How Should Korea Cope With Financial Globalization?

James P. Rooney

By way of background, I started out as a civil engineer, working in London, Saudi Arabia and Dubai, building, at that time, projects out of concrete and steel. Today, the materials that we use have changed, but I think the task is still the same. They call the job now more of a financial engineer rather than a civil engineer. But I think that the purpose and role of a financial engineer is still the construction of a brighter future.

Today, perhaps we can talk a little bit about how we all need to think about building Korea's future. By way of background, again, Templeton is a Korean fund manager, which – although I look like a foreigner – is actually a local fund manager. As my staff remind me, our staff is 97% local and 3% foreign. I'm the 3%. One day you will no longer be able to distinguish me. My hair and appearance will change and we will have accomplished the full transformation.

Our mission when we came to Korea was to raise money in Korea so that it could be reinvested back in the country to provide the kind of local financial intermediary that fidelities or other players have achieved in the U.S. market. In the process, we sought to bring world-class investing skills to every Korean family. In other words, we have a retail focus for our investment products. I hope that we will create wealth for our clients as opposed to the speculatory kind of investment that many people have been used to in the Korean stock market. We have been here for about three years and have something close to 2 trillion won of assets under management.

But let's talk a little bit about Korea now. Some of you may think of Korea geographically, as a peninsula sticking out the side of Asia comprised of a lot of provinces. Those of you who were born in Korea may have come from this province or that province. Another way of thinking about Korea geographically is in terms of its political situation, i.e. the division of North Korea and South Korea. But there are also bound to be those among you who are more romantic or culturally oriented, who think about Korea in terms of its history and tradition.

Overcoming profit failure, overinvestment and an over-leveraged economy

Unfortunately, I am not allowed to have any of those luxuries in my way of thinking. I have to be more pragmatic and think about Korea in terms of its economic model, which, I would argue, can be considered quite simply. There is the rest of the world, which looks very small. But if you are standing in Korea, that is natural. Between the rest of the world and Korea is a membrane that I call the FX (foreign exchange) frontier (Fig. 1). Across that membrane, anything that happens has to be translated using this exchange rate. Then, there is the financial infrastructure, the industrial base and the labor market in Korea, the three main elements and the one primary translator between Korea and everything that happens inside and everything that happens outside.

Looking at that economy over the last ten years, a number of positives but also a number of serious problems can be seen. The biggest positive is that Korea has been a high - growth economy for thirty years, growing at something greater than 8% per annum. But in the process, since 1988, it has suffered very severely from profit failure, overinvestment and an over-leveraged economy. These have led to stock market failure. At the same time, there has been an overvalued exchange rate, making a distortion between everything that happens inside Korea and everything that happens in the rest of the world, which has led to export failure. This completes the circle because export failure kills profits and so brings the economy back into the spiral.

The IMF (International Monetary Fund) crisis was actually a consequence of all of these things coming to a head. Many people talk about it as a foreign currency crisis, in which Korea was unable to pay its foreign debts. Yet that was merely a minor symptom of the much deeper problems. As we saw at the time, that problem could be solved by borrowing US$20 billion from the IMF and money from elsewhere. But the fundamental problems take more and harder work to resolve. They are the ones that are going to determine Korea's future and whether that future is successful or not.

Briefly to look at these symptoms, Korea had a tremendous high-growth economy with basically only one prior year of downturn at the end of the 1970s – right around the time President Park was assassinated – which was caused by a small correction in capital spending. Other than that, as mentioned, Korea has achieved in excess of 8% per annum compound growth rate – an achievement that basically has been unequalled anywhere else (Fig. 2). The closest I have seen has been Taiwan, which has also had reasonably similar growth rates. But Taiwan grew much faster in the 1980s and has been slowing down in the last decade.

Turning to the problems, profit failure stands out. There are two reasons why profit failure is important. The first is that if you do not make profits, you cannot pay your debts and cannot reward investors. The second is that from a country's perspective, if business does not make profits, the economy does not grow as fast as it should. Back in the 1970s, profits, wages and GDP (gross domestic product) were essentially in balance (Fig. 3). There was a small correction in 1980 and then they were again in balance through to the 1988 period. That great year of democratization and the Olympics was actually the beginning of the problems that Korea is trying to address today. At that time, profits began to fail to track with the GDP growth of the country. Wages, on the other hand, continued to grow strongly. Some would argue that wages grew too fast. Actually, it is not just the fault of labor. If that profit failure had not been there, GDP would have grown faster and the balance between productivity and wage growth would have been a lot better.

Overinvestment was quite dramatic. During the 1970s and 1980s, the economy was essentially driven by capital investment. But for every dollar that was put in, Korea was getting the right amount of economic growth out. The Korean economy was not

consumption driven, as the red line in Fig. 4 indicates. Consumption was lagging economic growth. The very frugal Korean people were not spending enough domestically to support their own economy. Unfortunately, Korea went wild with capital spending in the 1990s. In Fig. 4, the area between the blue line and the green line is excess capital spending, money that was spent without getting any net benefit out of it because GDP failed to grow at the same rate of capital investment. Korea had to pump more and more dollars into capital, while getting less and less for it.
Not surprisingly, these two major factors of profit failure and overinvestment have led to a very deep problem in the economy, which I call the over-leveraged economy. We have all heard of corporations that have over-leveraged balance sheets, but here is something deeper. In Fig. 5, the total financial assets of the Korean economy as a whole are measured as a percentage of GDP. The vertical axis shows total financial assets of around 270% of GDP in the 1970s. It was a very high inflation era. When that inflation was brought under control, there was a correction in the level of assets that were needed to fuel the economy. By the late 1980s, it had stabilized at about 370%.

Let's assume for a moment that was a stable point. In the 1990s, as Korea overinvested and failed to recover those investments through profits, these total financial assets began climbing dramatically and, in fact, started to go exponential. In 1997, even before the IMF crisis had hit, Korea had 100% of GDP growth in those financial assets. Korea needed to put more and more money into running the economy, and as we saw earlier, without getting the returns for it.

Now, some say the non-performing loans of Korea amount to around 60 or 100 trillion won. Arguably, they could represent about 300% of GDP if this were to be corrected to the level that it stabilized at in the 1980s. That is an awful lot of cleaning up yet to be done. It is going to take years to burn off these excess financial assets. Some of these assets are true investments, e.g. real estate and factories. Some of those factories are working, but some of them had no reason to exist in the first place. A lot of it is also double counting, circular investment that people have claimed as assets, but actually, if netted out, it does not end up looking quite as big. That must be looked at. There is a huge accounting problem as well as an awful lot of wasted money.

Not surprisingly, those problems led to stock market failure. In Fig. 6, the pre-IMF Korean stock market can be seen for the last ten years – it is flat as a pancake. Why would anyone want to invest in the Korean stock market? Looking over a longer time frame, it can be seen (Fig. 7) that the KOSPI (Korea Composite Stock Price Index) in fact has grown over time. Calculating from 1972 to the present gets about a 15% return, which is what shareholders should earn on their investments. But clearly, all that happened back in the past and has not been rewarding for shareholders in the more recent ten years.

If the stock market is considered a measure of wealth created and then compared with GDP, which is taken as the source of that wealth creation on an annual basis, then in principle, GDP growth and stock market growth should track more or less with each other. In fact, they do, but not very well. Fig. 8 shows that through the late 1970s there was relatively good tracking between the KOSPI and GDP. There was then a long period when the stock market was not functioning efficiently. It was liberalized in the mid-80s and there was a tremendous boom in the stock market in the late-80s. But since then, where has the stock market gone? Nowhere.

If profit failure, the operating surplus which failed to grow with GDP, is overlayed on this chart (Fig. 9), it can be seen even more clearly why profits have actually been the failure of the stock market. Remember, this is operating profits, not net income. In addition to the operating surplus, the interest costs that companies have had to pay to support their balances must be subtracted. If they are subtracted, because those interest costs have increased with that increasing financial burden over time – I cannot at the moment do that number because the data is not available – it would look like an even further depression, somewhere below the green line (Fig. 9). It would be apparent that the stock market is purely a reflection of the failure of corporates to run themselves financially in a sound manner.

Overvalued exchange rate

Finally, Korea has had an overvalued exchange rate. In Fig. 10, the exchange rate since 1970 appears to have been depreciating. It was 300 won/dollar from the mid-1970s to 1980 and 900 won/dollar just before the IMF crisis. That should mean that it is a sound and devaluing exchange rate. The problem is that there is no reference point. There is nothing on that chart that says what the exchange rate should have been. To create that benchmark, I took the exchange rate in 1970 and made a very simple adjustment. I compared inflation in Korea with inflation in the United States and created an index (see the pink line in Fig. 10) which, in my view, says what the exchange rate should have been in Korea for it to remain as competitive today as it was in 1970. This is purely an inflation adjustment, because if there is inflation in one currency that is greater than inflation in another currency, it should weaken the buying power in that other country.

Fig. 10 shows something quite different. There was a period of very high inflation in Korea relative to the U.S., when the exchange rate should have devalued all the way from 300 to 1,100 won/dollar. But during that time in Korea, the exchange rate was fixed. The government chose to have a fixed exchange rate policy all the way to the end of the 1970s. When the exchange rate was released, not surprisingly, it weakened dramatically and this kind of trend can be seen over the next five or ten years. Arguably, if it had been allowed to continue, the Korean won might have approached the 1,300-1,400 won/dollar level on a gradual basis over the last 10 or 15 years. But the won was driven back to strength in the late 1980s partly as the result of government policy and partly as the result of a trade surplus. From then on, the gap gets wider and wider. I liken it to an elastic band that is being stretched. An elastic band can be stretched for quite a long way, but eventually if one keeps pulling on it, it is going to snap. And not surprisingly, that is what Korea experienced at the beginning of the IMF crisis. Korea ran out of cash to support that artificial exchange rate and all of a sudden the exchange rate snapped. It went up at one point to 2,000 won/dollar. Fig. 11 only shows monthly averages, which ended up at around 1,600 to 1,700 won/dollar. But you may remember in December 1997 how dramatic that exchange rate movement was.

Now, the other thing that happened is illustrated by the two red lines (Fig. 12). During the period when the won was moving back to a competitive level, Korea started to generate a trade surplus for the first time in history. And during the period when it driven back into strength, the trade surplus was killed. Fig. 12 shows the data, with net exports (exports minus imports) relative to GDP. Korea was running a trade deficit all the way through the 1970s and into the 1980s. During that period when the exchange rate was starting to correct, the deficit shrank year by year until it eventually turned into a trade surplus of about 8% or 9% of GDP. When the exchange rate was turned around, the trade surplus was killed. Since then, Korea was in a deficit until last year. The one little bubble (Fig. 12) was just the semiconductor market, a supply and demand imbalance, when Samsung Electronics made out like bandits because they happened to have the capacity when nobody else did. That was a one-time deal not to be repeated on a regular basis.

So, it can be seen that Korea killed its own competitiveness through having too strong an exchange rate. As you can imagine, if you know what it is like to run a business, if you run a deficit long enough, you eventually run out of cash. Korea literally ran out of cash in dollar terms. Poor cash planning was the short-term factor. Korea could have probably raised any amount of dollars it wanted to on the international markets in 1995 or 1996 and could have continued to fund that kind of deficit. But Korea did not plan the cash and when the crunch came, there simply was not enough on hand.

Loss of market share

Perhaps more seriously, while Korea was running that trade deficit, it was also losing share in important markets in the world. Fig. 13 shows all the countries Korea exports to. What can be seen from the chart is that Korea had a very strong position in its exports in North America in the mid-1980s, once its exchange rate had become competitive, allowing it to compete in that market. It also had a relatively good position in Europe and was doing well in Japan. But since 1988, the ability to export to the U.S. has died dramatically. The ability to export to Europe has suffered significantly as well and exports to Japan have dramatically shrunk. To replace that lost volume in those developed markets, Korea had to retreat to all kinds of little niche markets around the world that no one else wanted to be in, the emerging markets. In fact, as can be seen in Fig. 13, Korea has become overexposed in its exports to Hong Kong, which represent in large part exports to China, along with its direct exports to China. Korea has too much share in a lot of underdeveloped markets which still have huge amounts of risk. Having lost its position in developed markets, Korea replaced it with positions in much more risky markets. In the process, I would argue that Korea has lost not only competitiveness but profits too.

For comparison, Fig. 14 shows imports by country on the same basis. Europe has become a slightly larger partner. Interestingly enough, Japan has shrunk and the U.S. has been relatively stable. But the export side of the story tells the tale. Korea has retreated to selling to its Asian neighbors. It is important to remember for the future that Asia is not the world. Korea needs to think about the world and recovering its position in those developed markets because, as in any business, you have to go where the money is. In Fig. 15, world GDP is dominated by about 12 countries, which represent 75% of world GDP. That in itself is dominated by the U.S., but Europe is very important. Those two continents are crucial for Korea's future success. Korea has to learn how to compete in them not only from a cost point of view, but from quality, service and marketing points of view as well.

I first observed some of these problems when I had been in Korea for about six months and did a presentation for the Federation of Korean Industries on Korea's competitiveness in the automobile market in the U.S., where I discovered that Hyundai had been losing market share quite dramatically. Even though it had good product, Hyundai was overpricing itself. The Japanese were gaining share at the same time as the Koreans were losing share.

Surge in interest rates and massive unemployment

One of the final couple of symptoms experienced at the beginning of the IMF crisis was the massive spike in interest rates. This was not just crushingly high interest rates (Fig. 16). At the same time, there was a terrible credit crunch because of the BIS (Bank for International Settlement) ratios that were imposed on banks essentially overnight. The banks stopped lending. They started calling back in all their loans. Guess who they called them in from? They called them in from the smallest people out there in the economy. The big guys would not let them have their money back. In fact, they demanded more. But the little guys could not resist and they ended up having to pay back their loans and many of them went into default and even into bankruptcy. That led to unemployment.

As Fig. 17 shows, Korea's traditional level of unemployment was around 500,000 people, with really no tremendously bad news except in 1980, when it rose to about 750,000 people. But last year, in the midst of the IMF crisis, that number rose to 1.7 million, and depending on how it is counted, one could argue that there were even more like 2 – 2.5 million people unemployed.

Lack of effective market forces

These symptoms that I mentioned earlier are not just indicative of some wrong ways of running things, they are also symptomatic of a lack of effective market forces in Korea. There were no self-correcting mechanisms that were functioning efficiently to keep the Korean economy in balance. Thinking about the future, it is necessary to consider how to ensure that effective market forces do come into play in this economy. The economic model ought to work by raising debt and equity to support and finance the industrial base. In a successful economy, the interest and the principal are repayed to the banks, the shareholders get a favorable return on their equity and labor is successful at increasing the standard of living (Fig. 18).

What has been achieved in Korea is a failure to repay debts to the financial sector and a failure to deliver profits to the shareholders (Fig. 19). Labor has done well. They have been tremendous savers. More than 35% of GDP has gone into savings. But unfortunately, those savings have been given to the financial sector and a large part of them has been destroyed. Of course, no one wants to tell the owners of those savings that their money has been lost. Instead, there have been all kinds of bailouts. If you think about it, taxpayers' money is being used to wallpaper over the lost money. That is not the way to run the economy in the future. The money might as well be run around in a circle without adding any value. Of course, that is not a realistic way to think about an economy.

Korea's Great Wall

I left out one very important piece in my simple economic model – the role of the government, which in the past has been a Great Wall around Korea (Fig. 20). I am sure you only thought that China had a Great Wall, but Korea actually had the modern equivalent, and a much more powerful one. In the 1960s, it was a great device to protect the baby economy and allow it to grow without fully exposing it to foreign competition. But by the late 1980s, Korea needed to start dismantling that wall. Unfortunately, Korea did not. It was not just a wall against foreigners, there were actually numerous walls inside Korea, dividing, compartmentalizing and fragmenting the economy, allowing it to be controlled by the government as a command economy (Fig. 21). This basically created a lot of inefficiency internally within the economy. So, we have actually ended up in a curious situation with the great Korean tiger, the tiger economy of Asia, inside a cage. This tiger has had to climb the mountains dragging this heavy cage with him (Fig. 22). Now, imagine what would happen if we could finally uncage the tiger and let him be free again to climb the mountains without all this weight on him.

Where Korea is today – and where Korea ought to be

Returning to the macro-perspective – a high-growth economy, failure to deliver profits, poor lending practices, no concept of credit risk – these are some of the things that have led to the excessive capital investment, the over-leveraged economy and the under-performing stock market. It may seem like I am saying, "Look at all these problems, what a terrible place to be!" But let me put it the other way around. "Look at all these problems. What a great set of opportunities if we can change these practices of the past and turn this economy around, where instead of profit failure we have profit success." But they are not trivial challenges. They are not things that can be solved overnight. Korea is not readily equipped to deal with them because the experience that is necessary to solve these problems is typically lacking in an economy that does not have a solid financial paradigm.

Where are we today? Since the IMF crisis, the exchange rate has come back down to around 1,200 won/dollar. This raises the interesting question of where it should be. If we argue that Korea was a successful exporter in 1988 (Fig. 23) and benchmark the index from there, we get a green line which comes up to about 1,300 won/dollar. That is another twist on what the exchange rate should be. Remember that Korea was a successful exporter in 1986~1987 with markets that were largely closed to imports. There were huge tariff and non-tariff barriers to imports. Of course, a trade balance is the sum of exports and imports. So, even if this level were adequate for Korea to be able to export reasonably competitively, if countries are also going to allowed to import into Korea, an even more competitive won is necessary. This is partly because it will help Korean exporters and partly because it will balance the demand for imports by having them priced at a reasonable level. So, I believe the right answer for Korea’s exchange rate is somewhere between the pink and green lines (Fig. 23), somewhere perhaps more like 1,400 won/dollar rather than 1,300 won/dollar.

For Korean companies trying to export, 1,300 won/dollar is the threshold at which they *can* export, but it is not necessarily the point at which they make satisfactory profits on their exports. So, we need to think about where we are going. Many suggest an exchange rate of 1,100 won/dollar or 1,000 won/dollar. In my view, that is very dangerous. But draw your own conclusions from the data.

Interest rates have come down dramatically from the temporary highs during the IMF era. They came down into the high-teens and then they came down to the levels of the past. In Fig. 24, interest rates in Korea over the last five years or so have been in the range of about 12~15%. That level was reached in the middle of last year. Then it went down below that level and for the last year, Korea has had interest rates lower than ever in its history, of below 10%. I would argue that the interest rates were pushed down too far when they were taken down to 8%. Interest rates around 9~10% would have been a tremendous stimulus to the economy earlier this year. Pushing them down below those levels created some distortions because they came down too far and too fast. Some of those distortions were created in the investment trust industry.

Now, the spike up in the interest rates has created a lot of danger in the financial sector. But in principle, having interest rates in the single digits reflects that Korea is much more of a developed country than most people give it credit for. It also shows that Korea can deserve to have interest rates that are closer to those of developed countries, as opposed to the interest rates of the past, which were more like what returns on equity should be. If you can get equity returns on debt instruments, why would you ever invest in equity? A debt instrument is supposed to be much safer because you get your principle back at the end. So, we are seeing Korea shift from a paradigm where debt is priced like equity and treated like equity to a paradigm where debt is a cheaper instrument and equity has to provide its own risk capital approach to financing.

Unemployment, which reached those horrendous levels and looked like it might go through the roof last year, has started to come down quite dramatically (Fig. 25). Now, maybe half a million people have come out of the unemployment rolls. That does not mean that the problems have been solved by any means. But the trend is in the right direction. It could take two to four years for Korea to get back down to where it was, but I think that various policy measures by the government have had a tremendous effect in avoiding a worse crisis. The tide of unemployment has been stemmed. People are starting to get back to work. If some of those things which were done last year had not been done pro-actively, Korea risked having chronic high unemployment for maybe 10 to 15 years, much as has been seen in European countries when they have had this same kind of system shock.

As for our friend the stock market, just this year it rose from 600 to 1,000 and is now down again at around 800 (Fig. 26). To be honest, I think at 1,000 it was overheated. 800 was the number I had projected at the beginning of the year as where the stock market ought to reach. Arguably, because the economy is coming around faster than we expected, somewhere between 800 and 900 would seem reasonable. But a lot of this distortion and this overreaction in the stock market was driven by interest rates that were too low and liquidity that was forced out of the financial sector and into the stock market. Unfortunately, a lot of people have lost money. But I think that if we look at the longer-term prospects for the stock market, if things are done right, it may be more interesting.

Outlook for Korea – service sector, small companies

So, where does the future lie? First, in terms of economic sectors, it comes as no surprise that agriculture has been declining in terms of importance to Korea from somewhere around 28% to less than 5% of GDP (Fig. 27). But manufacturing, which has been thought of as the driver of the Korean economy, is not the largest segment. Second, although it grew in the 1970s and 1980s, it actually peaked in 1988, when it reached 33% of GDP. Ever since then, it has been declining. We can expect that in the long-term it will continue to decline. There may be one or two years of recovery because of the exchange rate adjustment. But in principle, manufacturing is going to be less important to the Korean economy in the future than it was in the past. What will become increasingly important is the service sector. It has always been the largest and also the most neglected sector. It has not had easy access to capital because it lacks a large asset base to borrow against. It is the sector that has been restricted and which will need creativity and all kinds of new skills.

In my view, this is the sector to watch. Looking at the sectors on an index basis, agriculture has failed to grow with the growth of the economy (Fig. 28). Manufacturing and mining, which were the drivers of the economy in the first twenty years, peaked and then began to grow less fast than the economy (Fig. 29). The service sector, which was tracking with economic growth until the mid-80s, started growing faster in the last 15 years (Fig. 30). So, I think the future is for the service sector, which is a very broadly defined sector. But there are more opportunities in some places than in others. The electricity, gas, water and construction sector, which was growing with the economy through the late 1970s (Fig. 31), stepped up in the early 1980s. Now, this is actually a reflection of overinvestment. Some of this bubble has to go away. Some of the excess investment that has been made before must be reversed so that this sector can catch up with the economy again.

Fig. 27 is in terms of GDP, or value added. It is remarkable that all the people used to be in agriculture (Fig. 32). That is no longer true. They migrated to some extent into manufacturing, but manufacturing's employment base is shrinking. Today, services and the social overhead sector are by far the largest employers of people in the country. All the future growth in employment is likely to come from there, much as it did in the U.S. However, the U.S. between 1990 and 1995 (Fig. 33) is not an equivalent to the decade that Korea is about to go through. Even during that relatively benign period, 80% of all the employment growth in America came from the service sector. Expect the same in Korea.

Second, the future is going to lie in the hands of small companies. If I had said that forty years ago in 1960, you might well have believed me because in those days, Korea only had small companies. Today, those companies have grown up to become big conglomerates. Well, step back to the 1960s and ask yourself where the future large companies of Korea are. Many of them are small companies today, companies that we may not even recognize. We can expect those companies, which already represent more than 80% of employment in Korea, to be the future source of Korean economic growth.

Chaebol – too big for their own good

Less than 20% of companies in Korea have 300 employees or more (Fig. 34). The idea that big companies are the dominant factor is actually an illusion. I like focused companies that are in business to do one thing really well. If they have an affiliate it is for a good business reason. Maybe it is a marketing affiliate so that they can export into the United States. The top 30 chaebol in Korea represent less than 5% of the total employment in the country (Fig. 35). This is quite remarkable considering how everyone views these chaebol. They also represent less than 15% of the value added (Fig. 36). In other words, less than 15% of GDP in Korea is created by the chaebol. This number was declining from 1985 and I understand that in 1998 it actually dropped to 10.2% of GDP. So, the chaebol are not as important to the economy as we tend to think in terms of contribution to GDP. On the other hand, they consume the largest part of the assets of the country (Fig. 37). 45% of the assets are with the top 30 chaebol. These assets have allowed them to build these constellations of businesses.

For example, the “red” chaebol (Fig. 38) has many affiliates. It has needed to raise many assets to do that, and in the process, has incurred 45% of the liabilities of the country (Fig. 39). So, most of the assets and most of the debt have ended up with these companies which only generate 15% of GDP and 5% of employment, at least on a direct basis. To raise these assets, cross-guarantees and cross-equity investments, or circular investments, have been made between these companies. Companies which ought to be floating free in space as independent centers of risk have been locked together in a rigid structure out of the supposedly flexible business model (Fig. 40). The little affiliate cannot fail. It may be a lousy business. It may have been a bad business decision to get in there, but because of its affiliates it cannot be allowed to fail. Failure has failed to be tolerated in Korea.

Though it may seem that just the chaebol themselves are tied together, looking at the system, it is clear that the chaebol are tied to the entire banking system. All of the banks of Korea have a piece of the pie. This has created a system web, which is a system risk (Fig. 41). In Taiwan, the economy is built on small companies. There is a healthy bankruptcy rate of 3-5% (Fig. 42). That means that every year the gardeners are going out and cleaning the garden, trimming the weeds, cutting back the flowers, pruning the roses and cutting away the dead wood. It allows the economy to put those assets back to good use and to be reborn every year in a more efficient manner. In Korea, on the same scale, there is a bankruptcy rate less than one tenth of that, 0.3-0.5% (Fig. 43). Korea has not been cleaning the garden and pruning the dead wood out of the economy. Therefore, it has not learned how to do it.

Let's take "Mr. Green," for example, as he considers this conglomerate (Fig. 44). He thinks one of these companies is a very good place to invest his money. What he does not realize is that his money goes in the front door, out the back door, down the street and across the road into a radioactive waste dump, which we might call generously, Samsung Motors. He has a friend who is also an investor, "Mr. Blue." Mr. Blue liked this company too. He looked at it and said, "Gee, they drill for oil. I think drilling for oil is good. I'm going to invest my money in that company." (Fig. 45) What he did not realize is that every time the company strikes oil, it moves the oil wells over to another company. It happens to suit their purpose, but it never does Mr. Blue any good as an investor because he never gets to share in the profits, only the costs. So, both Mr. Blue and Mr. Green are a little puzzled by investing in Korea.

Looking at this uncertain investment environment of Mr. Green and Mr. Blue, it is apparent that the "too big to fail" syndrome stops any consequences from happening to poor investments. This creates errors without consequences, and because there is no experience from failure, there is no learning from failure. I will tell you honestly, I have always learned far more from my failures than my successes, whether it is putting my finger on a hot stove and realizing that I get burned or losing money on some ill-advised investment.

So, there is massive system risk in Korea. That is the background to the chaebol restructuring – untangling these corporate webs, letting these businesses float free so they can stand on their own feet. Then they can be viewed individually as investments and if one makes a wise investment, one earns a wise return. If the business does not deserve to be alive, it is allowed to fail. Then the system can be purged and those assets and people can be put back to good work somewhere else.

Of course, there is not only the "red" chaebol, but the "purple" chaebol too. The red and purple chaebol might be thought to exist independently in space. Unfortunately, that is also an illusion because they are tied together across the entire banking system (Fig. 46). Because they are linked together, failure of one chaebol can echo throughout the banking system and create problems for other chaebol. Thus, there is massive system risk, not just a singular risk.

The concept of "big deals" is an interesting one. Industries need to be rationalized because there is too much capacity in the same business. So one business is moved from one chaebol to another. Unfortunately, when that occurs, residual linkages are left behind, e.g. a responsibility of one chaebol for some business that has now moved elsewhere (Fig. 47). Lo and behold, what has been created? The chaebol are now tied together more tightly than they ever were in the past. If Samsung Motors had been given to Daewoo, not only would have Daewoo been even worse off, but there would also have been the risk of bringing down Samsung itself. So, "big deals" have interesting secondary effects.

Finally, within these corporate webs, we discover on closer examination – one has to be sort of an archaeologist or a forensic detective to find things – that there are "green" businesses (Fig. 48). These "green" businesses are financial institutions. Now, the chaebol have not been allowed into banks, so instead they have created securities companies like Daewoo Securities, along with life insurance companies and investment trust companies. These are the piggy banks of the Korean chaebol and have led to interesting situations. Not only are there inter-linkages from the big deals, but there is also self-investment, or investment from one chaebol into the equity of another chaebol (Fig. 49). This has produced massive temptations which the Korean infrastructure is not equipped to resist. There is call loan support to affiliates. Daewoo Securities lent vast amounts of money to other Daewoo affiliates during the sixth months immediately prior to their workout. This was money they had borrowed elsewhere on the market. So, what is wrong with purchasing the bonds of an affiliate, purchasing the equity of an affiliate and interestingly, purchasing the equity of a competitor using other people's money? Basically, it generates huge conflicts of interest. The money that is being used in these financial institutes is not the company's own money, it is other people's money.

For example, take the investment trust industry. There is a collection of trust assets that are intended to be invested in bonds and stocks using objective and independent investment decisions. This money has come from depositors through investment accounts that have been placed with an investment manager (Fig. 50). There is no risk absorption. They are supposed to be on the hook for all the risk. They are the owners of this money. The money that is being played with in these "green" businesses is from Mr. and Mrs. Kim, Mr. Park and Ms. Lee, the ordinary people of Korea. But these companies are playing with their money without respecting that it belongs to them and not to the companies. So, we need to be aware of these new temptations. They are very serious and not easy to control.

As another example, purchasing the equity of an affiliate creates the opportunity for stock price manipulation. It also allows a company to support the rights issues of corporates with other people's money. It also increases corporate shielding. One of the biggest concerns the chaebol had earlier on this year, with the market fully open to foreigners, was how to protect themselves from hostile takeovers. They wanted shares to be in the hands of friendly players. Who is more friendly than a piggy bank controlled by your own chaebol? You can also imagine purchasing the equity of a competitor. First, when running a fund, just by spreading money across the market on some kind of market waiting, a conglomerate can end up potentially earning a lot of LG Electronics or some other competitor not in the chaebol. That can allow the chaebol to do barter transactions with that other chaebol. It could also allow all kinds of hostile attacks on them. It becomes power and an opportunity for screwing around. The worst effect probably is that all these things lead to a defeat of market forces. I think that is where I came in. If these things are allowed to continue unchecked, the self-correcting market forces that are necessary to be successful in the long run will not be available.

Let me summarize on running corporates from a financial point of view. Always ask whose money you are using. Is it yours or somebody else's? And let's recognize that better business performance should be normally rewarded by a lower cost of capital, which allows the corporate financial management to become a competitive advantage, just as much as the products that a company operates with.

Financial Infrastructure – its proper function

I would like to briefly touch on the financial infrastructure once more. What is the purpose of financial intermediaries? They should raise capital from the market and then allocate that capital based on sound business principles: risk return, pricing for investors and borrowers, safety, at least on a relative basis for investors, and finally, but not first and foremost, making profits for their own shareholders. Financial intermediaries are the guys in the middle, between the ordinary people and the corporates that need capital (Fig. 51). They allocate that capital across the economy.

Banks function as what I call balance sheet spread machines: the liabilities on the one side are the money that they have raised from outside, the assets on the other side are what they have lent to corporations (Fig. 52). They absorb risk along the way, interest rate risk and credit risk. Insurance companies are very similar, with the addition of one extra risk, actuarial risk or event risk – the risk your house burns down or an earthquake happens, or you crash your car (Fig. 53). Investment trusts, as I have mentioned already, have no risk absorption. But it is interesting that in Korea, this industry has been run as though there were no risk (Fig. 50). Therefore, somewhere along the line, someone has had to absorb the risk. This has typically ended up being ordinary people.

The spread at which a bank needs to operate is usually 200-400 basis points. Investment trust businesses run with a lower spread or a lower fee because they do not absorb these risks. They have not been rewarded for taking those risks, whereas in fact, they have taken those risks by offering guaranteed products. In the U.S. through the 1980s and 1990s, the mutual fund industry, which was essentially non-existent at the beginning of the 1980s, grew to have a huge share, equal to banks, in terms of financial assets being looked after in the U.S. market (Fig. 54 & 55).

In Korea, which has had growth in financial assets at an even faster rate, the investment trust business has been relatively stable for the past 20 years, at about 10% of total financial assets (Fig. 56 & 57). But huge dynamics have been going on in the last two years that have opened up that share of the market. New players have entered (Fig. 58). In the future, there are likely to be even more players. Investment trust assets have quadrupled from 1995, when they were 62 trillion won, to the middle of 1999, when they reached 245 trillion won (Fig. 59).

Money only came because it was getting 1~2% higher interest rates than the market on a three-month basis and could go home any time. When it discovered that there were bad assets in the pot, it wanted to go home right away so that it did not lose any more. When that money tried to go home, there was an industry where everybody was trying to sell bonds. This industry is basically the driver of the bond market, so when everybody was selling, there was nobody to buy and there was a complete freezing of the bond market. Interest rates shot up to 10~11% and the government is now having to bail it out by providing a liquidity mechanism to allow this big bubble to be unwound.

The investment trust industry arguably must come down to something south of 100 trillion won before it gets back to where it should have been all along. So, what we are experiencing at the moment in this big dislocation from the Daewoo crisis is actually an investment trust problem caused by some structural defects in the whole design of the investment trust industry. For the next 3 months to a year, we are going to go through all the pain and uncertainty of restructuring this industry. It is not going to be fun. But I will tell you frankly, it was self-inflicted, self-created and could easily have been avoided.

Looking into the future, as mentioned earlier, Korea's historical interest rates were in the 12~15% range (Fig. 60). I hope that we are now moving into a new paradigm for interest rates, of about 7-10% range for corporate paper. I would hope that over the next year, we would be at the higher end, around 9-10%. Gradually, over the next three to five years, I would like to see a step down to 9%, 8.5%, etc., allowing a gentle adjustment of the economy to a different paradigm where debt is repaid and equity takes risks.

Korea in the future – a comparison with the U.S.

So, what does the future hold potentially for Korea? Well, imagine taking that past experience with profit failure and turning it into profit success. If the green line in Fig. 61 had tracked with GDP instead of dragging its heels as it did, GDP would actually have grown faster simply because GDP is 80% wages plus profits. So, if profits grow faster, A + B becomes a bigger number, and without changing compensation at all, creates a higher growth rate of the economy. Two full percentage points of growth were wasted over the past decade because Korea was not focusing on generating profits. Whatever your perspective might be about the future potential of the Korean economy, arguably, you could add another two percentage points of growth if Korea could get profit success – if Korea could get the religion of profits as opposed to the religion of profit failure. I have no doubt that the Korean economy will recover over the next five years or so. This is my own projection on a very simplistic basis for the future. The blue line (Fig. 62) is projected at about 5% real growth, with something like 3% inflation. The Korean economy will get back on track after this one-time blip of the IMF crisis.

As for the stock market, the huge gap mentioned earlier will only continue to open up if the GDP recovers (Fig. 63). Therefore, there is an opportunity to see in Korea what we saw in the last twenty years in the U.S. Before 1940, the U.S. was suffering terribly from the Great Depression of the 1930s (Fig. 64). World War II was basically the great savior from that Great Depression. From 1940-43, the economy doubled as the U.S. ended the war and supported its European allies. The stock market, which had also been very depressed, started to track with the economy (Fig. 65). But notice that it tracked on the low side. At the end of the World War II, there was the Cold War and the Korean War. The end of the Korean War in 1953 was the mark of a change of paradigm. The U.S. moved from the war years to what I call the "Best of Times" (Fig. 66). The world was essentially at peace. There were strains and stresses, but by and large, in the developed countries, there was peace. In the U.S. there were low interest rates, low inflation, a government surplus, and U.S. companies were the leading players in their industries on a global basis. Not necessarily because they were the best, but because other countries' industries had been destroyed and they were too focused on rebuilding or on the internal recovery of their own economies.

These "Best of Times" lasted for ten years and the stock market was tracking above the economy over that time. It got so good that the U.S. went to sleep. By the mid-1960s, U.S. companies failed to keep focused on becoming competitive, creating a fifteen year period that I call "Sleeping Beauty." During this period, the stock market went nowhere even though the economy, which from the beginning of that time was around 800, quadrupled several years later to about 3,200 on a relative basis (Fig. 67). This was the era when America allowed other countries to catch up, especially the Japanese, in automobiles, televisions, steel, etc. The "Sleeping Beauty" period led America into its own version of the IMF crisis. By the late 1970s and into the early 1980s, things were going terribly wrong in America. It had to borrow money from the IMF and by 1981~82, when I arrived in the United States, interest rates shot up to 20%. This was unheard of for America. The U.S. therefore had a major crisis, but it recovered, just as Korea is doing now.

The U.S. then had to get down to the tough job of restructuring, downsizing and cleaning up the mess that had been built over fifteen years (Fig. 68). It was not easy and was very costly. There was tremendous resistance to doing it. But it was successful and the economy not only continued to grow, but the stock market also enjoyed a major recovery. In the last fifteen years or so, the stock market has been climbing up to where it should have been all along. This is also the great era of entrepreneurs. There are huge companies today, which either did not exist or were just little garage operations back in the 1970s. Those companies have fueled the economic growth of America. Companies like U.S. Steel and General Motors have been downsizing. Small companies have been growing and driving the vitality of the U.S. economy. Finally, about three years ago in 1997, the two lines crossed again, and the U.S. got back to the "Best of Times" – low interest rates, low inflation, the U.S. government running a budget surplus and U.S. companies once again competitive in the world arena (Fig. 69).

The reason I mention this is not so much to talk about America – although if you want a prediction of the future, I would suggest transposing the post war "Best of Times" period of Fig. 69 for the next decade. That amounts to reasonably modest growth expectations for the U.S. stock market. It is no great surprise to me that it has been bouncing around from 8,000 to 11,000. It should be somewhere in that range.

But more interestingly, where is Korea on this chart (Fig. 70)? I think the answer to that question lies in the hands of Korea itself. It depends on what Korea does. Korea could go anywhere, but it has the potential to be at the beginning of a long and painful period of restructuring. If that is done successfully, Korea can release that caged tiger and see a stock market recovery for the next three, five or even ten years that will be very similar to what was experienced in the last fifteen and twenty years in the United States (Fig. 71). But it is a big "if." That reminds me of a famous poem by Rudyard Kipling. It goes:

If you can keep your head
When all around are losing theirs
Or watch the things you gave your life to broken
And stoop and build them up with worn out tools

That reminds me of Korea last year.

If you can fill the unforgiving minute with sixty seconds of distance run

Well, in Korea, we are 빨리 빨리!

Then yours is the earth and everything that's in it
And what is more, you'll be a man, my son

Now, that is a father's advice to his son. There are many ways in which it applies to Korea as it grows up and becomes a developed economy in the world. But the real "ifs" that must be focused on are such things as: profit success, not profit failure; wage growth that aligns with productivity growth; a competitive exchange rate, value-added investment – not just investment for the sake of bragging rights; new capital market discipline; untangling the corporate webs; reducing system risk; reducing over-leveraged corporate balance sheets; removing the crippling regulations to allow Korea to get the tiger out of the cage; reduction of government interference – which will take time because it is impossible to change overnight; an emphasis on the service sector, the knowledge-based industries and; a creation of a new entrepreneurialism.

Again, the future lies with independent, efficient, entrepreneurial companies. They do not have to be small but they must meet those criteria. I think small- and medium-sized companies are going to represent the future for Korea. I think it lies with the service sector, more so in the future than the manufacturing sector in the past. As for the service sector, I am talking about things that do not even exist in Korea today – tourism for example, which is terribly neglected today. It will lie in building the financial infrastructure, that weak base made of sand, and turning it into a solid foundation for the economy. It also lies in the creative infrastructure, knowledge-based industries and being able to think outside of the box. I am sure that revamping Korea's infrastructure would benefit manufacturers and other physical distributors of goods. I think the future lies in these areas and of course, becoming a part of the global economy.

I hope I have stimulated you a little bit to try and think about not only the realities of what Korea has gone through but also the opportunities for its future and perhaps challenged you to think what you can do for your part to participate. Korea is not going to get there automatically. It will only happen because we all try hard to pull on that rope, whether we are Koreans who live here or foreigners who have come to make their careers here. As I have said to many of my foreign colleagues, we have to engage and be part of the solution. I hope we can. Korea, I think, for the first time in many years, is welcoming foreigners and is actively seeking their help. The foreigners have much to learn, but I am sure that we have skills and experience that we can bring to the party, and at the end of the day, it will hopefully be a better party for everybody

Question and Answer Session

Q: We have a saying in Korea that the remains of people are their good names and those of tigers are their expensive skins. Is it possible to create not only one big tiger in the cage but many small tigers?

A: I think the simple answer is yes, it is absolutely possible. Looking at Korea's history, although I described it as one tiger, in fact, many tigers were created. But they were not necessarily as efficient as they should have been. I hope that the future tigers – the future children – of Korea can be dynamic, competitive tigers and not just tigers who learn to live fat and happy because they are fed automatically inside the cage. They need to learn to live in the wild jungle of the global economy.

Q: What is your view on the possible November financial debacle? Do you think the Korean government and financial authority are dealing with the potential problem or do you see any other course of action which the financial authority should take?

A: Six months ago, my biggest worry about the end of the year was the Y2K problem, that ahead of the Y2K problem we would have all kinds of dislocation in the financial sector. Conveniently, the Daewoo crisis removed that worry from my mind. It was no longer important what Y2K would do because we were going to have the effects some months earlier. As to whether there should be a November crisis, personally, I think we have been experiencing the November crisis for the last month and a half, so it is a little ironic to me that people think of it as happening in the future. It is an August, September and October crisis.

Second, the government was very bold but absolutely correct to take the Daewoo challenge head on back in July. I give them full marks for being as brave as they were to do that. I think, however, that in the follow-through there were too many new things which they were not expecting and the plan was perhaps not well enough developed – although who is to say in a crisis that you can make a plan? Plans for crises are a sort of oxymoron. What you have to be ready to do in a crisis is respond very quickly as you learn about the nature of the crisis. I think there have been many confusing signals from the government side and there have been many initiatives that have been announced but not effectively followed through. So, it has been very difficult to know exactly what to expect over the last month or so, but I think we are starting to move into a more controlled environment and out of the great uncertainty that has crushed the bond market. In the process, it has taken some of the steam out of the stock market, but I do not think that was a bad thing. I think the stock market was due for a correction and there was a little too much optimism around. Certainly, in some areas, companies that were overpriced are now getting back to being reasonably priced or bargain territory. This is much healthier for the long-term, more stable development of both the stock market and the financial sector.

But I think the recent crisis illustrates just how much we have yet to do in rebuilding the financial infrastructure in Korea. The process has barely started. Last year we just injected liquidity into the banks as a temporary measure. But Korea has delayed attacking some of the deeper problems with, for example, the investment trust industry. These are problems Korea must start addressing. We have got to start putting better business practices into those companies. Things like mark-to-market in their bond funds. That in itself would take away a lot of the risk in the Korean economy. That risk needs to go away because we have got a lot of other things to pay attention to if we are going to build a future, and not just deal with old risks from the past.