Globalization of Capital Markets and the Asian Financial Crisis

by E. Han Kim,
University of Michigan
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With the current financial turmoil in Asia, a frequently asked question these days is, “Are open capital markets good for emerging economies?” Critics of unfettered markets point to Mexico’s peso crisis in 1994 and the recent Asian currency problems to argue that emerging markets should resist the temptation of easy foreign money, or at least place regulatory restraints on capital inflows and outflows. They also cite the case of China, which has been able to avoid speculative attacks on its currency due in part to its relatively closed capital market.

One prominent critic of open markets is Joseph Stiglitz, Chief Economist of the World Bank, who recently stated that “the benefits from unimpeded capital flows are overrated, and short-term investments sometimes spark currency crises.” Even Michael Camdessus, the Managing Director of the IMF, has cautioned against “a mad rush to liberalization, regardless of the risks,” while urging nations to implement regulatory structures to deal with investment surges.1

And such arguments have been translated into actions. The most dramatic occurred on September 1, 1998, when Malaysian Prime Minister Mahathir Mohamad imposed currency controls and prevented foreign shareholders from taking their money out of the country for a year. In the same month, Taiwan also announced that, in light of Asia’s financial crisis, it was reconsidering its plans for full liberalization of international capital flows by the end of the year 2000.2 Nevertheless, not all countries are rushing for capital controls. On September 16, 1998, Chile announced the elimination of a capital constraint known as the encaje, which required 10% of foreign capital inflows to be kept on deposit at the central bank. Although the encaje has often been cited as a model for countries that need to reduce volatility and speculation in their financial markets, Carlos Massad, head of Banco Central de Chile, stated that capital controls in Chile caused “a large increase in the cost of foreign financing for Chilean companies.”3

In any event, the new respect for capital controls seems to be at odds with the recent move toward capital market liberalization by emerging economies. With the dissolution of the Soviet Union and the general decline in the number of centrally planned economies, politicians in developing countries have increasingly come to recognize that they can no longer ignore the global movement toward free markets. Partly to incorporate elements of market capitalism into their own economies, and partly to satisfy their need for new capital, many countries have allowed a free flow of capital across their borders, including participation by foreign investors in their stock markets.

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For emerging nations, the inflow of foreign capital is essential for building infrastructure and making other investments necessary for economic progress. The industrial development of low- and middle-income countries tends to depend heavily upon capital formation. Recognizing the ability of foreign investors to provide capital and hasten the development process, many emerging economies have opened their capital markets to foreign investment. Thus, before emerging economies reverse their recent liberalization measures and implement further regulatory restraints on capital flows, it would be useful to reexamine the opportunity costs of a closed market and the risks associated with open markets.

This paper has three basic aims: (1) to analyze the impact of open capital markets on the economies of host countries; (2) to investigate the causes of the Asian financial crisis; and (3) to evaluate the likely effects of the South Korean government’s recent attempts to restructure its corporate sector. These three issues are closely intertwined. In addressing the first, I summarize the findings of my recent empirical study (with Vijay Singal) that examines the experience of a sample of emerging economies around the time they first opened their stock markets for foreign investment. I then investigate the causes of the current Asian financial crisis by reviewing evidence on the role of foreign investors, host governments, and corporations in the currency crises. The results of this investigation, together with lessons from the U.S. corporate restructuring of the past 20 years, then provide a basis for evaluating the recent attempts by the Korean government to restructure its economy.

THE CASE FOR (AND AGAINST) STOCK MARKET OPENINGS

There are major benefits from having a well-functioning stock market. First of all, a market that is open to global investors reduces the cost of capital for local companies by allowing stockholders to achieve efficient diversification, thereby increasing the probability that promising new ventures will attract funding. Stock markets also lower the cost of capital by increasing the liquidity of investments. Greater liquidity not only reduces the required rate of return demanded by investors, it encourages companies with promising growth prospects to retain and reinvest earnings (instead of paying them out as dividends) as long as investors remain confident in their own ability to convert the retained earnings into cash by selling shares in the market.

For emerging economies, opening their stock markets to foreign investors serves as a catalyst for achieving greater efficiency in the domestic market. The catalyst is the new competition from foreign financial institutions that accompanies the opening of the market. Such competition puts pressure on host countries to import more sophisticated financial technology, to find ways to adapt the technology to the local environment, and to encourage more investment in improving information-processing and financial services.

In addition, foreign investors will demand the transparency and improved disclosure rules that enable them to monitor corporate performance and capital allocation. As part of the push for greater disclosure, investors will also demand greater accountability of management to shareholders in order to protect themselves against expropriation of wealth by the controlling investors. A coherent and convincing response to these demands will decrease investors’ perception of the risk of holding stocks, which will in turn lower the cost of equity.

Opening up the domestic stock market also offers other avenues for reducing capital costs. The cost of foreign capital tends to be lower because foreign portfolios can be more broadly diversified across national boundaries and therefore are more “efficient” in managing “country-specific” risks, resulting in a lower risk premium. The cost of foreign capital will be even lower if the newly opened market provides a unique diversification opportunity for foreign portfolios. Thus, in addition to increasing capital availability, internationalization lowers the cost of capital and generates greater efficiencies in allocating capital.

A lower cost of capital leads in turn to greater investment and employment as domestically produced goods and services become more competitive in the global marketplace. More efficient use of capital in turn leads to the value creation in the corporate sector that is necessary for sustainable economic growth.

For policymakers in emerging economies, however, such benefits must be weighed against various uncertainties associated with opening the market. One issue of major concern is the movement of so-called “hot money”—that is, international flows of funds that are highly sensitive to differences in
interest rates, perceived economic growth rates, and expected returns from holding securities. Because of the sensitivity of these investments, even a small shock to the economy or revision in expectations may lead to a volatile change in fund flows, which further exacerbates the shock and destabilizes the domestic economy.

In other words, while limited inflows are good because they provide a means of funding economic development, unlimited inflows can present problems for policymakers who believe their economy cannot be left to the vagaries of unpredictable market forces that threaten sustainable growth. For instance, a large capital inflow may cause appreciation of the domestic currency, which may threaten the competitive position of export-oriented economies in the global marketplace. Policymakers are also concerned that there may not be enough investment opportunities to absorb the inflow of money and that the excess capital will fuel inflation.

Another issue of concern is that if foreign fund flows are in fact volatile, such volatility may lead to greater volatility in domestic stock prices, exchange rates, and inflation. Greater volatility in stock prices would cause investors to demand a higher risk premium, which implies a higher cost of capital and less investment. Likewise, greater volatility in exchange rates and inflation increases the risk of international trade and makes it more costly to maintain stability in the economy.

**EMPIRICAL EVIDENCE**

The relative merits of these opposing arguments depend on how the foreign investment flows actually affect the economies of host countries. That is, do those foreign flows of funds induce greater volatility? Or are they more likely to have a stabilizing effect on the emerging economies’ stock market, inflation, and exchange rates?

In an attempt to answer such questions, Vijay Singal and I examined the economic effects of stock market liberalization on 20 emerging economies over a 10-year period surrounding their market opening dates. More specifically, our study attempted to detect the effects of financial liberalization on a number of variables: (1) the level and volatility of stock returns; (2) stock market efficiency; (3) inflation; and (4) exchange rates.

In general we found that while some countries experienced undesirable side-effects from liberalization, on average the benefits to emerging economies of opening up their markets greatly outweighed the costs. Soon after market liberalization, stock prices tended to rise, reflecting both the resolution of uncertainty about the liberalization itself and the new external demand for domestic securities. Stock return volatility, rather than rising, actually decreased somewhat after the market opening. And this finding of reduction in price volatility makes perfect sense: It says, in effect, that when markets are opened to outsiders, the markets become more liquid and resilient due to the larger numbers of investors with diverse opinions and requirements.

We also found that stock markets become more efficient in the sense that information is more rapidly reflected in the stock price. One likely reason for this increase in efficiency is foreign investors’ reliance on sophisticated financial techniques to exploit market inefficiencies, which in turn puts competitive pressure on domestic investors and financial institutions to improve information-processing in pricing financial assets. Another possible reason is that stock market liberalization is often accompanied by other financial reforms, such as stricter disclosure requirements, insider trading regulations, and better investor protection.

When we examined the effects of stock market liberalization on inflation and exchange rates, the results were equally encouraging. Inflation, instead of increasing, appears to have decreased. For our entire sample, the average inflation rate fell from 1.67% per month before liberalization to 1.39% per month after liberalization. And, again, our finding makes sense: If the foreign capital has been put into productive use, it would increase the supply of goods and services available to consumers, dampening inflationary pressures in the long run.

Moreover, whether measured in nominal or real terms, we found no evidence of appreciation of...
estimated net positions of the major funds were neither unusually high nor low,
suggesting that global hedge funds did not move exchange rates. Furthermore, the
fluctuations were uncorrelated with movements in the exchange rate, thus
net long or short positions in the ringgit or its correlates over the past four years,
and in a basket of Asian currencies. Although they find dramatic fluctuations in the
changing positions of the ten largest currency funds in the Malaysian ringgit
(6427, February 1998), Stephen Brown, William Goetzman, and James Park estimate

Portfolios Investment in Developing Countries
Evidence and Policy Implications," in Stijn Claessens and Sudarshan Gooptu (eds),
Portfolio Investment in Developing Countries (The World Bank: Washington, D.C.

In the second of the two studies, "Do Foreign Investors Destabilize Stock Markets? The Korean Experience in 1997," (Ohio State University working paper
98-6, June 1998), Hyuk Choe, Bong-Chan Kho, and Rene Stulz use trading data to
examine the impact of foreign investors on stock returns in Korea from November
30, 1996 to the end of 1997, a sample period that includes the crash of the Korean
won between October and December of 1997. Although the trading data reveal
"positive feedback" trading and "herding" behavior among foreign investors, the
findings do not provide evidence that foreign investors destabilized the stock
market. However, the study does find evidence of "abnormal profits" during the
period of the first crash (July-September 1997), and the findings suggest that
foreign investors were not as influential as they have been made out to be.
During December 1994, at the height of its peso crisis, Mexico lost over $6 billion in foreign exchange reserves. But during this period, foreign investors
sold only about $370 million of Mexican debt and equity. It was Mexican firms and individuals who did
the rest of the selling! And net portfolio capital inflows, though down from those in 1993, still ended up at a positive $8.2 billion for the entire year of 1994.

In a similar vein, a study of the Korean stock market reported that the turnover ratio has been
much higher for domestic investors than for foreign investors. Based on this (and other) evidence, I am
tempted to suggest that foreign investors are more likely to be the patient money. As sophisticated
investors, they are aware of the volatility, instability,
and risk of the emerging stock markets—and they accordingly enter these markets with a relatively longer investment horizon.

So if the culprits are not foreign investors, who is responsible for the massive capital outflows during the Asian crisis? The Mexican experience points to domestic corporate and individual investors as the villains. As U.S. Treasury Secretary Robert Rubin observed in a recent speech about the Asian crisis,

*When these crises began, foreign investors started to withdraw capital, local companies sought to hedge hard currency exposures, exporters stopped bringing their export earnings home, and citizens moved their savings abroad. I think it has now become accepted that most of the pressure on these currencies comes from local sources and not foreign investors.*

As if to confirm Rubin’s assertion, a recent IMF report revealed unrecorded capital flight of $20 billion from South Korea, Indonesia, Malaysia, Thailand, and the Philippines during 1997, with South Korea suffering the largest outflow of $8.7 billion. Such “off-the-books” transactions, which were almost twice the recorded total net private outflow of $11 billion, tend to be conducted by local corporations and households.

**The Causes**

It is important to note that capital flight, whether accomplished by foreign or domestic investors, is merely a symptom, not the cause, of the crisis. The list of potential causes is long, but a short list would include the following: governments’ futile attempts to keep their currencies at artificially high levels; government-directed banking systems and lending decisions; crony capitalism; massive overinvestment by corporations funded by excessive borrowing; the lack of transparency that masked the extent of problems as they developed; inadequate financial regulation and supervision; labor market “rigidities”; and a pronounced mismatch in the duration of assets and liabilities in both the corporate and banking sectors.

Perhaps the two most important contributors to the current Asian crises are (1) low corporate profits and (2) policymakers’ unwillingness to relinquish control. The government-directed banking systems and weak corporate governance structures (including managerial incentives to increase size and market share at the expense of shareholder value) that characterize most Asian economies have resulted in systematic overinvestment and sharp declines in corporate profitability. And the shrinking profits, besides reducing the overall value of many Asian economies, have greatly weakened the banking sectors on which many firms have historically relied for much of their funding.

**Government Intervention in the Currency Market.** Such effects, not surprisingly, have been accompanied by large reductions in currency values in several Asian countries, including Thailand, Indonesia, Malaysia, and South Korea. The important thing to note here is that these have not been “normal” currency devaluations. Under normal circumstances, at least in economies where the government allows the market to re-establish the exchange rate, a deterioration in an economy’s prospects will be reflected in series of relatively gradual downward adjustments to the currency.

Take the case of Japan in recent times. The Japanese yen, which reached its peak of 80 per U.S. dollar in 1995, was above 140 in July 1998, thus representing a depreciation in excess of 40%. This large drop in the currency value occurred with relatively little intervention by the Japanese government; it was more or less an orderly adjustment over three years in response to market forces. With the gradual adjustment in currency value, the Japanese economy has had the time to react and so avoid the dire consequences of a financial panic that accompanies a sudden collapse in currency value (which is not, of course, to deny the major structural problems of the Japanese economy that still need to be corrected through radical reform).

Unfortunately, such was not the case for the three celebrated cases of full-fledged currency crises—those in Mexico, Thailand, and Korea. For

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12. As was witnessed during the Korean crisis, a financial panic can be triggered by the refusal of foreign lenders to renew short-term loans as they mature. When domestic borrowers choose to finance long-term projects with short-term borrowings, they are building up a dangerous duration imbalance in exchange for somewhat lower financing costs. The root cause of such reckless borrowing and lending behavior is the moral hazard in the “too big to fail” legacy and the implicit role of the IMF as the lender of last resort.
these countries, the culprits were partial decontrol of financial markets and policymakers’ unwillingness to relinquish further control.

With the move toward liberalization, many emerging economies relaxed controls on currency flows while continuing to control the exchange rate. This works fine as long as the currency value is close to its market-determined value. But when the discrepancy becomes too great, market forces can be counted on to put pressure on a government to devalue. If the government does not oblige, there will be a one-way shift in private-sector speculative currency flows that will force the currency to crash, which is precisely what has happened in the three countries.

The recent Korean experience was similar to the earlier Mexican and Thai crises. At the beginning of 1994, the Mexican peso was estimated to be about 40% overvalued; yet the government was reluctant to devalue the peso because of commitments it had made to business and labor in an agreement known as the pacto. Moreover, the government was preoccupied with the upcoming presidential election and was concerned that devaluation would push up inflation and generate a loss of investor confidence. But whatever the reasons for the failure to act, when President Zedillo’s government assumed control in early December of 1994, it found that foreign currency reserves had been depleted by defending the peso, which forced the devaluation on December 20, 1994.

The Thai currency, the baht, was similarly overvalued. And the government similarly decided to fight market forces rather than allow an orderly depreciation, perhaps because the government thought it had sufficient foreign exchange reserves ($38.7 billion at the end of 1996) and wanted to avoid the high political costs associated with a baht devaluation. Speculators started to bet against the Thai government by borrowing baht and converting them to dollars with the expectation that, when it came time to repay the baht, it would take fewer dollars. And, of course, their expectations were realized. The Thai government spent an estimated $12 billion buying baht, but ultimately caved in on July 2, 1997. The baht was finally allowed to “float”; and, by the end of July, its value had fallen to 32 baht per dollar, down 25% since May.

Korea’s case is painfully similar to those of Mexico and Thailand. During the month of November 1997, the Bank of Korea spent $25 billion in a futile attempt to protect the won. It took only a few weeks to deplete most of its foreign exchange reserves (down to $6 billion) as a prelude to the collapse of the won by 50%. This collapse effectively doubled the foreign debt load of already highly leveraged Korean corporations virtually overnight and forced the Korean government into the hands of the IMF. Even though the Korean government had ample time to observe and learn from the experiences of Mexico and Thailand, it apparently didn’t do any good.

Value Destruction. Although it was the ill-fated attempt by policymakers to resist market forces that transformed an otherwise normal currency depreciation into a crash, a more fundamental cause of the Asian crisis has been the widespread value destruction by Asian corporations, which has led to a lower value for the overall economy and weakened the banking sector. The countries that have been hardest hit by the Asian turmoil—Indonesia, Korea, Malaysia, and Thailand—have all seen their corporations engage in chronic overinvestment with little regard to earning a rate of return adequate to compensate the suppliers of capital. In the pursuit of growth and expansion, the cost of capital was often underestimated or ignored altogether in making investment decisions. This resulted in inefficient allocation of capital and the destruction of corporate value.

In a recent study of Korean corporations commissioned by the Korean Stock Exchange, Myeong Kyun Kim, Jaekyung Yi, and I demonstrated the widespread nature of this value destruction in the Korean economy. We calculated the Economic Value Added (EVA) for 570 non-financial firms listed in the Korea Stock Exchange from 1992 through 1996. (EVA is defined as net operating profit after taxes minus cost of capital.) When we summed up the annual EVAs of each company over the five-year period (which preceded the crash), we found that only 27% of the listed companies created shareholder value; the rest, nearly three-quarters of them, destroyed value. That is, nearly three-quarters of the listed companies did not generate sufficient operat-
ing earnings to cover their capital costs during the five years preceding the crisis.

I suspect that similar value destruction has been taking place not only in the emerging economies of Thailand, Indonesia, and Malaysia, but also in Japan. And such value destruction has been clearly evident in Asian stock markets. For example, Japan’s Nikkei average, which was as high as 39,000 at the end of 1989, is now in the 14,000 range, reflecting a sharp decline in the profitability of Japanese firms since the late ’80s. The Korean stock market index, the KOSPI, was above 1,000 in March of 1989; now it is around 300.

Another interesting observation from our Korea Stock Exchange study is that each of three large firms (Jinro, Mando, and Halla) that went bankrupt in 1997 (and that were each part of large Korean conglomerates known as chaebol) had core businesses that were highly profitable. Indeed, when viewed as stand-alone companies, these three core businesses of Jinro, Mando, and Halla had cumulative EVAs that would have enabled them to rank 15th, 17th, and 28th, respectively, among the 570 firms. The failure of the three companies was thus clearly attributable to their disastrous diversification into unrelated businesses.

CORPORATE RESTRUCTURING IN KOREA

The conglomeration of Korean firms is comparable to the conglomeration of U.S. firms during the 1960s and ’70s. At the time, the rationale for U.S. conglomerates was their ability to create “internal” capital markets that allowed internal funding across unrelated businesses and led to smoother growth and stable cash flows at the overall firm level. In the majority of cases, however, U.S. conglomerates ended up breeding inefficiencies that led to lower earnings and share prices. And, in the 1980s and ’90s, many U.S. conglomerates were dismantled after becoming the targets of hostile takeovers and leveraged buyouts (LBOs). The transfers in control that accompanied these transactions were typically followed by massive restructurings involving the selling off of unrelated businesses to pay off outstanding debt. The general aim of such restructurings was to restore operating efficiencies and improve the capital allocation process by refocusing on the remaining core businesses.15

The lesson to be learned from the American experience is that the creation of internal capital markets through conglomeration allowed firms to bypass the discipline of the external capital market, allowing inefficient operations to continue until the firm as a whole became a takeover candidate. And it is tempting to prescribe the same medicine for the Korean chaebol: namely, the large-scale restructuring undergone by many U.S. conglomerates during the last 15 to 20 years.

The “Big Deal”

This is presumed to be the rationale for the Korean government’s current attempt to restructure the chaebol. The government is essentially demanding that the chaebol do what LBO firms did after they took over large conglomerates during the 80s: divest unprofitable (or at least non-core) businesses, use the proceeds to reduce outstanding debt, and refocus on the remaining core businesses. But there is a crucial difference. In its efforts to implement the so-called “big deal,” the Korean government is assuming the role traditionally reserved for the private market for corporate control.

The “big deal” solution is to encourage the chaebol to make large-scale swaps of entire businesses with the objective of inducing each of the chaebol to specialize in core businesses. Although the justification for the government’s initiative in promoting the “big deal” is the absence of an effective market for corporate control, the important question that must be addressed is: Can the government effectively replicate the role of the market? Do government officials have incentives compatible with the private economic incentives that motivate U.S. corporate raiders to restore value?

Government officials clearly have neither the same incentives seek out, nor the ability to identify, value-creating synergistic gains through corporate restructuring. Moreover, government-imposed “big deals” run the risk of creating monopolistic inefficiencies and negative synergies. In essence, the “big deal” policy represents yet another form of government intervention in the marketplace that is likely to lead to misallocation of resources and a net reduction in the overall efficiency of the economy.

Corporate restructuring is likely to produce the desired results only when it is pursued voluntarily by the private sector. The government’s role should be limited to improving the market mechanism and enhancing competition in the markets for capital, for corporate control, and for goods and services. The Korean market for corporate control transactions could be greatly improved by increasing the efficiency of bankruptcy proceedings and by allowing hostile takeovers by foreign as well as domestic investors. When capital markets, as well as the market for goods and services, are fully competitive with appropriate levels of transparency and accountability, corporate restructuring will become a matter of necessity for the chaebol—and market forces will then produce value-increasing restructuring decisions.

Cross-Payment Guarantees

Government prohibition of payment guarantees among affiliated firms also appears to be a premature and therefore intrusive “reform” that interferes with contractual efficiency in the capital market. It is intrusive because loan guarantees, if executed in a transparent fashion, can reasonably be expected to increase financial flexibility and generate a joint economic benefit. For this reason, most free market economies allow payment guarantees among affiliated firms.

Korean policymakers, however, seem to believe that the chaebol cannot be trusted with payment guarantee contracts because they will be used to keep economically unprofitable businesses afloat. That is, the rationale for cutting off guarantees seems to be that it will ensure that only economically viable firms remain. Although such drastic measures may be required to prod chaebol into undertaking the necessary restructuring immediately, it is not clear that the economy can be made better off by prohibiting business practices that are considered normal in most free market economies.

For this policy to yield the desired outcome and ensure an uninterrupted supply of capital to economically viable firms, Korean capital markets would have to be capable both of distinguishing value-increasing from value-destroying firms, and of imposing the proper discipline on the latter. But due to the long history of government intervention, Korean capital markets have a long way to go in terms of increasing transparency, accountability, and ability to discriminate—not to mention liquidity and depth. Even in economies with highly advanced financial systems, such as the U.S. and Britain, there is an information “gap” between corporate insiders and the external capital market that makes it difficult to value companies with a high degree of confidence. In an economy like Korea where information problems abound, internal capital markets could have an advantage over external capital markets, at least in some circumstances.

To be sure, internal capital markets in the U.S. have often served as a pretext for allowing managers to avoid the discipline of external capital market, with lower earnings and share prices as the principal consequence. But it is equally important to note that such abuses and mistakes are likely to be corrected in the market for corporate control, where the inefficient conglomerates that run internal capital markets for “the wrong reasons” are subsequently taken over. Thus, in prohibiting guarantees, the Korean government is attempting to correct internal abuses by decree rather than by relying on market forces.

Not only does the prohibition of payment guarantees appear to be intrusive, but it also is premature: It abolishes an internal capital market without offering an alternative. Abolishing internal capital markets in the absence of properly functioning external capital markets runs the risk of crippling the ability of Korean corporations to finance necessary investments to maintain their competitiveness in the global marketplace. Any further reduction in corporate investment activity will not only worsen the economic recession and unemployment, but will seriously weaken the foundations on which to build future growth and value.

What the government must do instead is to concentrate its efforts to strengthen the disciplinary power of the external capital market by increasing transparency, accountability, competitiveness, and fairness in the rules of the game for the participants in capital markets. When the external capital markets attain sufficient disciplinary power, the chaebol will pursue the necessary restructuring voluntarily as a matter of survival.

Other Reform Measures

As the Asian financial crises illustrate, an economy cannot enjoy sustainable growth while ignoring the claims of ownership. In a global capital market, the suppliers of capital will take their money elsewhere.
if they do not get fair rates of return. Providing equity investors with adequate rates of return, however, will require substantial increases in both operating efficiencies and the productivity of capital. So, in addition to the afore-mentioned reforms of the external capital markets, it is necessary to change the internal objectives and revise the decision-making processes inside Asian corporations.

To increase the productivity of capital, Asian corporations must realign managerial interests with the claims of shareholders by linking managerial compensation to value creation. Such a realignment will of course require abandonment of the previous goal of growth at any cost and replacement of the seniority-based egalitarian compensation system with merit-based performance pay.

Although such changes in compensation criterion are necessary, they are not in themselves sufficient. Outside investors need assurance and protection from expropriation of their wealth by the controlling investors. This requires much greater transparency in financial reporting, accountability by management, and legal protection against management and the controlling investors. For example, prior to the IMF-imposed reform measures, the chaebol were not required to file consolidated financial statements. Since the chaebol typically have 20 to 30 affiliated firms under their control, without consolidated financial statements they could easily disguise their true financial health by shifting funds among the affiliated firms. Furthermore, the controlling shareholders of the leading chaebol usually were not directly accountable to the public shareholders because they often did not hold an official position in any of their affiliated firms.

Much has already been accomplished by the Korean government on these accounts. To increase transparency, consolidated financial statements are required for the chaebol beginning with the 1999 fiscal year. To increase accountability, chaebol owners now must hold an official position on the Board of Directors and will be held legally responsible for their actions. To protect minority shareholders, their rights to review financial accounts, dismiss directors or auditors, and vote in the shareholder meetings have been greatly strengthened. The recent victory by the minority shareholders of Korea First Bank, in which punitive damages of 40 billion won (about $30 million) were imposed on four top former executives, should act as a bellwether in increasing accountability of management and enhancing shareholder rights.

To facilitate the exit of non-viable firms, reforms have been enacted in bankruptcy-related laws and M&A processes. Markets for corporate control and real estate have been opened up to foreign investors, allowing hostile as well as friendly takeovers. These measures, if implemented properly, will surely enhance the market mechanism for changing corporate control. In so doing, it will bring about value-increasing corporate restructuring that redeploy assets to more productive uses.

Other promising economic reform measures have been initiated or announced. It is the government’s stated intention to encourage competition by reducing the barriers to entry and exit, opening markets to foreigners, promoting foreign direct investment, and increasing labor market flexibility. All of these changes bode well for the future Korean economy.

CONCLUDING REMARKS

Even though the recent Asian financial crisis has led some to question the merits of open capital markets and to call for regulatory restraints on capital flows across international borders, the scientific evidence suggests that the opening of stock markets to foreign participation has been largely beneficial for the majority of emerging economies. On average, stock market liberalization has been associated with an increase in stock valuations and a reduction in stock return volatility, a reduction in inflation due to productive use of foreign capital, and a reduction in currency depreciation attributable to increased confidence among foreign investors. Furthermore, the real culprits in the currency crises are not the hedge funds or foreign speculators, as many politicians (and even some economists) would have us believe; much of the speculative pressure on currencies appears instead to have originated from local sources.

Perhaps the most fundamental cause of the crises is corporate sector value destruction caused by systematic overinvestment. Such corporate overinvestment was in turn made possible by excessive borrowing from both domestic and foreign sources.

16. For further elaboration of these points, as well as for an analysis of the current condition of various markets in Korea and reform measures announced and undertaken, see my article, “The Korean Financial Crisis and the Future of Its Economy,” Journal of Asian Business (forthcoming).
banks. The banking sectors have historically had no qualms in funding projects regardless of their economic merit, provided the projects were sponsored by large companies that were therefore likely to be protected by the government. Domestic bankers have demonstrated the meaning of “moral hazard” in their response to the “too big to fail” legacy. And international bankers have done the same with the implicit assurance that the IMF will function as the lender of last resort.

In this regard, the recent Russian default in August 1998 had the beneficial effect of reducing moral hazard by imposing painful losses on Western investors, losses which they had been able to avoid with the help of the IMF in the previous currency crises in Mexico, Thailand, and Korea. And to the extent that country defaults reduce moral hazard and restore market discipline to the international flow of capital, the Russian default is a blessing in disguise. Its importance in the international political arena makes the event highly visible, but the relatively small size of the Russian economy prevents a mortal wounding of global capital markets. Nevertheless, the disciplinary role of the capital market will not be fully effective as long as the existence of the IMF offers a potential for bailouts.

Corporate value destruction alone would not have created the crisis. For the process of currency depreciation to be accelerated into a crash, it also required governments’ futile attempts to maintain the value of their currencies at artificially high levels. The Korean government’s recent initiatives to restructure the chaebol, under the name of the “big deal,” have a surface resemblance to the restructuring of U.S. conglomerates during the 1980s. Unfortunately, the Korean government’s plan seems to overestimate its ability to guide the market. The “big deal” runs the risk of introducing monopolistic inefficiencies and creating negative synergies. Moreover, the government’s prohibition of cross-payment guarantees seems to be an attempt to undo mistakes by decree rather than by relying on market forces. Furthermore, it cuts off an existing source of funding for new value-creating ventures without offering a reasonable alternative.

These reservations notwithstanding, the various economic reform measures that the Korean government has announced or initiated to date are impressive. It will take time, however, for these reform measures to yield the desired results. In the meantime, the short-run costs of implementing reform, such as unemployment and an increase in business bankruptcies, will outweigh any short-term benefits and surely test the public’s patience. But policymakers should not succumb to public pressure for quick results, as they appear to be doing in the push for “big deals” and prohibition of cross-payment guarantees.

Finally, whenever there are attempts to reform, there are powerful vested interest groups with much to lose. They will lobby hard against the changes to protect their own interests. Thus, what is required for productive change is not only the need for greater efficiency but also the consensus and the political will for reform. Korea and Thailand now appear to be moving rapidly in the direction of accepting necessary changes; and they both may benefit greatly in the long run from surrendering some domestic control of their economic policy to the IMF. This is in sharp contrast to Japan, the world’s second largest economy, where lack of the will for reform may keep the nation mired in its now decade-long stagnation.

In all of the Asian economies, the economic argument for reform is apparent and compelling. But essential to the process is the political will to reform and the patience to allow the changes time to work. And it is owing to differences in these two scarce commodities that the paths of the Asian economies could diverge—and quite sharply.

E. HAN KIM

is Fred M. Taylor Professor of Finance and International Business, as well as Director of Mitsui Life Financial Research Center, at the University of Michigan Business School.