

OVERCOMING THE THREE C's*

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During the past year I have traveled about Korea and met with many different groups and associations, including managerial associations, industrial groups, civic groups, academic associations, government associations, NGOs, etc. This has been a richly rewarding experience and has given me a unique opportunity to understand the concerns of many people throughout various regions of the country. Based upon these experiences, my interaction with both domestic and foreign companies and my observations of the Korean economy and society today, it is clear that Korea has graduated from the "IMF" crisis. The foreign exchange crisis has been resolved and the basic structural reforms implemented by the government over the past three years will ensure that another similar crisis cannot occur in Korea.

We are, however, deep in the clutches of three crises much more difficult to recognize, the effects of which are devastating to our economy. I am calling this the "Crisis of the 3 C's." The first is the crisis of *Compromise*, the second is a crisis of *Circulation* and the third is a crisis of *Confidence*. Let me explain.

It is a bit odd to say that we are in a crisis of compromise as compromise is usually a good thing. Unfortunately, in Korea today we have compromised our attitudes about Korea. Many of us today do not recognize the newly attained status that Korea has achieved in the world and as a result, we are willing to accept a much lower standard of behavior than we are capable of performing.

As I meet with the various groups I always ask how they feel about Korea. Do you think of Korea as an advanced country, a developing country or an under developed country? Out of 100 people, 2 or 3 will respond that Korea is an advanced country, 2 or 3 will respond that Korea is a backward or underdeveloped nation and the remainder see Korea as still in the developmental stages or as an emerging nation. This is our crisis of compromise. In fact, based upon Korea's educational and economic performance, Korea is an advanced nation. I point out a few statistics.

There are approximately 200 to 220 nations in the world today. The economy of Korea is ranked 11th among all these nations. That puts us in the top 5% and that is not a bad place to be. Korea has the highest literacy rates in the world. We may have a lot of complaints about the severity and lack of flexibility in the education system in Korea, but the fact is that Korea's population includes some of the best-educated people in the world.

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If we look at the world's number one economy, the United States, and its trading partners, we find that in overall trade Korea is the 6th largest trading partner with the United States. That puts Korea ahead of many of the G-7 nations when comparing the importance of the trading relationship with the United States.

A much more important and surprising statistic however is the current state of trade in agricultural products with the United States. Agriculture is a very good indicator of a country's economic development and the maturity of its economy because of the importance most countries place on protecting agricultural markets. Almost all nations in the world tend to establish policies of protecting their farmers and attempt to limit the importation of agricultural products. In my view, therefore, a nation that has made the decision to open its agricultural market to imports is an advanced or developed nation. Such a nation has made the decision that by opening their agricultural market, they are improving the economy and efficiency of economic performance and that their future is not in agriculture.

Turning to the U.S. statistics on agricultural trade, the number 1 and number 2 importers of agricultural products from the United States are Canada and Mexico. This is somewhat misleading, however, as Canada and Mexico have concluded a free trade agreement with the United States making the movement of goods among those three nations free of any restrictions and their geographical location makes it easy to ship from the U.S. Following Canada and Mexico, we see two very interesting and important statistics.

The third largest importer is Japan. Japan has a population three times the size of Korea and there is no question about the status of Japan as an advanced nation. Now comes the astonishing number. The fourth largest importer of agricultural products from United States is a country we know well: Korea. Today, of all the food consumed by Korea, 65% is imported. Most of us have made the decision, perhaps a subconscious decision, that we do not want to be involved in agriculture. Only 6% of the total population of Korea is involved in agriculture and the number is rapidly decreasing every year. The reason we have made this decision is that we have decided that we can achieve greater economic value by using our scarce land for activities other than agricultural production. This is an amazing statistic to which few of us give any attention, but one which screams to me that Korea is an advanced nation.

Lets take a look at some other very impressive developments and Korea's standing in the world. We accept the fact that the club of the G-7 nations represents the most advanced countries in the world. In my view, however, the G-7 should be the G-8 with Korea being given membership in this exclusive club. The fundamental purpose of the G-7 meeting is to basically to establish monetary and industrial policies and seek to implement these policies throughout the world. Given Korea's importance to the world economy and the impact that Korea has on the economies of most nations, Korea clearly deserves a seat at the G-7. Let me give you an interesting example of Korea's influence around the world.

If we think of the most important and highest value-added products that mankind is capable of producing today, these five products would probably be i) airplanes, ii) ships, iii) automobiles, iv) steel and v) semiconductors. Korea's world ranking in these most important products that mankind has learned to produce is very impressive. That ranking is as follows:

Airplanes: Korea does not produce airplanes, but neither does Italy, Germany, Canada or Japan. Of the G-7, only the U.K., France and the U.S.A. produce airplanes. Korea is, however, a major producer of airframes and wings.

Ships: Korea is the number **1** producer of ships in the world today.

Automobiles: Korea is the 4th or 5th largest producer of automobiles and more recently, Korea has captured more than 5% of the U.S. market given the high quality and low price of its current production.

Steel: Korea is the world's second largest producer of steel and arguably the most efficient.

Semiconductors: Korea ranks either number **1** or **2** in the production of semiconductors.

In comparing Korea's ranking, one can only reach the conclusion that Korea has more influence on the world's economy than many of the G-7 nations. And yet, Korea is not invited to the club. In my view, one of the reasons we are not invited is because we do not accept that we belong. We have compromised ourselves and our attitudes into thinking that we are still a developing nation. We still somehow think of ourselves as a nation with the same standing and economic force as we had in the 70s or 80s.

Today, Korea's per capita income utilizing the purchasing parity power statistics (PPP) is \$16,000. If we were to take the economically active population in the Seoul metropolitan area, this number would be much greater. While this number is still lower than the average among OECD member countries, we are by no means an under developed or developing nation at this standard.

During the past three years, under the leadership of President Kim, we have gone through a revolution in Korea. The changes and reforms that have been implemented have vaulted Korea to the status of an advanced nation. These reforms and systematic changes have ensured that Korea will be able to compete with the world and the statistics above prove to us that we are doing so. There is still much to do.

We need to reform attitudes about ourselves and our standing in the world. We need to go through a mind change and rid ourselves of the concept of Korea as a developing or even emerging nation. We are no longer the country we were in the 80s and 90s, but we still think of ourselves this way and as a result we compromise our standards of behavior and what we are willing to accept from ourselves. This is our crisis

of compromise. If we can accept our newly found status as an advanced nation, we will rid ourselves of the temptation to accept lower standards of behavior in how we conduct our various institutions.

Our second crisis is that of *circulation*. Money is not circulating in our economy and we began to first see the negative impact of this lack of circulation in September and October of last year when the economy began to stumble. There is plenty of money in Korea but it is not circulating in the economy, rather it is flowing between the government and the banks. In order for our economy to be healthy, cash must flow into industry through the banks, insurance companies, the stock markets, the bond markets, etc. These institutions and markets are not fulfilling their intended role in the economy.

Banks are enjoying a boom in lending to consumers, but they have chosen not to lend to companies. KDB and the Korean government faced significant criticism from abroad recently for trying to pump the bond market which was not functioning. Without this circulation of money to industry, they will ultimately choke and success will be difficult to achieve.

I believe this second crisis is actually the result of the third crisis which is the crisis of **confidence** or credibility. There is basically very little trust of industry. Historically, financial institutions relied on the government to perform their credit function. Companies were viewed as credible based upon the nature of their political connections. With the reforms instituted these past few years, particularly the reform of the financial sector by the government, financial institutions are now required to judge for themselves whether they can safely lend money to a company. As a result, banks prefer to lend to individual consumers who they believe to be a better risk. Investors in the bond markets are unwilling to assume the risks of industry and investors in the stock market are not placing confidence in industry. The numbers speak for themselves.

If we think of the Korean economy over the past ten years, we have made remarkable strides and developed tremendously, particularly since the crisis of 1997. There can be no debate that we are much better off today than we were ten years ago. And yet, the stock market tells us a different story. In 1991, the KOSPI was around 700. Today it lingers at approximately 550, a 25% decline over that ten-year period. The stock market will always experience swings in value depending upon current conditions and performance, but over time there should be positive long-term growth. If we compare the market performance in the United States for example, we see how there can be swings in the market, but positive long-term trends. In 1991, the Dow Jones was around 2000 and today it is over 10,000. This represents a five-fold increase in this same ten-year period.

Why is it that we have not achieved a five-fold increase like the United States? If the KOSPI was five times the 1991 figure, the index would be at 3500 today rather than 550. An additional 3000 points on the KOSPI would have a tremendous impact on the economy and the wealth of the nation. If the KOSPI today were 3500, can you imagine how wealthy we all would be irrespective of whether we had invested in stock? If the

market was performing that well, companies would have more money to develop new technologies and products, they would be able to pay better salaries and dividends, they would be looking for greater outsourcing and services, investors would be looking to make their lives better by buying more TVs, cars and new houses. The positive impacts are endless and the result is that we would all be so much better off. The government has established our per capita income goal at \$20,000. If the stock market was at 3500 we would have surpassed this long ago.

It is very sad that we have not had growth in the stock market to actually reflect the growth in the economy. I believe one of the major reasons for this lack of performance is the lack of confidence in Korean companies. Investors do not give credibility to publicly listed companies. Simply put, there is very little trust.

There is a very interesting phenomenon in Korea and it relates to the way in which we buy stock. Korea has established two very remarkable records in the stock market – world records in fact. This first world record is evidence of the degree to which Korea has embraced the Internet and helps to explain why Korea is on the leading edge of developing Internet related technologies. Of all stock purchases in Korea, 70% of such purchases are made over the Internet. There is no other nation in the world that can match this volume of Internet usage. This is a remarkable and outstanding achievement.

The second world record, however, while equally remarkable is something to be less proud of and serves as clear evidence of the lack of confidence placed by investors in Korean enterprises. This record is the average holding period of a share by Korean investors which today stands at 6 days. The Korean investor is simply not willing to risk money for longer periods of time given the lack of confidence in the market.

When an investor buys stock, he should study the balance sheets of the company, look at comparable industry values, review the products of the company, future products under development, market conditions for the company's products, management and their philosophy and review any analysts reports. Typically, however, investors pay no attention to such details and rather they rely on hearsay and rumors in making investment decisions. Typically, we purchase a stock based upon a tip received from an uncle who has a friend, a very credible friend, who has told the investor that a particular company will do well. Based on such a tip or inside information, we quickly buy the shares only to sell them six days later based upon a subsequent tip from another uncle whose friend has stated that the company will soon fail. We are not investors, but gamblers.

On the Korean stock market today there are over 2500 listed companies. I often ask my audiences to name ten listed companies that they can trust. It is very difficult for them to name ten companies and the list is almost always the same: SK Telecom, POSCO, Samsung Electronics, Samsung Life Insurance, Kookmin Bank, Housing & Commercial Bank and LG Chemical. Once beyond this list, it gets very difficult for people to think of reliable companies. Out of 2500 companies, it should be easy to name of 10 to 20 companies. Again, I believe this is evidence that we truly are in a crisis of confidence; we simply don't trust Korean industry.

It is not just the investing public who don't trust industry. There is a general lack of confidence in companies by government agencies as well. Recently one of the members of AMCHAM, a well-respected multinational, related to me his experience with the tax office and the audit of his company. He stated that he had "suffered" a tax audit. He indicated that the auditors came into his company and told him to pay a stated amount of tax. He protested to the auditors requesting that they show him based upon his books and records why such a tax was owed. The auditors stated that he should just pay the tax. In essence, the auditors did not rely on the records of the company based upon the underlying assumption that the records are not accurate. After years of experience, the tax officials have learned to conduct tax audits by establishing an objective on the amount of tax they believe should be paid and then seeking ways in which to negotiate that amount during the audit. The tax officials are not the villains in this story. They also are the victims of years of abuse from the practice of not maintaining transparent records and therefore not being able to rely on the books of the company. This practice is improving rapidly and in the next few years we can expect to see dramatic improvements in the reliability of the financial statements and other records of companies.

There are three very simple ways in which we can overcome this crisis of confidence. It is so very simple and if we do this, within two to three years, the KOSPI index will easily surpass the 3000 mark.

First, companies must become transparent. This is an absolute must. We must learn to be disciplined in accurate reporting of the results of the companies and not seek to manipulate or hide those results. By being honest in our reporting, investors, government and the public will gain greater confidence in our companies and we will see the values of these companies increase dramatically so that stock prices will greatly exceed book values and reflect the real earning power of a company's assets.

One of the criticisms of U.S. companies has been their tendency to focus on short-term results rather than thinking about the long term potential. This of course stems from the fact that the analysts will review and report on the quarterly results of these companies. Every manager of a company has to create a budget of his expected income and expenses and therefore profits. This manager's performance is based upon his ability to achieve the targets set forth in those budgets and the stock analysts rate the performance of companies on their ability to achieve these budgets. On CNBC or in any report on company performance, you hear constantly the evaluation of a company based on whether they meet or beat the expectations of the "street." Because of this type of transparency, companies are given much higher values than they could achieve without such openness. We are losing tremendous value because of this lack of transparency.

Secondly, a company can only become more transparent if that company and its managers and employees are keeping the law. The basic responsibility of ensuring that a company is in compliance with the laws and regulations governing its activities rests solely on the shoulders of the CEO. Only the CEO of the company can create the atmosphere and expectations within a company that that company will produce accurate

and fair financial statements and that the activities of the company will be consistent with the laws and regulations. If a company chooses not to follow the law, there is absolutely no way that company can be transparent in its accounting practices and other record keeping. It is imperative therefore that the leadership of industry in Korea develops an attitude of respect for the law and instills this within each employee of the company. The failings of a company in this regard can only be the responsibility of the leadership of the company.

Transparency and legal compliance are issues that each individual must struggle with. These are issues that have nothing to do with government and must be resolved by individuals. It is imperative therefore that shareholders choose CEOs who are committed to transparency and legal compliance. By doing so, the shareholders will ensure that they will improve the value of their holdings. The chaebol system has essentially changed and these large companies are generally no longer run simply for the benefit of family owners. These companies are becoming models of transparency and they are being run by professional managers, e.g., SK Telecom, POSCO, Samsung Electronics, etc. The family-owned small- and medium-sized companies must learn from the examples of these large reformed chaebol. They too must hire professional managers or learn to operate the companies for the benefit of all shareholders which demands therefore that they be transparent and legally compliant.

Finally, government must learn to regularly and systematically enforce the legal system that is in place. Korea's legal system is essentially that of an advanced nation. The essential difference between Korea and the United States for example is in the enforcement of the laws. Historically, the United States has not always been a country that enforced its legal system. It was not until after the great depression in 1929 that the U.S. began a more systematic enforcement of the law, including the laws. One may recall the fairly lawless state of the United States in the 1920s that fostered such famous gangsters as Al Capone. Thereafter and essentially for the next 70 years, the U.S. has very vigorously enforced the laws governing the companies and this has resulted in the habit of Americans becoming honest. Americans pay their taxes because they fear going to jail. Business managers create transparent and honest records of their companies because they fear going to jail. Going to jail in the United States is not like the practice in Korea of granting a few months vacation to executives who are caught violating the law. Executives in the U.S. spend many years in their cells before they are set free.

There are special circumstances in Korea brought about by the culture and history of Korea that sometimes make enforcement a difficult issue. One such circumstance is the unusual habit of seeking to create a Utopia through the passage of law. There is a tendency in the government ministries to create laws which are not realistic, but which are very well intended to establish a higher standard of behavior that we believe would be ideal. As a result of creating laws that are often too idealistic, we create sympathy for those who are unfortunate to be found in violation of law and subject to arrest. Because of this sympathy factor, we tend to let people out of jail early and our enforcement efforts are sporadic and often based upon political revenge rather than commitment to creating a transparent and predictable society.

An example of our desire to create a Utopia can be found in the Labor Standards Act. This act was originally passed in 1953. I would dare say that there was not a single company in Korea in 1953 that was capable of maintaining all of the standards and paying all of the benefits to employees as required by that law. As a result, a practice developed that was outside the scope of the law which may companies vulnerable to either political attack or blackmail by disgruntled employees and created an atmosphere of mistrust between labor and management. We would have been much better off with a law that provided more realistic standards that matched the economic realities of the time. Rather than creating laws which create a goal that we hope to achieve as a society, we are much better off with laws that ban behavior that we can not tolerate at this moment and then putting people in jail when they violate those standards. By doing so, we will soon find that Korean society will become a society that plays by the rules and is much more transparent. Singapore is an example of a Confucian based society that has achieved transparency by creating a rule by law environment.

I can make an absolute promise that if i) government will create laws with realistic standards that we can follow and then they strictly enforce those laws and ii) shareholders choose CEOs who are committed to keeping the law and creating transparency and those CEOs perform as expected, we can create a transparent society within a matter of just a few years. By so doing, we will boost the value of the stock market by a factor of four or five times and the overall value of the Korean economy and therefore the wealth of the nation will increase greatly.

I know this is possible. Korea has the ability and potential for success more than perhaps any other nation. This potential lies in the great intellectual power of Koreans, the desire to learn, the ambition to get ahead and achieve financial as well as social capital and the ability to work very, very hard. Together we can achieve this great potential and in the process become wealthy.

Q&A

Q: You said that if Korean laws and the way Korean companies treat their books are properly handled and rectified, the stock-market can reach 3500 in 2 years. How do you come to that estimation?

A: The possibility of our being able to achieve a 3500 level in the stock-market, a seven-fold increase, is not terribly realistic, but if we establish transparency in our financial statements and create credibility, we could reach 2000 in 18 months without any problem. However, great improvements towards establishing transparency are going on. Of course, new accounting standards have now been created in terms of financial statements, etc. So, as those new standards are implemented and enforced from this year onwards, there is a real possibility that we could be at 2000 within 18 months to 2 years. With this in mind, in the long-term, I would definitely buy stock in Korea.

Q: In the past you and the American Chamber of Commerce have advocated a US-ROK free trade agreement. Do you think an FTA with the US is realistic within the next 10 years?

A: I would say an FTA with Korea is very realistic in less than 10 years. In fact, this week there is a team from the US International Trade Commission in Korea investigating the circumstances under which an FTA could be concluded. They will be making a report to the Senate Finance Committee.

The Bush administration is just now putting people in place and very soon President Bush will come out strongly for FTAs. The Summit of the Americas is going on in Quebec this week also and at that summit the Bush administration is calling for a huge expansion of NAFTA as well as supporting FTAs. This is the only way to go.

Once there is an FTA with Korea, it will spur things in Japan, it will certainly make China nervous, which it should, and we will see great improvements in the trading relationships here. We are very confident that an FTA will be good for the economies of the US and Korea and I would encourage people in Korea to think very positively about the Chile agreement that is now under consideration, because that will be a great momentum towards an agreement with the US.