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The *Two* South Koreas

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An emerging love-hate relationship with direct foreign investment.

Everyone knows there are two Koreas—North and South. But when it comes to international business, there are also two Koreas within South Korea itself.

In one South Korea, it is literally a new day for foreign investors.

As the sunrise broke over the peak of Bongcheon Mountain on New Year's morning, an American corporate chief joined one hundred Korean employees to hike along a waterfall trail. Once they reached this peak, Nick Reilly, president and CEO of GM Daewoo, and Lee Seong-jae, chairman of the Daewoo Motor Labor Union, prayed for mutual success. "If the past was a time of struggling for survival, then the future will be a time of commitment towards growth and peaceful coexistence," Lee said.

In this South Korea, Deputy Prime Minister Han Duck-soo extols the virtues of direct foreign investment in South Korea. Such declarations have the ring of truth: South Korea is far more open to foreign

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AP PHOTO/AHN YOUNG-JOON

Daewoo Motor's workers with hammers beat a car symbolizing U.S. automakers Ford and GM during a rally to oppose the selling of South Korea's ailing Daewoo Motor Co. to a foreign company in March 2000. Some 2,000 workers attended this protest.

investment than it was before the financial crisis of the late 1990s. As a consequence, both direct and portfolio foreign investment have grown enormously there since the crisis. Direct investment flows into South Korea averaged under $1.4 billion annually 1990–97, but jumped to an annual average of over $5.9 billion 1998–2004. Portfolio equity flows into South Korea were negligible before 1993, averaged about $4.2 billion 1993–97, and then jumped to an annual average of almost $9.1 billion 1998–2004.

Unfortunately, foreign investors can stumble into another South Korea. In this "second" country, Financial Supervisory Commission Chairman Yoon Jeung-hyun floated proposals for new rules that would impose Draconian penalties on foreign investors who attempt to exercise their shareholder rights. In this South Korea, foreign shareholders who become too vocal can be portrayed as "hostile" and "grasping." Somehow, the larger lesson has been lost—that South Korea has benefited enormously from foreign investment, and that experience strongly indicates that more foreign investment would mean an even more prosperous country.

Why do the benefits of foreign participation remain such a tough sell? In part, it is because many Koreans are still mired in the culture of the old-line "chaebols." These are conglomerates of often radically dissimilar enterprises in which a single family can dominate the holding company, and secretly infuse cash from strong

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companies (often bolstered by foreign investors) to float weak ones (usually run by a hapless relative). "Minority" shareholders rights are trampled upon, even when in fact "minority" non-family shareholders collectively hold a majority of the equity in a firm. Compounding the difficulty, the Korean government has acted recently in ways reminiscent of the chaebol heyday of the military dictatorships of Park Chung-hee and his successor, Chun Doo-hwan.

For example, no business case can be made for continued government pressure on banks to prop up Hynix Semiconductor and LG Credit, two hopelessly bankrupt companies; but bailouts, in the form of bank loans to these firms orchestrated by the Korean government, have been extended. (In fact, the Hynix bailouts have been the subject of two pivotal WTO cases. In one case (a dispute brought by Korea against the European Union), the panel found in essence that such bailouts amount to WTO-inconsistent government subsidies. In the second case (a dispute brought by Korea against the United States) the Appellate Body overruled a panel finding that these bailouts were not WTO-inconsistent.

In short, South Koreans seem to be of two minds when it comes to foreign investors. They know, academically at least, the experience of the United States, which saw its greatest economic expansion since the 1950s after unprecedented levels of foreign investment entered the U.S. economy in the 1980s and 1990s. South Korea also can view from close at hand the experience of China, which has drawn huge amounts of foreign direct investment since the late 1980s (almost $600 billion cumulatively) and where research shows a possible causal link between this foreign direct investment and China's impressive growth rates.

Even so, on a practical level, many South Koreans have trouble granting foreigners a real voice in firms in which foreigners have become significant shareholders. Thus, foreigners are often invited in, only to be treated subsequently like unwelcome interlopers. In some cases, the result is particularly egregious—the management of SK Corp. recently beat back the efforts of the largest overseas shareholder to remove its chairman, a man convicted and imprisoned for his role in a multi-billion accounting scandal. Stories abound about pressure on governmental or quasi-governmental bodies to take actions against foreign acquisitions or control.

How do we explain South Korea's ambivalent and sometimes xenophobic attitude towards foreign investment? Local political sensitivities are especially inflamed by large capital gains earned by foreign equity funds. The poster child for foreigners reaping vast profits in South Korea is U.S.-based Newbridge Capital, which recently sold its 50 percent equity position in Korea First Bank for a staggering 400 percent profit. Local public relations further deteriorated when it was revealed that Newbridge was able to avoid paying cap-

Chaebol Culture

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ital gains taxes in South Korea by invoking a tax treaty between that country and Malaysia.

However, South Korean outrage over Newbridge is instructive for all the pertinent facts that get lost in the fog of outrage. To begin, Koreans' ire is misplaced given their government's ownership of half of Korea First. In fact, when the bank was sold in 2005 to a British banking firm, Standard Chartered, the Korean government shared almost equally with Newbridge in the spectacular capital gain.

More importantly, Koreans are tempted to forget that when Newbridge bought the bank in the late 1990s, Korea First was technically bankrupt. (In fact, the International Monetary Fund wanted it liquidated.) Korea First, therefore, had no equity value. It was questionable whether this bank could be turned around at all. Newbridge took a huge risk when it gambled that it had the expertise to revive Korea First. To achieve this, Newbridge shifted the bank's strategy from a focus on the corporate sector to the consumer sector. This was a shrewd move, for it was the large portfolio of non-performing loans to corporations that was strangling Korea First. By making this shift, however, Newbridge ran afoul of efforts by the Korean government to bail out failing chaebol-linked firms in 2001 to 2003. In particular, Korea First resisted efforts by the Financial Supervisory Commission to grant large loans to Hynix and, later, to LG Credit. (Korea First did participate in some loan packages to Hynix, but over considerable internal protest.)

Thus, the opprobrium generated by Newbridge's participation in Korea First was arguably more about Korea First's efforts to change its ways than the size of its capital gains, its status as a partly foreign-owned firm, or the tax implications of these. Korea First tried not to participate in what amounted to a revival of Chun-era policies toward the chaebols—and thus made itself vulnerable to considerable official hostility.

Fortunately, not all associations with foreign investors are so fractious. In fact, when foreigners and Korean companies decide to work together, the results can be notably successful. A model for such cooperation, one that extends beyond Korea, is the transformation of the Japanese firm Nissan (which holds a large position in a South Korean auto firm originally in a joint venture with the Samsung chaebol). Nissan was acquired in 1999 by the French firm Renault. Led by a Franco-Brazilian, Carlos Ghosn, Nissan shed crushing debt, increased its manufacturing efficiency, and upgraded its product line, such that the firm went from a loss-making operation to become one of the most profitable car companies in the world. Ghosn's culturally sensitive approach to Asian business is now being tested in the South Korean market as Nissan Korea begins to introduce its Infiniti line there through the former joint venture.

But more relevant to Korea is the effort by GM-Daewoo to bring the Nissan experience to Korea's second-largest car firm. The initial plight of Daewoo Motors, once part of Korea's third-largest chaebol controlled by founder Kim Woo-choong, was even more spectacular than Nissan's. Daewoo Motors went on the block after the Daewoo chaebol went bust in 1999. Daewoo was initially to be sold to Ford. However, Ford was scared off by due diligence reports that revealed undisclosed debt and fraudulent accounting, combined with intransigent labor politics at Daewoo's Incheon factory. Daewoo's image was not helped by the sudden flight from Korea in 1998 of its founder, presumably to avoid prosecution over irregularities at Daewoo, and who remained a fugitive until he decided to return to his native land in early June of this year.

But Daewoo had some assets that interested GM, one being a foothold in the growing Indian market, as well as other centers of Asian growth. GM rolled the dice that Ford had dropped and won, acquiring Daewoo for a fraction of the price that Ford had initially intended to pay.

How did Koreans react to the sale? Many early reactions were negative. Accusations were made that

South Korea is far more open to foreign investment than it was before the financial crisis of the late 1990s.

GM had acquired a Korean "crown jewel" at a fraction of its true value. Fortunately, in this case, Korean officials realized that without foreign investment, Daewoo Motors would almost surely fail and so the transaction was allowed to proceed. And these officials are now glad that they did so: GM Daewoo is enjoying a remarkable turnaround, with car sales increasing by more than 55 percent from 2003 to 2004.

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Volvo is another example of a successful foreign investor in South Korea, having acquired a heavy equipment-maker from the Samsung chaebol. This firm was in fact one of the weaker elements of the Samsung empire. By contrast, its successor, the Volvo Construction Equipment Company of Korea, has—like GM Daewoo—experienced a remarkable turnaround and indeed is poised to challenge giants like Caterpillar and Komatsu in burgeoning East Asian markets.

The South Korean economy is also benefiting from the competitive pressure that foreign companies are placing on auto companies that have remained in Korean hands due to the opening of the Korean auto sector. Consider the automotive offspring of the collapsed Hyundai chaebol, the Hyundai Motor Car Company. Chairman Mong-Koo Chung, son of the founder of the old Hyundai chaebol, has led the effort to completely separate the new automotive company from the now-defunct group. Faced with more domestic competition, Chung set out to transform Hyundai from a relatively inefficient company noted for products of questionable quality into a world-class competitor. Importantly, Chung resisted efforts by the Korean government to involve Hyundai Motor Car Company in efforts to bail out failing operations of the old chaebol. (In fact, the old Hyundai flagship company, Hyundai Engineering and Construction Corporation, HECC, has gone bankrupt.) Chung argued that the resources were better placed to improve the motor company than to bail out HECC. The result? Hyundai has grown to become the seventh-largest car company in the world, and has raised itself to score only slightly less than Toyota and Honda—the global leaders—in the most recent J.D. Power and Associates study of automotive quality. Hyundai has also opened a giant $1.1 billion factory in Alabama that rates as one of the most technologically advanced automotive and finishing assemblies in the world.

In all these ways, foreign investment is transforming one of Korea's most important industrial sectors. This impact carries over into employment. Initial fears that the acquisition of Daewoo Motors by GM would lead to vast, American-style layoffs have proved unfounded. In fact, two years after the acquisition, GM Daewoo made aggressive investments that enabled the firm to create more than six thousand new jobs in 2004.

Even so, there is another nationalistic force that could darken South Korean prospects for foreign investors—the politically grounded rigidity of Korean labor markets. While the Korean union movement is fragmented, it nonetheless managed to unite to support the election of Korea's current president, Roh Hyun-moo. President Roh, in turn, has repaid his labor backers by generally meeting their demands, no matter how excessive. Moreover, Korean corporations have become timid in their labor relations. For example, in spite of its growing global presence, Korea's Hyundai Motors remains overstaffed (a key reason why the company opted to move production to locations as distant as Alabama in order to expand capacity).

Koreans are likely to find, as did pre-Thatcherite Britain, that in a global economy, union militancy ill-serves the national interest or even the ultimate interest of the worker. In the meantime, foreign investors can play a helpful role in moderating the often-counterproductive demands of organized labor. For example, last year GM Daewoo's CEO Nick Reilly tentatively suggested that recent wage increases, as high as 8 percent, would have to cool down; and that multi-year labor contracts might be in order.

The important thing, whether in labor relations or in chaebol reform, is for South Koreans to keep in mind that access to global capital and expertise is the surest road to continued progress and greater prosperity. Foreign investors are betting—at times, anxiously—that Korean leaders will on balance continue to see the benefits of a welcoming attitude. But alas, that second South Korea is still out there, and the nation has yet to resolve its ambivalence over much higher levels of foreign involvement in its traditionally quite closed economy. ◆