

Korea's Economy 2008

Korea's Economic Achievements and Prospects

The Graying of Korea: Addressing the Challenges of Aging

Financial Asia Rising: Asian Stock Markets in the New Millennium

Korea's Money Market

Ingredients for a Well-functioning Capital Market

The Capital Market Consolidation Act and the Korean Financial Market

Progress in Corporate Governance

Tax Issues Affecting Foreign Invested Companies and Foreign Investors

U.S.-Korea Economic Relations: View from Seoul

U.S.-Korea Economic Relations: A Washington Perspective

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Realistic Expectations of the Future Role of the IFIs on the Peninsula

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STRUCTURAL REFORM

PROGRESS IN CORPORATE GOVERNANCE

By Stijn Claessens

Introduction

This article investigates the progress in corporate governance reform in Korea since 1997 as well as current corporate governance challenges. It focuses on corporate governance issues and, as such, does not analyze other aspects—overall reform and competitiveness of the corporate sector, macroeconomic policies, and financial sector reforms—these have also been crucial to Korea’s recovery to date and will remain essential to sustain growth going forward. It concludes that much progress has been achieved in corporate governance reform, with many of the main corporate governance deficiencies contributing to the crisis having been eliminated. Corporate sector performance has improved, with corporate sector profitability generally restored and investment becoming more rational. Financial vulnerabilities have declined, as leverage has fallen and maturity and currency mismatches have been reduced.

Improvements to corporate governance in Korea can be attributed to a combination of multiple factors, most importantly ownership changes, including greater outside (foreign) ownership, and deep institutional reforms including strengthening of minority rights and requiring greater representation of outside directors. Buttressing these changes have been government-led initiatives, especially measures aimed at large and distressed corporations, and a tight framework for corporate financial restructuring; a broad set of other institutional reforms covering, among other procedures, accounting and auditing, including increased liability for proper financial reporting, improved bankruptcy restructuring, and other forms of financial restructuring procedures; financial sector reform, including banking

system recapitalization and restructuring; and changes in ownership structures in the financial sector.

The question is whether corporate governance needs to be further enhanced or modified in light of past experiences, global lessons, or changing circumstances. Some of the corporate governance problems preceding the crisis still remain today. In spite of many reforms, the corporate governance practices of Korean corporations are still perceived to be below those of firms in many comparator countries. Ownership structures remain characterized by high wedges between cash-flow rights and control rights, with adverse consequences for minority shareholders and resource allocation. Barriers to entry for small- and medium-size enterprises (SMEs), such as the time and cost to open up a business, are still large, and they hinder efficient growth. More generally, Korea’s relatively low level of investment coupled with generally unimpressive profitability and low productivity growth raise some doubts about the quality of corporate governance. And the advent of more knowledge-intensive production, with less need for investment in fixed assets, puts a greater emphasis on high-quality corporate governance. Further corporate governance reforms will be necessary to assure the right level and type of investments, with a proper risk-return balance.

Corporate Governance before 1997 and Reform since 1997

Problems before 1997

Korea’s corporate governance problems before the 1997 financial crisis that led to large financial vulnerabilities and weak performance have been well docu-

mented.¹ Many of the corporate governance problems arose from a high concentration of ownership control particularly among the large *chaebol*, the predominance of business groups in Korea, and the various interlinks among corporations. These features meant poor transparency and weak corporate governance, which in turn often facilitated an inefficient allocation of resources and much risk taking.

The weak governance structure was further aggravated by two factors. One was the generally passive nature of the Korean banking system, with its limited risk management and credit analysis skills and the still very large role of the government, both directly as an owner and indirectly as an overseer of banks. The second factor was the existence of many links between the corporate and financial sectors, most notably the control by the *chaebol* over many merchant banks and other nonbank financial institutions. The resulting lack of overall market discipline was reflected in the limited exit of weak corporations. In the capital markets, poor corporate governance translated itself into expropriation, low stock market valuation, and low rates of return for minority shareholders.

Improvements since 1997

In hindsight these problems have been identified and documented extensively as important factors behind the 1997 crisis, but at the time of the crisis too little emphasis was given to them. Thanks to vigorous policy actions following the crisis, however, much has been achieved in terms of improving the corporate governance regime. Actions have included a mixture of government-issued guidelines such as the required elimination of cross-guarantees, the forced reduction in financial leverage, special requests for the larger *chaebol* to reduce their investments and consolidate their operations, a specific process for large-scale corporate financial restructuring, recapitalization and financial restructuring of the banking system, financial sector reform, and increased market pressures facilitated by a number of institutional reforms.

Across a wide spectrum, data confirm that measures have led to reduced financial vulnerabilities and im-

proved corporate performance. Leverage has declined, debt maturity profiles have lengthened, and cash balances have sharply increased. Both profitability and investment behavior have improved, especially among the *chaebol*. Important to all this has been the large exit of weaker firms. This restructuring has been accompanied by somewhat improved direct ownership structures, including larger foreign ownership and reduction in cross-ownership among related parties, which have facilitated higher transparency in management and allowed for more efficiency in resource allocation. However, signs of weakness and unfinished restructuring needs still remain.

Corporate Governance Reforms

It was not just corporate governance reforms, but also other factors that allowed for the rapid progress in the corporate sector. These additional factors included large government-led initiatives immediately following the financial crisis; drastic restructuring of the financial system; and many improvements in the institutional environment, notably covering the frameworks for corporate financial distress and the disclosure and quality of information. Corporate governance changes have been due to three forces: government-led initiatives, improvements in the overall institutional environment, and changes in ownership structures.

Immediately following the crisis, a number of measures, such as the elimination of cross-guarantees and the prohibition on ownership links, aimed directly at improving financial and general transparency and corporate governance structures in the large *chaebol*. Through legal and regulatory changes, there have been many improvements in the institutional framework for corporate governance; also part of the financial restructuring and reforms were considerable changes in the ownership structures of many corporations:

- Minority shareholder rights strengthened by lowering the threshold for various shareholder initiatives,
- Outside board of directors introduced,

1. *Republic of Korea: Establishing a New Foundation for Sustained Growth*, vol. 1, Report no. 19595-KO (Washington, D.C.: World Bank, November 1999); "Republic of Korea: Article IV Consultations," IMF Staff Report (Washington, D.C.: International Monetary Fund, 1998); *Economic Survey: Korea* (Paris: Organization for Economic Cooperation and Development, 1999).

- Fiduciary duty of corporate directors introduced,
- Cumulative voting for directors allowed,
- Debt guarantees between *chaebol* subsidiaries prohibited,
- External auditors and corporate accounting officers subject to stiffer penalties,
- Approval by the board of directors required for related-party transactions,
- Introduction of economic criteria for evaluating applications for corporate reorganization,
- Ceiling on foreign shareholdings in individual companies abolished in 1998,
- All forms of mergers and acquisitions, including hostile takeovers by foreigners, permitted,
- Class action suits introduced for all listed companies,
- Ability of *chaebol* to exercise power over financial affiliates restricted, and
- Amendment to the Commercial Code to make managers and controlling shareholders more accountable to minority shareholders.²

Assessments of Corporate Governance Today

The improvements in corporate governance and shareholder capitalism have made the management of *chaebol* more transparent and are believed to have contributed to alleviating the “Korean discount” in the stock market.³ This in turn has led to the better functioning of equity markets and an improvement in the allocation of resources. Although in the past equity returns were very low, with dividends low and overall returns often below those on government and corporate bonds even though equity volatility was

higher, equity returns have been much higher since the crisis. Most important, the equity cost of capital has become a better guide for corporations’ investment opportunities, and the allocation of resources has therefore been improved.

It is difficult to say definitively, however, how much of the change is due to the upgrade of the corporate governance regime, how much to factors such as increased competition and further globalization, and how much to changes in ownership structures away from insiders and toward much more demanding investors. One reasonably objective way to assess the contribution of the institutional framework to the improved performance is to score the formal corporate governance regime in Korea relative to that of other countries (*Table 1*). Korea scores quite well compared with other Organization for Economic Cooperation and Development (OECD) and Asian countries. For example, the disclosure and shareholder suit indexes

Table 1: Corporate Governance Rules, 2006

Region or economy	Disclosure index	Director liability index	Shareholder suits index	Investor protection index
Asia and Pacific	5.2	4.4	6.1	5.2
OECD	6.3	5	6.6	6
Brazil	5	7	4	5.3
China	10	1	4	5
Germany	5	5	5	5
India	7	4	7	6
Indonesia	8	5	3	5.3
Japan	7	6	8	7
Korea	7	2	7	5.3
Malaysia	10	9	7	8.7
Philippines	1	2	7	3.3
Thailand	10	2	6	6
United States	7	9	9	8.3

Source: *Doing Business 2007: How to Reform?* (Washington, D.C.: World Bank, 2006).

2. *Economic Survey: Korea* (Paris: OECD, 1999, 2001, 2003, 2005, and 2007); *Report on the Observance of Standards and Codes (ROSC), Republic of Korea: Corporate Governance* (Washington, D.C.: World Bank, September 2003).

3. Lee Jong-wha and Rhee Chang-yong, “Crisis and Recovery: What We Have Learned from the South Korean Experience,” *Asian Economic Policy Review* 2 (2007).

are better than the OECD average. But director liability remains far below that average, making the overall shareholder index below average.

But it is also clear that, as elsewhere, a divergence exists between the regulatory environment and (market perceptions about) corporate governance practices in Korea.⁴ Among the nine sampled countries in East Asia, Korea is ranked far ahead of Hong Kong and Singapore in terms of principles and rules of corporate governance (*Table 2*). In corporate governance practices, however, Korea is perceived by fund managers and analysts to be significantly behind these two countries (although still ahead of most other East Asian countries). With a regulatory framework for corporate governance now largely set in place, it is therefore important to concentrate efforts on implementing and enforcing rules and regulations.

Table 2: Corporate Governance Rules and Practices

Countries	Rules and regulations		Investors' perceptions	
	Index	Ranking	Index	Ranking
Philippines	3.61	1	2.08	7
China	3.54	2	1.72	8
Korea	3.38	3	2.68	3
Thailand	3.20	4	2.60	4
Taiwan	2.98	5	2.50	6
Indonesia	2.92	6	1.57	9
Malaysia	2.62	7	2.60	4
Singapore	2.57	8	4.00	1
Hong Kong	2.48	9	3.88	2

Source: Stephen Y. L. Cheung and Hasung Jang, "Scorecard on Corporate Governance in East Asia," Working Paper no. 13 (Waterloo, Ontario: Center for International Governance Innovation, December 2006).

Further confirmation of the differences between rules and corporate governance practices comes from the annual 2005 Credit Lyonnais Asia Pacific survey (*Table 3*), where Korea is ranked in the middle of all East Asian countries in both rules and corporate governance practices. The weak corporate governance practices of corporations are further confirmed in the ratings of corporate governance practices by commercial agencies such as GovernanceMetrics International (GMI). Out of 49 countries, the average GMI corporate governance score for Korean corporations was only 2.31, which ranks Korea as fourth from the worst. Corporations in all Asian countries rated better, and no OECD countries rated worse than Korea (*Table 4*). Also, a study on the evolution of corporate governance practices in various markets suggests less improvement in Korea.⁵

Corporate governance is still weak in practice because some of the pre-crisis deeper underlying reasons for the problems remain. Most of the corporate governance problems in Korea center—as they do in most emerging markets and many developed countries—on the conflicts between minority and controlling shareholders, the latter often still represented in management. For most Korean corporations, there exists large outright control by insiders—only a handful of share or small-cash-flow owners are involved—allowing insiders to fend off market pressures. And *chaebol* with a lower ratio of ownership continue to exploit the treasury stock holding system as an effective tool to defend against takeover attempts.⁶ Conversely, those firms whose shares are largely held by major shareholders other than the controlling shareholders and their affiliates tend to maintain higher ratios of treasury stock. It may even be the case that during the past decade insiders have increased their control stakes and acquired more assets, and some argue that the regulations on circular investments were and still

4. Some of this is confirmed by Stephen Y. L. Cheung and Hasung Jang, "Scorecard on Corporate Governance in East Asia," Working Paper no. 13 (Waterloo, Ontario: Center for International Governance Innovation, December 2006).

5. Using market data, G. De Nicolo, L. Laeven, and K. Ueda, in "Corporate Governance Quality: Trends and Real Effects," Working Paper no. 06/293 (Washington, D.C.: IMF, 2007) show that, with the use of a corporate governance quality index that consists of accounting standards, earnings opacity, and stock price synchronicity, Korea is ranked not only quite behind developed countries but also below the average Asian country. Although the accounting standard indicator is the highest, earnings seem to be manipulated and stock prices do not reflect corporate governance problems quite rapidly. This result is consistent with the survey findings of Cheung and Jang, "Scorecard on Corporate Governance in East Asia."

6. Youn Tae-hoon, "Analysis on the Takeover Defense and Treasury Stock Holdings [in Korean]," in *Studies on the Market for Corporate Control in Korea*, ed. Youn Tae-hoon, Research Monograph no. 669 (Seoul: Korea Development Institute, 2005).

Table 3: Corporate Governance Score: A Market Perspective

Economy	Rules and regulations	Enforcement	Political and regulatory	IGAAP	Corporate governance culture	Economy score
China	5.3	4.2	5	7.5	2.3	4.8
Hong Kong	6.6	5.8	7.5	9	4.6	6.7
Indonesia	5.3	2.7	3.8	6	2.7	4
Korea	6.1	5	5	8	5	5.8
Malaysia	7.1	5	5	9	4.6	6
Philippines	5.8	3.1	5	8.5	3.1	5
Singapore	7.9	6.5	8.1	9.5	5.8	7.4
Thailand	6.1	3.8	5	8.5	3.5	5.3

Sources: *East Asian Finance: The Road to Robust Markets* (Washington: World Bank, 2006); Credit Lyonnais Securities Asia, *Emerging Markets Survey* (Hong Kong: Asian Corporate Governance Association, 2005).
Note: IGAAP = international generally accepted accounting principles.

are being circumvented today.⁷ Also in the immediate aftermath of the financial crisis, although rules were in place to prevent this from happening, the large cor-

Table 4: GMI Country Ranking Based on Individual Corporations' Ratings, Selected Countries, 2006

Country (no. of firms in parentheses)	Average overall rating	Rank in this group	Rank in all GMI
USA (1,739)	7.22	1	4
Thailand (8)	5.75	2	15
Germany (66)	5.66	3	16
Philippines (2)	5.50	4	21
OECD average	5.45	5	n.a.
Malaysia (16)	4.72	6	29
India (24)	4.67	7	31
Japan (409)	4.01	8	38
Indonesia (6)	3.83	9	41
Brazil (23)	3.23	10	42
China (17)	2.94	11	43
Korea (51)	2.31	12	46
Total number of country observations		12	49

Source: GovernanceMetrics International, September 18, 2006

porations were among the few able to acquire assets, thereby increasing their asset base.

Anecdotal examples confirm the difficulties that outside investors have in affecting management and controlling shareholders. Hyundai Motors, for example, has had periodic demands from labor unions for wage hikes, to which management has often acquiesced at the cost of minority shareholders' interests. One reason is that, without a market for corporate control and with the predominance of controlling shareholders, Hyundai Motors and other corporations like it do not face enough market pressure. Although direct ownership structures changed after the crisis, including through larger foreign ownership, until control changes from a small group of insiders to a larger group of dispersed shareholders, many of the corporate governance problems will remain. Importantly, the valuation of Korean firms, while improved, is still below that in many other advanced countries. As of the end of 2005, Korean firms were valued with a Tobin's Q of 1.02, significantly lower than firms of most other OECD and East Asian countries (*Table 5*).

For the SMEs, as in many other countries, corporate governance is usually even weaker than for the larger listed corporations. At the same time, and perhaps surprisingly given the attention most often paid to the

7. Lim Young-jae and Jun Sung-in, "Circulatory Shareholding of the Group Companies: Roles of Market Discipline and Supervisory Discipline [in Korean]," KDI Policy Forum (Seoul: Korea Development Institute, 2006).

Table 5: International Comparison of Tobin's Q, Selected Countries, 1995, 2000, and 2005

Country	1995	2000	2005
India	2.56	3.61	2.22
United States	1.91	3.20	1.83
Indonesia	2.29	1.21	1.50
Brazil	0.47	0.48	1.33
Thailand	1.58	0.93	1.33
OECD average	1.07	2.02	1.32
Malaysia	1.83	1.15	1.17
China	1.45	3.09	1.14
Germany	0.76	1.29	1.12
Philippines	2.03	0.90	1.09
Japan	1.00	3.17	1.05
Korea	0.82	0.93	1.04

Source: International Monetary Fund, Corporate Sector Vulnerability Utility, as based on Thomson Financial's Worldscope database.

Note: Tobin's Q ratio is approximated as the market capitalization weighted averages of the market value of equity plus book value of debt, divided by the book value of assets.

largest corporations, SMEs are a large part of Korea's economy, up to 50 percent of manufacturing output and approximately 32 percent of exports. To improve SME governance—a difficult task—Korean commercial banks will have to play a large role because they, as lenders, have a large stake in the governance of their borrowers. Another important responsibility in improving corporate governance of the smaller firms will fall to the accounting and auditing profession. Because weaknesses in corporate governance among the large firms in Korea tend to spill over to SMEs—many SMEs are domestic suppliers and subcontractors—improvements in large firms' corporate governance will go a long way toward aiding SMEs' corporate governance.

Corporate Governance Challenges

Many observers agree that in specific areas corporate governance reform efforts still need to be intensified to

assure an efficiently and prudently operating corporate sector in Korea. At the same time, new challenges facing the corporate sector have come up recently.

Remaining Challenges

Many efforts continue to be spent on improving and deepening corporate governance rules. The overall direction of these policies is in further enhancing the role of the market and in the use of market-based methods to determine how corporations are monitored and governed and how financial difficulties are resolved. Consequently, many changes have involved delegating to the market—instead of to regulating authorities, as was the case in the past—more of the tasks of ensuring compliance with the new rules.

This delegation has been a learning experience for many market participants and authorities. As in many other countries, the full benefits are yet to be seen, while risks have arisen in the meantime. For example, analysis shows that outside directors do not yet play a large enough role in improving corporate governance,⁸ and outside directors on management boards have yet to act independently of the executive directors. Although the responsibilities and incentives for outside directors are quite well established, outside directors have been lacking in their responsibilities and corresponding activities to improve corporate transparency. Outside directors have tended not to attend regular board meetings and often have entrusted their voting rights to the executive directors who effectively appointed them.⁹ Other evidence points to continued corporate governance weaknesses and severe agency costs.

More thus needs to be done, given global trends in corporate governance and capital markets. The establishment of a sounder corporate behavior requires not only improving the overall corporate governance and restructuring frameworks but also diligently maintaining the current rules or introducing new direct prohibitions and interventions. Tighter regulations on the circular shareholding of conglomerates are needed, for example, as there still exist concerns that

8. Cho Sung-bin, "A Study on Agency Costs of Korean Firms [in Korean]," KDI Research Monograph no. 717 (Seoul: Korea Development Institute, 2006).

9. Cheung and Jang, "Scorecard on Corporate Governance in East Asia."

the *chaebol* circumvent these rules. Several controlling shareholders' dominant control over affiliated companies through cross-shareholding greatly increased between 1998 and 2001 when the government, in order to facilitate corporate restructuring, removed the regulation on the total amount of shareholding in other companies.¹⁰ As a result, the controlling shareholders' voting rights have increased via their affiliated companies quite rapidly. In addition, some believe that circulatory shareholding creates voting rights among affiliates without requiring any cash outlays or other costs or expenses.¹¹ This is an infringement on minority shareholders' rights by artificially reducing their relative voting shares.

Another important policy issue is the role of corporations in the ownership of financial institutions. Many observers—including, for example, Standard & Poor's in 2005 when it was upgrading Korea's sovereign rating—have noted that preventing control of the financial system by large corporations and business groups is crucial to preventing the recurrence of a financial crisis. Recently, however, the inability of nonfinancial firms to acquire stock in Korea's commercial banks—the limitation was a 4 percent maximum ownership stake—has been relaxed. The relaxation of bank ownership rules and allowing more ownership by corporations might lead, however, to misallocations and introduce systemic risks, especially because Korea has much larger business groups than most other (advanced) countries. Besides the concerns about systemic risks, worries about economic power concentration and concerns about fair competition have in many countries led to limits on the ownership of banks by nonfinancial corporations.¹² Because ownership has already been somewhat liberalized, it is crucial that existing measures are enforced at the same time, especially those rules governing conflicts of interest and transparency, and that additional measures be

taken, such as increased disclosure on related-party transactions.

Some of the current policies being considered by the incoming Lee Myung-Bak government would impact on corporate governance. In particular, the proposals to ease restrictions on the investments by large conglomerates in related organizations, the further relaxation of restrictions on investments in other corporations and financial entities, the removal of the 200 percent limit on leverage, and the reduction in taxes on intragroup dividends would strengthen the role of business groups. If these proposals are to be adopted, it would be imperative that at the same time transparency, financial reporting, and corporate governance requirements in general be enhanced as well. The move toward greater use of holding companies could help clarify organizational structures and complement such changes, but should not lead to favorable treatment of the *chaebol*. Any planned reorganization of the respective responsibilities of the finance ministry, the Financial Supervisory Commission, and Financial Supervisory Service would have to ensure that enforcement of corporate governance rules does not diminish.

New Challenges

Besides these existing reform issues, larger challenges for Korea's corporate sector lie ahead; the challenges have to do with the overall business environment, especially in terms of fostering innovation. It is clear that going forward the economic model will have to be different from the past. Rapid accumulation of input factors combined with solid productivity growth have allowed for Korea's impressive growth for the past 35 years, but the limits are being reached. Increased competition from other countries makes it less clear how Korea can repeat the fast growth of the past de-

10. Lim Kyung-mook and Cho Sung-bin, "The Role of Equity Investment in Corporate Control of the Large Business Conglomerates in Korea [in Korean]," in *Studies on the Market for Corporate Control in Korea*, ed. Youn Tae-hoon, Research Monograph no. 669 (Seoul: Korea Development Institute, 2005).

11. Lim and Jun, "Circulatory Shareholding of the Group Companies"; the authors suggest as a more effective regulatory tool, an ex post system in which minority shareholders, whose rights are infringed, are allowed to file a low-cost lawsuit asking the court to nullify the resolution of the general meeting of shareholders.

12. Although other advanced countries generally do not ban nonfinancial firms from controlling banks, in most countries such investment is rare; see "Republic of Korea: Selected Issues," IMF Country Report no. 06/381 (Washington, D.C.: International Monetary Fund, 8 September 2006).

cedes, and Korea needs new sources of growth.¹³ Part of the solution will have to involve a better business environment and more focus on fostering innovation, and all must be supported by better corporate governance. Following are some specific areas of corporate governance that need to show improvement.

Chaebol have control rights that far exceed their cash-flow rights. Although the rules protecting investors are now largely comparable with those in other OECD countries (with the exception of liability of directors), corporate governance is still found wanting, as can be seen in the ratings of investors and other agencies. Much of this is due to the *chaebol*'s having control rights far exceeding their cash-flow rights. This still occurs in part because the *chaebol* exercise indirect control over their firms through institutional investors' ownership. For example, the controlling shareholders of the 13 investment trust companies with market shares of more than 2 percent are either *chaebol* (6) or banks (7).¹⁴ *Chaebol* also control many nonbank financial institutions; they control, for example, more than half of the insurance and securities companies. Because of their indirect powers over institutional shareholders, insiders often dominate control in Korean *chaebol* at the expense of other minority shareholders.

Poor implementation of rules. The system of outside members on the boards of directors needs to be reformed. The proportion of outside directors appointed by the largest or the major shareholders is very high, 76 percent in 2003;¹⁵ thus, outside directors are unlikely to play an active whistle-blower role and oversee the activities of management.

Capital markets are still relatively passive in corporate governance. Although there has been more active investor engagement on some corporate governance issues that has been aided by sharehold-

ers activist groups such as People's Solidarity for Participatory Democracy, participation in general by domestic investors is limited, in part because of conflicts of interest. Foreign investors, except for a few well-publicized instances, are too widely dispersed to play effectively the role of active agents. The level of foreign direct investment is still relatively low in Korea, and this limits further another form of corporate governance pressure.

The fundamental role of corporations in Korea's economy is undergoing questioning. This reassessment is happening at the same time that the basic corporate governance principles and practices are still being put in place or tested. Corporations are, for example, increasingly being asked to play a social role in the country. Under the outgoing administration, more emphasis was put on balanced growth, with a particular focal point on alleviating bipolarization in various segments: these include issues of urban vs. rural areas; large enterprises vs. SMEs; management vs. labor; and permanent laborers vs. temporary laborers. Corporations, especially large ones that have benefited during Korea's expeditious growth periods, are asked to shoulder the costs of the country's social safety net. One of the challenges to large corporations is that these additional burdens coupled with global competitive pressures push them to diversify to other sectors, which sometimes causes them more difficulty. For example, they are shifting more of their operations overseas and relying less upon Korean SMEs to meet their production needs. As a result, SMEs are under further pressure and go into more distress. Policies that impose large social costs on corporations are not likely to be viable in the era of globalization. Instead, in order to survive, straitjackets on corporate activities should be removed and more incentives to innovation should be provided, while transparent corporate governance is firmly put in place to assure economic fairness.

13. *Economic Survey of Korea 2005* (Paris: OECD, September 2005); World Bank Institute and Korea Development Institute, "Korea as a Knowledge Economy: Evolutionary Process and Lessons Learned" (Washington, D.C.: World Bank, 2006); and "Republic of Korea: Selected Issues," IMF Country Report no. 06/381.

14. Lim, Young-jae, "Institutional Shareholders, Chaebol Agency Costs, and Public Policy in Korea," in *Institutional and Policy Reforms to Enhance Corporate Efficiency in Korea*, ed. Cho Lee-jay, Somi Seong, and Lee Sang-hyop, 121–65 (Seoul: Korea Development Institute, 2007).

15. Cho, "A Study on Agency Costs of Korean Firms [in Korean]."

Concluding Remarks

Thanks to strong policy actions, reform measures, and market pressures, Korea has made great progress in improving its corporate governance regime. Nevertheless, concerns remain, including about implementation and enforcement of corporate governance rules, the low level of outside investors, the (increasing) role of family ownership in the large *chaebol*, and the associated large wedge between ownership and control. New corporate governance issues have come up as they have been triggered by concern about the general competitiveness of Korea's corporate sector. Increased global competition makes continued corporate governance reform necessary and requires a more vibrant services sector and SME sector; this has in turn led to a continued need to reform the overall business environment, to lower entry barriers, and to adopt policies fostering innovative behavior of corporations consistent with appropriate risk sharing.

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