marine engineering, and heavy industries. What caused the fall of this massive conglomerate was the heavy use of debt financing to expand into activities with low rates of return on capital invested, but also distortions of financial

statements, to hide the true extent of borrowing and, a common characteristic of chaebols, poor performance of operations. Furthermore, despite being a huge conglomerate it was not a leader in any of its core businesses. As previously mentioned, the government acted under the principle of economic discrimination. However, somehow Daewoo never encountered difficulties in obtaining financing to expand regardless of its performance. Apart from fake financial statements, the group had been probably favoured because of Kim Woo-Choong close relationship with first Park Chung-Hee and much later Kim Dae-Jung. Moreover, banks clearly misjudged the ability of the group to turn around and continued lending money to it.

The big deal with Samsung never took place because the group was in critical conditions, and even if some of its subsidiaries could be sold to other foreigner firms, it would not have been enough as it was already too late. Later, Daewoo creditors were allowed by the government to sell Daewoo's financial subsidiaries without which the group could not survive and meet its daily cash obligations. The group disbanded and Daewoo was left only with its automotive company which was acquired by General Motors at a very reduced price.

In the meanwhile, Kim Woo-Choong fled the country and returned to Korea 6 years later in 2005. He was arrested on charges that included fraud, illegal financing, and embezzlement and in 2006 he was sentenced for initially 10 and later 8 and a half years. Nonetheless, in 2007 he received a special presidential pardon.

### **3.2 The Korea Fair Trade Commission**

The Korea Fair Trade Commission is the national regulatory authority for economic competition. Established in 1981 under the then EPB, the KFTC promotes fair and free competition in the market, helps business innovation and consumers to make reasonable choices in their purchasing decisions. From 1994 it acts as an independent agency and in 1996 the chairperson position was elevated from vice-ministerial to ministerial level.

The KFTC consists of a committee which is the decision-making body, and a secretariat, the working body. On the one hand, the committee is composed by 9 commissioners: a chairperson, a vice-chairman, three standing commissioners and other four non-standing commissioners. Their goal is to discuss and determine what to do for the protection of

competition and consumers. On the other hand, the secretariat drafts and promotes competition policies, investigate antitrust issues and reports to the committee.

### **3.2.1 KFTC mandates**

To ensure fair trade and balance the growth of the national economy, the KFTC operates focusing on four main goals.

The first one focuses on promoting competition by improving monopolistic market structure and finding remedies to unfair acts such as abuse of dominance by conglomerates, cartels, or unfair trade practices like tie-in sales. The KFTC tries to limit market entry when considered necessary and reviews mergers and acquisitions.

The Fair Trade Commission implements also policies specifically designed for large business groups. To this end, the organization prohibits mutual and circular equity investment and checks concentration of economic power by enhancing more transparency. Indeed, information on business groups is available to the public with the aim of making the conglomerates more responsible and improve governance structure and corporate ownership.

Moreover, in 2007, the Commission became the only competent authority of consumer issues. Hence, it operates towards their protection and strengthening of their rights. It organizes consumer education programs for a better consumption life and provides information on prices, qualities, and alternative products on the “smartconsumer” website. In addition, its consumer policies address unfair acts in areas where consumers are more likely to be vulnerable: instalment transactions, e-commerce, death care business, or adhesion contracts.

Lastly, the Commission addresses practices between large companies and SMEs to foster a friendly and competitive market environment. One of the goals of the KFTC is to protect smaller companies from practices imposed by large ones. They indeed can undermine the growth of SMEs. Unfair unit price setting and refusal to pay by large businesses are some examples. Furthermore, it protects technologies developed by smaller companies and encourages coexistence and cooperation through the Fair Trade Pact (KFTC official website, 2021).

### **3.2.2 KFTC challenging task**

Even though, they have partially caused the fall of the country in 1997 and many of them were in critical situations, chaebols still dominate the Korean economy.

After 1997, their concentration increased and, in some industries, they were able to consolidate even more. Although the IMF required the implementation of effective reforms, the government failed in resolving chaebols' concentration which continued also in the following years. For instance, from 2009 until 2017 intragroup transactions between chaebols and affiliates occurred within 80% of business groups (Park, 2021).

Nowadays, chaebols continue to have extreme influence and power. Mergers and acquisitions by conglomerates obviously reduce the number of players operating in the market. Thus, it is much more difficult to encourage SMEs to innovate. The presence of chaebols undermines their motivations to improve products, processes and services or even enter competition. The only way they can compete is in terms of price alone, where it is likely for them to lose. For example, the industries in which chaebols have almost always been present, such as the manufacturing sector, are much more inclined to this phenomenon.

Therefore, chaebol reforms are still crucial for the health of the Korean economy. The government has been asking business groups to remove cross shareholding and enhance transparency. In 2014 regulations on related-party transactions were introduced by the Monopoly Regulation and Fair Trade Act. Some results have been obtained: cross-shareholding arrangements are actually disappearing.

Prior his election, the current president of the Republic of Korea, Moon Jae-In was determined to terminate politics-business connections. However, fundamental changes have not been made as the system established throughout the decades is complex and the parties involved are several. For instance, chaebols have significant power and can influence media to their advantage. Moreover, the Court of Appeals acts with lenience toward Chaebol families.

In 2017, Lee Jae-Yong, then vice chairman of Samsung Electronics, was involved in Park Geun-Hye political and corporate scandal. Park Geun-Hye, daughter of Park Chung-Hee, at that time president of South Korea, was convicted and removed from her position because of abuse of power, bribery, coercion and leaking government secrets. Samsung Electronics was accused of paying significant amounts of money to two non-profits foundations



managed by a friend of Park Geun-Hye, in exchange of political support. Lee Jae-Yong was arrested and charged of bribery, embezzlement, hiding assets overseas and perjury. However, his 5-year sentence was first suspended and reduced in 2018 to 2.5 years and just recently, on April 13, 2021, he was released on parole after 207 days in prison.

Nonetheless, the KFTC continues working for better competition by investigating companies and imposing fines whenever unfair practices are detected. For example, in June 2020, Hyundai Heavy Industries (HHI) was fined ₩970 million for unfair trade with its subcontractors. The FTC reported that HHI stole technologies used by its subcontractor, and later leaked information to another subcontractor to reduce the price of the products supplied by the first one. Also, in June 2021 the Commission decided to impose fines of ₩234.9 billion to five Samsung Group affiliates for making sweetheart deals with the affiliate Samsung Welstory. The fine levied on Samsung is currently the KFTC highest amount of money imposed to a Korean company (Jung, 2021).

### **3.3 Today's Business Environment**

After the financial crisis, the Korean economic environment did not change much. The industries that dominated the economy were still the electronics, automobiles, telecommunications, shipbuilding, chemicals, and steel ones. However, in the last 10 years, other businesses such as the e-commerce, gaming, or the music and entertainment industries gained relevance in the country. Dominance of Chaebols still exists, but it is decreasing as new competitors are enlarging and innovating in other new or unexplored industries by family-led conglomerates. Especially, during the COVID-19 pandemic, this process has been accelerated, as citizens and especially the younger generation are changing consumption habits (KFTC, 2021)

#### **3.3.1 New domestic players**

The expansion and easy accessibility of the internet has considerably increased the use of platforms and social network services. Two examples of new players different from the “traditional”, family-led chaebols are Naver and Kakao, top internet firms.

On the one hand, Naver is the largest web search engine of Korea and substitute of the global and commonly used Google. It was founded in June 1999 and gained popularity in the subsequent years. Its core businesses are online advertising and content creation, but it is also expanding in other services through its affiliates. The most famous one is the messaging app LINE, a Tokyo-based subsidiary started by Naver in 2011, in response to the Tohoku Earthquake and Tsunami, when people could not connect through communication infrastructures but internet-based resources. Although it was started by a Korean company, it is much more popular in Japan, Taiwan, and Thailand, as the Korean market is dominated by KakaoTalk.

NAVER Webtoon is another affiliate that was launched in May 2017. It is the national main digital comics platform, a business which is currently gaining popularity nationally and abroad.

On the other hand, Kakao Corporation was founded in 2006 by Kim Bum-Soo, currently Korea's richest man (Bloomberg Billionaires Index, 2021). KakaoTalk, launched in March 2010, is the first Korean messaging app created by the corporation. Despite being available in 15 languages, the mobile instant messenger is mostly used by Koreans. Indeed, during the fourth quarter of 2020, out of 52 million active users worldwide 45 million were based in South Korea.

Kakao Corporation is not operating only in the mobile messenger industry. It has, in fact, grown into a conglomerate, and it is expanding its services in games, e-commerce and themed shops and cafés. It also has a bank, an entertainment company, a transportation service, and a fashion platform. In 2021, Kakao group was announced to be the biggest business conglomerate which does not operate in the manufacturing sector, the one dominated by family-led groups (Yonhap Infomax, 2021).

Both founders of Naver and Kakao represent a change in the Korean entrepreneurial landscape as they are self-made entrepreneurs.

### **3.3.2 Digital economy and the Korean unicorns**

The spread of the COVID-19 virus had a strong and deep impact on the global economy. Most countries are in recession, struggling to contain new cases and further circulation. During the first months of the pandemic, South Korea had the second highest number of

cases only after China. However, thanks to innovative screening it was able to manage and flatten the curve of infections without completely closing businesses or having a strict lockdown as many other countries had.

The virus accelerated digitalization of businesses and, therefore, companies tried to develop solutions to go contact-free and digital. For the businesses that already operated in such industries, the pandemic brought great results in terms of sales and profits.

In the last year Korea has seen an increase in unicorns, start-ups which are valued 1\$ million or more. The country has now 15 unicorns specialized in digital applications, e-commerce, gaming, and fintech. This number was only 6 in 2018, 10 in 2019, and 13 in 2020.

A few examples are Krafton, a game developer company founded in 2007, mostly known for the popular online game PUBG, and Market Kurly, a doorstep delivery service for fresh groceries.

Some of the unicorns are planning to file for an initial public offering and thus, leaving their startup status. One of them which successfully entered the stock exchange in March 2021 is Coupang. Known in the western countries as the “South Korean Amazon”, Coupang debuted on the New York Stock Exchange after having grown into an e-commerce giant. Moreover, in June 2021, it started its international market expansion by launching its service in Japan and only one month later it also entered the Taiwanese market.

2020 has been a demanding year for all companies. Nonetheless, Korean conglomerates have performed well and were prominent in exports. In addition, as unicorns represent a tangible threat to chaebols’ positions, the latter will purposefully look for start-ups with potential opportunity for growth and consequently invest on them.

The emergence of new conglomerates represents a new challenge for the KFTC, which is indeed considering redefining its definition of chaebol owners to include Coupang’s founder Kim Bom who, in principle, does fall within the definition due to his US citizenship (Bae, 2021). Moreover, the Commission is planning to enforce policies which will focus on fair competition in digital economy while still facilitating innovation (Kim, Koh, Chun, 2021).

## Conclusion

In conclusion, this dissertation provided an analysis of the events and policies that favoured the development of the country, focusing on the Korean monopolistic conglomerate structure, chaebol.

South Korea evolved into a global competitor at an extraordinary rate thanks to the government and chaebol companies. Indeed, within only two generations, it achieved a rapid and sustained economic growth that can be considered almost impossible looking at the state the country was left after the Korean War. Indeed, South Korea, once known as the “Land of tigers”, turned from a small and underperforming economy to a powerful, modern and highly developed one. Much like tigers which culturally are a symbol of strength, power, and optimistic spirit, the country was able to get back to its feet and surpass economically any other nation that declared its independence after WW2.

After the Japanese colonization and later the Korean war, the Republic of Korea had to face many challenges, financially and politically wise. US aid and post-war policies were of extreme importance to recover from years of destruction and overall poverty. However, the economy started to truly flourish and enlarge when Park Chung-Hee seized power in the 1960s. The HCI drive is definitely the policy that showed the most results and affirmed Korea as a major exporter. It became a competitor highly specialized in the Heavy and Chemical industries, title which still holds today. It is in this period that some politically well-connected firms began to extend their business scope and dominate several industries. Established mainly during the 1960s, family-led companies were able to monopolize or oligopolize entire sectors. Through corruption and illegal practices, they expanded and overinvested to receive the government support.

The strong and intimate relationship between the government and chaebols was indeed determinant for their concentration. Nonetheless, even during the 1980s when policies emphasized liberalization, the process of concentration further increased together with unfair and illegal practice.

It was only after the 1997 financial crisis that reforms started to address the issues created by these conglomerates. The government had to intervene against their anticompetitive behaviour characterised by aggressive growth strategies, control over affiliates, frightening debt, monopolization, and consequent abuse of power.

However, the complexity of the system, which is not constricted only to the corporate world but also to politics, made the government and the KFTC intervention somewhat weak. Nevertheless, the Korean antitrust regulator, nowadays tries to deliver stronger actions for balanced economic competition. Moreover, new competitors might interfere with the strategies of family-led business groups.

Although they had a significant role in the development of the national economy and still comprise a large share of the national GDP, their image is deteriorating. Nowadays, Korean citizens have more tools and information channels to understand the corporate world. Following several scandals, they are much aware of the increasing disparities between the rich and the rest of the society. The wage gap is significant, and inequalities are frequently exposed through scandals that reveal acts of nepotism such as employees abuse. Furthermore, social trust is diminishing as chaebols are found guilty of corruption, bribery, and tax evasion among others. Other players could counteract chaebols' drawbacks. However, even the new competitors are now accused of expanding through illegal practices mirroring the behaviour of chaebol business groups.

Major reforms are needed to make the country less dependent from business groups, limit their power and enhance competition. Yet, a drastic change in chaebol's system that can favour better competition and maximization of social welfare seems still far from happening.

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