

OVERBORROWING AND OVERINVESTMENT IN EAST ASIA: THE CASE OF THE KOREAN FIRMS*

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This paper examines whether there has been overinvestment by Korean firms in the 1990s, particularly during the few years leading up to the crisis in Korea. Overinvestment is defined as the statistically significant discrepancy between the forecasted value from an econometric model of investment and the actual investment. Our analysis shows that overinvestment was found most frequently for chaebol firms. Moreover, it was most evident in a few industries showing viable exports in the 1990s, such as electronic and communication equipments, basic metals and transport equipments other than motor vehicles. However, capital account liberalization was not found critical in inducing overinvestment. Overinvestment by chaebols during 1994-1996 period indicates that loosening strict restrictions on lending in the financial sector to chaebols backfired. In this sense, the Korean crisis was caused by structural weaknesses in corporate and financial sectors.

JEL Classification: F34, F41

Keywords: Overborrowing, Overinvestment, Currency Crisis

I. INTRODUCTION

Overinvestment by the corporate sector is often pointed out as one of the fundamental causes that brought about the Asian collapse. By lowering profitability and raising the likelihood of bankruptcy in borrowing firms, overinvestment might have resulted in an increase in non-performing loans held by banks and downgraded the credit ratings of banks on international financial

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markets. If so, it is important to investigate the incentives that induce overinvestment, and to confirm empirically the existence of overinvestment itself in relation to the studies on the Asian crisis.

Various theoretical models have been put forth regarding causes of overinvestment. At the macroeconomic level, moral hazard generated by implicit as well as explicit government guarantees for bad loans, implementation of financial liberalization policies, changes of industrial policy from sector-specific to functional intervention, and prevalence of soft-budget constraints are suggested as some key reasons. On the other hand, at the firm level, the agency cost problem between managers and shareholders, misallocation of capital due to diversification, and capital allocation through internal capital markets are discussed as the sources of overinvestment.

Although theoretical debates on this subject are relatively active, few studies have been done to verify the existence of overinvestment using empirical tools. Furthermore, it is hard to find a study on whether overinvestment has been done at the firm level in a specific period of time. In this paper, we investigate, using a simple econometric model, whether there has been overinvestment in the 1990s, particularly during the few years leading up to the crisis in Korea.

We define overinvestment as the statistically significant discrepancy between the forecasted value from an econometric model of investment and the actual investment. The existence of systematic forecasting errors may be interpreted as evidence for overinvestment. Our analysis shows that overinvestment was found most frequently for chaebol firms. However, capital account liberalization was not found critical in inducing overinvestment. Overinvestment by chaebols during 1994-1996 period indicates that loosening strict restrictions on them backfired.

This paper is organized as follows. Chapter II briefly reviews theoretical and empirical works on overinvestment. In Chapter III, we examine investment behavior of Korean firms to test the existence of overinvestment during the 1994-96 period. Chapter IV summarizes the major findings of this study and draws policy implications.

II. LITERATURE REVIEW

1. Moral Hazard and Financial Liberalization

Various types of incentives have been pointed out as the key to overinvestment. The moral hazard argument, which is the most popular, emphasizes the major role of the implicit as well as explicit safety net provided by government in inducing overinvestment.¹ Krugman(1998) argues that

¹ Chang et al.(1998) argue that the Korean crisis is hardly caused by moral hazard because there has been no instance where the Korean government has bailed out failing chaebols in the

over-guaranteed and under-regulated financial intermediates can lead to excessive investment. Furthermore, this situation can easily be made worse by globalization. As a national economy, in which investment was previously funded by a limited supply of domestic savings, has access to the world capital market, it may be worse off by allowing moral hazard in the financial sector to translate into real excess capital accumulation.

Corsetti et al. (1999) developed a model in which moral hazard was the common source of overinvestment, excessive borrowing, and current account deficit in an economy with a poorly supervised and regulated financial sector. McKinnon and Pill (1996, 1999) show that when there is moral hazard in the capital market, especially in the banking sector, and the capital account is liberalized, potential for disaster arises. Given world interest rates, both consumption and investment increase relative to the equilibrium levels, which would be unsustainable without a lucky payoff for investment. They argue that this is the essence of the overborrowing syndrome.

Financial liberalization is often referred to as another source of overinvestment. Chang et al. (1998) argue that the Korean excessive investment in the private sector, which led to the crisis of 1997, had been made possible by rapid and ill-designed financial liberalization, especially capital account liberalization. McKinnon and Pill (1996, 1999) also assert that many liberalizing economies, where banks exploit the potential for moral hazard, have suffered from overborrowing, which is due to overconsumption and overinvestment, followed by financial crisis and bust.

The Korean government opened the equity market to foreign investors in 1992. Incidentally or not, the Korean economy experienced a substantial increase in capital inflows in the early 1990s. Various factors worked to create such voluminous capital inflows during the 1994-96 period: an aggressive search for higher return on capital by banks and financial institutions in developed countries, the big differential between domestic and foreign interest rates, and improvement of the credit ratings of Korean banks and corporations in the international financial market in the mid-1990s. As the result, they could enjoy easier access to investment funds from abroad. However, it remains highly debatable that financial liberalization during 1990-96 worked to induce capital inflows to the Korean economy.

2. Incentives for Overinvestment

There are a number of theoretical models that explain overinvestment from the perspective of an incentive for individual firms. Jesen (1986) explains overinvestment as an agency cost phenomenon. If managers prefer growth to profitability, they may invest free-cash flow in negative present value projects.

This argument can be applied to Korean chaebols' seemingly excessive investment behavior. In the case of Korean chaebols, controlling shareholders, who usually have less than 10% of the total equity, work as top managers of the firm. Therefore, chaebol families in Korea have a tendency to maximize the total size of their groups, not market value of individual firms. This distortion in incentive may have led to an overinvestment (Hong and Ahn (2000)).

Extensive diversification of East Asian corporations is also referred to as one of main causes for the financial crisis in 1997. Diversification is usually associated with misallocation of capital investment towards less profitable and more risky sectors, leading to overinvestment. Classens et al. (1998) test the misallocation of capital hypothesis in East Asian countries. They find that firms in Indonesia, Korea, Taiwan and Thailand appear to have suffered a significant negative impact of vertical integration on short-term performance, which implicitly suggests the possibility of overinvestment in these countries. Scharfstein (1998) and Rajan et al. (1997) also examine investment patterns across segments in diversified firms and find that diversification often leads to misallocation of investment funds.

Meanwhile, Huang and Xu (1999) show that soft-budget constraints, with no explicit termination of a given project, are more likely to generate overinvestment when there is no bankruptcy. Because poorly informed depositors are misled to be overly optimistic, loss-making projects can be covered for a long time by overborrowing.

3. Industrial Policy and Capital Allocation

In spite of frequent criticism of overinvestment by Korean chaebols, there are few studies to verify the existence of overinvestment. Demetriades and Fattouch (2001) provide an empirical analysis of the Korean economy in which large volumes of excess or unproductive credit since the late 1970s exist by using a cointegration technique to estimate the underlying long-run equilibrium relationship between the stock of credit and its determinants. Their findings are broadly consistent with the hypothesis of overlending and overinvestment in Korea. They also show that the volume of unproductive credit increased sharply during the 1993-96 period, which reveals the possibility of the overinvestment in that period preceding the crisis.²

Ueda (1999) investigates whether there was overinvestment or underinvestment in Korea during 1970-90. He calculates the expected marginal products of capital (MPK) of nine manufacturing industries, and compares them with the average value of the manufacturing sector as a whole. If the expected MPK of a certain

² From a long-run equilibrium relationship among consumption, investment and output, Kim et al (2000) conclude that there was no overinvestment, but overconsumption and underproduction in the 1990s.

industry is lower (higher) than the average, then it is interpreted as evidence for overinvestment (underinvestment) in that industry. According to these criteria, there were overinvestments in Korea's basic metal industry and machinery industry in the 1970s. Meanwhile, Hahn (1999) shows that the investment rate of the Korean firms is positively related to the dummy variable representing affiliation with chaebols. He interprets this finding as evidence for overinvestment for chaebols.

It goes without question that changes in industrial policies had an influential impact on investment behavior of the Korean firms. To achieve rapid industrialization, the Korean government extensively intervened in the industrial allocation of capital through control over credit allocation.³ During the 1980s and the early 1990s, the traditional predominance of the state over the market, represented by regulation, protection and support, was actively interacting with new forces in the market, represented by trade liberalization, competition, deregulation and privatization (Yoo and Lee(1997)). Since the new Korean government under President Youngsam Kim was launched in 1993, deregulation was emphasized as the most important reform agenda. Furthermore, the Korean government changed its stance on industrial policy from a sectoral approach to a functional one.

Dismantling of the investment coordination mechanism made it easy for each firm to implement its investment projects. This might have resulted in falling profitability and in the bankruptcies of major chaebols in Korea during 1996-97. Chang et al. (1998) argue that, with the serious weakening of a sectoral industrial policy, there was a fundamental transformation in the state-business relationship in Korea.⁴ Hong and Ahn (2000) also insist that the retreat of state intervention in the late 1980s has worsened the latent principal-agency problems of capital and labor markets.

III. METHODOLOGY AND ANALYSIS

1. Analytical Framework

In order to judge whether there has been overinvestment, we need to know what is the optimal level of investment. There are well-defined economic theories for investment such as a Neoclassical model based on comparison of marginal product of capital with interest rate, Tobin's q theory, and the accelerator model. Each theory is useful to identify determinants of investment,

³ Kim and Lee (2002) present a model in which government subsidies lead to overinvestment, making the rapid-growing economy susceptible to adverse shocks.

⁴ According to them, cronyistic relationships spread into the major manufacturing industries and policy coordination mechanisms no longer worked to prevent overinvestment in a number of leading industries including electronics, cars, steel, petrochemicals and shipbuilding in the mid-1990s.

but it is not easy to find out appropriate variables for empirical analysis. Moreover, any model is not satisfactory enough in explaining actual investment decision of firms. Therefore, most empirical studies on investment adopt an eclectic approach by utilizing insight from each theory.

Hoshi, Kashyap and Scharfstein (1991) use measures of liquidity, Tobin's q , and lagged production as determinants of investment rate. Reeb and Kwok (2000) employ Tobin's q and coverage ratio in order to examine whether the Japanese firms with main banks show a tendency for investment inefficiency. In studying investment behavior of the Korean firms, Hahn (1999) tests whether uncertainty of rate of return affects investment using sales-capital ratio, rate of return, cash flow, and size of firms as explanatory variables. Lee (2000) uses Tobin's q , cash flow ratio, sales to capital ratio, and total debt rate. Drawing on these previous studies, we use the following model to explain investment decision of firms:

$$IK_t = f(SK_t, SK_{t-1}, ROR_t, ROR_{t-1}, CFK_t, CFK_{t-1}, SIZE_t, TDK_t, DRSP_t) \quad (1)$$

IK: growth rate of tangible capital

SK: sales to the beginning of the period tangible capital ratio

ROR: operating profit to the beginning of the period total asset ratio

CFK: cash flow to the beginning of the period tangible capital ratio

TDK: debt to capital ratio

SIZE: logarithm of lagged total asset

DRSP: real stock price change rate

The above equation postulates that investment decisions are affected by sales, rate of return, liquidity, size, and debt-capital ratio. DRSP, which is defined as the rate of increase in stock price minus the inflation rate of the GDP deflator, may be considered as the first difference of Tobin's q (Barro and Sala-i-Martin (1991)).⁵

It is another matter how to define an appropriate criterion to decide overinvestment. Unfortunately, there is no previous work to draw on. We propose to use the forecast error from estimation of investment decision of firms (equation 1) as a measure for overinvestment. The fitted value of the dependent variable is interpreted as the optimal investment level for given values of its determinants. If the forecast errors are systematically positive, then we may conclude that there was overinvestment.⁶ This approach is not only objective in

⁵ It is debatable whether Tobin's q plays a significant role in investment decisions. Blanchard et al. (1993) find that market valuation appears to have a limited effect, given fundamentals. Hoshi et al. (1991) show that the estimated coefficient on q is statistically significant, but small in the case of Japanese firms. Meanwhile, Barro (1989) insists that the rate of increase in real stock price is immune from many problems intrinsic to calculation of the marginal q , and often proves to be effective as a proxy for future profitability.

⁶ Blanchard and Summers (1984) examine the effect of higher real interest rate on investment

defining overinvestment, but also able to consider changes in investment environment.

The forecast error is by definition dependent on the regression result. In our analysis, therefore, there are several problems which deserve due attention. Firstly, the Korean economy has experienced a substantial structural change while it has continued to grow rapidly. Therefore, it is important to take the right sample period for estimation in order to get a meaningful forecast result. Secondly, affiliation with chaebols may make access to the financial market easier.⁷ Therefore, we need to differentiate chaebol affiliates and independent firms. Thirdly, capital account liberalization in the 1990s may have lowered financial costs of firms in general. The banking sector could have increased its local loans through borrowing in the international capital market. A boom in the stock market following opening up to foreign investment could have helped direct financing of the listed firms. Fourthly, degrees of overinvestment are expected to differ depending on industries. In the 1990s, exports have been most viable in a few industries: automobiles, ships, steel and semiconductors. Therefore, we may expect that overinvestment would be more apparent in these industries.

2. Data and Variables

The firm-level data for Korea can be obtained from the Korea Listed Companies Association. We can get comprehensive corporate and financial information on listed companies beginning in 1980. We selected manufacturing firms listed continuously since 1980 up to 2001. While the total number of firms is 490, data for some variables are missing. Therefore, actual number of observations for regression may be smaller.

Meanwhile, we classified firms into three groups: 1-5 largest chaebol firms, 6-30 largest chaebol firms, and other independent firms. We identified the firms affiliated with chaebols by using official announcements from the Korean government. The Korea Fair Trade Commission has continued to rank the 30 largest chaebols and announced their affiliates every year. These firms are subject to specific restrictions on loans from the financial sector. The order of chaebols by size changes year to year.

The characteristics of our sample are shown in Table 1. There are 88 chaebol affiliates and 402 independent firms in the sample. 33 chaebol firms are affiliated with the five largest chaebols in 1996: Samsung, Hyundai, LG, Daewoo, and SK. 55 chaebol firms are affiliated with the sixth to thirtieth

using forecast errors of a simple accelerator model.

⁷ In the case of Japan, many empirical studies confirm the close relationships with banks lowers costs of financial distress and may induce overinvestment (Hoshi et al. (1990), Reeb and Kwok (2000)).

largest chaebols. Differently from the five largest chaebols, these smaller ones show instability in their status and higher risk of default.

The industrial distribution of sample firms shows a big difference between chaebol and independent firms. Chaebol affiliates are most active in chemicals, basic metals, electrical machineries, electric components and motor vehicles. On the other hand, there are few chaebol firms in the light industries such as textiles, apparel, wood, printing, rubber, etc. Food and beverage industry is an exception in this respect. It is noteworthy that our sample consists of firms that have been listed since 1980, so it may be unable to reflect the structural changes fully. For example, computer and office machinery industry is one of the most heavily invested industries in the 1990s. However, there is just one chaebol firm included in our sample. This sample bias asks for caution in comparing overinvestment patterns in different industries.

[Table 1] Characteristics of Sample Firms

Industry	Group 1: 1-5 chaebols	Group 2: 6-30 chaebols	Group 3: Independent	Total
Food and Beverages	2	8	34	44
Textiles			22	22
Apparel and Fur articles			20	20
Leather, luggage and footwear		1	5	6
Wood products except furniture			3	3
Pulp and paper products		1	20	21
Publishing and printing			2	2
Coke, refined petroleum products	1	1	4	6
Chemicals and chemical products	10	12	82	104
Rubber and plastic products		1	14	15
Non-metallic mineral products		6	17	23
Basic metals	1	8	34	43
Fabricated metal products		3	7	10
Machinery and equipment	2	3	24	29
Computers and office machinery		1	5	6
Electrical machinery and apparatuses	2	2	18	22
Electronic components, radio, TV and communication equipment	8	0	49	57
Medical, precision&optical instruments	1		8	9
Motor vehicles and trailers	2	6	27	35
Other transport equipment	4	2		6
Furniture and manufacturing n.e.c.			7	7
Total	33	55	402	490

Note: The classification of chaebol affiliates is based on 1996 data.

Before estimating the investment model, it is useful to review general trends in investment. The upper half of Graph 1 shows the investment rate ($I/K(-1) = \Delta K/K(-1)$), the growth rate of tangible capital for the manufacturing sector as a whole, and for each group of firms. The overall investment rate was very unstable in the 1980s, reflecting radical changes in business environment following the Plaza agreement and rising factor prices in the late 1980s. The investment rate began to increase after 1992, and recorded 25% in 1996. The rise in investment in the 1990s was led by chaebol affiliates. The consolidated investment rate for Group 1, the five largest chaebol firms, was tripled from 10% in 1992 to 30% in 1996. The investment rate for Group 2, the 6th to 30th largest chaebols, also showed a similar trend starting in 1993. The independent firms shows only a gradual increase after 1993.⁸

Next, let us consider the changes in the debt-capital ratio in order to check whether an increase in investment rates was accompanied by higher debt burden. As shown in the bottom of Graph 1, the ratio of total debt to capital continued to fall in the 1980s. It began to rise gradually in the early 1990s, but stayed rather stable until the 1997 crisis. It was Group 2 that showed a continuous rise in debt-capital ratio from 1990. In 1998, the consolidated debt-capital ratio for Group 2 reached a record high 600%, implying structural weaknesses.⁹ Combined together with observations on investment rates, the changes in debt-capital ratios may be interpreted as supporting that chaebol affiliates were responsible for overborrowing and overinvestment

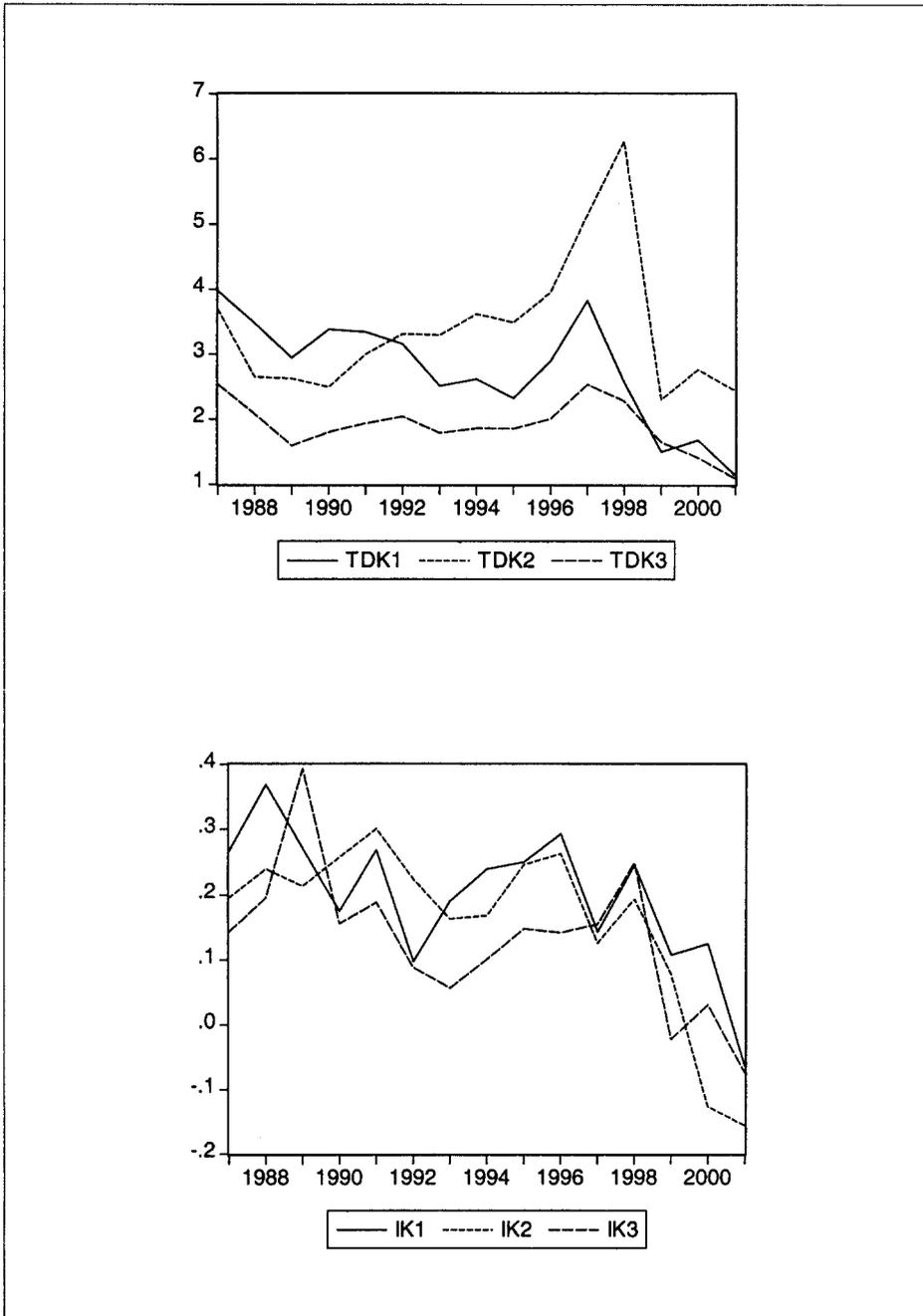
Average values for the investment rate and its determinants are summarized in Table 2. The sample period was set between 1990 and 1996, taking into account rapid changes in investment environment in the late 1980s. The overall investment rate is 19%, and the average profit rate is 6%. The rate of change in real returns on stock was negative during the period.

As expected, investment rate was the highest for Group 1, while the lowest for Group 3. Interestingly enough, Group 2 appears to be inferior to Group 1 in the soundness of financial structure as well as in performance. Group 2 recorded the lowest sales to capital ratio, operating profit rate and cash flow rate. Meanwhile, it showed the highest debt-capital ratio.

⁸ It is not certain whether capital account liberalization has a significant effect on changes in investment rates. The turning point for higher investment rates for Group 1 coincides with the opening up of the stock market in 1992. However, it was only in 1994 when higher investment started for Group 2. It needs to be further examined whether changes in investment rate were affected by other determinants rather than the capital account liberalization.

⁹ In contrast to chaebol affiliates, independent firms as a whole showed a stable debt-capital ratio, which seems to indicate limited access to external financing.

[Graph 1] Trends in Investment Rates and Debt-Capital Ratios



[Table 2] Main indicators related to Investment (1990-1996)

Variables	All	Group 1:1-5 Chaebols	Group 2:6-30 Chaebols	Group 3: Independent
IK	.1940	.2194	.2178	.1888
SK	3.6479	3.5012	3.1462	3.7313
ROR	.0619	.0744	.0537	.0622
CFK	.2102	.2179	.1791	.2143
TDK	3.6916	2.4949	4.3759	3.1991
SIZE	7.9400	8.6751	8.2521	7.8421
DRSP	-.0258	-.1206	-.0435	-.0166
Number of Observations	2636	153	318	2165

[Table 3] Regression of Investment Function

Variable	1982-84	1985-87	1988-90	1991-93	1994-96	1982-96
C	-.05 (-.18)	.79 (2.45)	.28 (1.13)	-.16 (-.81)	-.46 (2.15)	-.01 (-.10)
SK	.05 (5.57)	.02 (1.67)	.04 (3.60)	.03 (2.62)	.02 (1.66)	.03 (6.64)
SK ₋₁	-.02 (-2.43)	.01 (.64)	.02 (2.64)	-.00 (.28)	.01 (.83)	.01 (1.93)
ROR	-5.31 (-10.72)	-2.58 (-4.78)	-1.04 (-2.44)	-3.01 (-6.67)	-1.60 (-3.47)	-2.20 (-10.97)
ROR ₋₁	2.05 (4.28)	1.84 (3.51)	1.28 (2.95)	2.57 (5.91)	.49 (1.07)	1.65 (8.95)
CFK	1.08 (10.28)	.20 (2.31)	-.52 (5.81)	.24 (2.48)	.14 (1.47)	.14 (3.47)
CFK ₋₁	-.10 (-1.10)	-.04 (-.64)	-.17 (-2.45)	.01 (.11)	.15 (1.46)	-.05 (-1.93)
TDK	-.001 (-.68)	.00 (.06)	.01 (3.48)	.00 (.18)	.00 (.14)	-.00 (-.09)
SIZE	.04 (.94)	-.09 (-2.19)	-.02 (-.60)	.03 (.13)	.06 (2.44)	.01 (.75)
DRSP	.10 (1.64)	.11 (2.84)	.13 (2.62)	-.07 (-2.52)	-.03 (-1.23)	.01 (.75)
Number of observations	491	551	832	1112	1188	4174
R ²	.38	.09	.17	.10	.07	.08

Source: Korea Listed Companies Associations, 2003 (on line).

3. Estimation and Interpretation

[Table 3] summarizes regression results of the investment model. We applied the ordinary least squares method to panel data covering a three-year period from 1982-85 up to 1994-96. The regression results consistently show significance of sales ratio (SK), profit rate (ROR), and cash flow ratio (CFK) as explanatory variables. On the other hand, debt-capital ratio, size and real returns on stock turn out to have wrong signs or are statistically insignificant, depending on the sample periods.

[Table 4] tests whether affiliation with chaebols makes a difference in investment decisions. The sample period is from 1987, when the Korean government began to restrict loans to chaebol affiliates, to 1996. The value for

[Table 4] Investment Function for Chaebol and Non-chaebol Firms (1987-1996)

Variable	All	All	Group 1: 1-5 Chaebols	Group 2: 6-30 Chaebols	Group 3: Independent
C	-.11 (-.09)	.11 (.68)	-.21 (-.86)	-.10 (-.22)	.08 (.53)
SK	.02 (3.45)	.02 (3.47)	-.00 (-.24)	.02 (.60)	.02 (2.61)
SK ₋₁	.02 (3.27)	.02 (3.27)	.05 (2.16)	.06 (1.73)	.01 (1.63)
ROR	-1.87 (-7.48)	-1.86 (-7.48)	-4.88 (-5.39)	1.62 (1.66)	-2.43 (-9.24)
ROR ₋₁	1.70 (6.96)	1.71 (6.99)	3.44 (3.90)	-1.52 (-1.57)	1.93 (7.56)
CFK	.07 (1.51)	.07 (1.50)	.91 (3.50)	-.57 (-5.76)	.35 (5.94)
CFK ₋₁	-.15 (-3.08)	-.15 (-3.05)	-.80 (-2.72)	-.25 (-2.42)	-.08 (-1.31)
TDK	-.00 (-.34)	-.00 (-.36)	.02 (1.37)	-.00 (.67)	.00 (.43)
SIZE	.02 (1.51)	.01 (.44)	.04 (1.23)	.02 (.52)	-.00 (-.21)
DRSP	-.01 (-.68)	-.01 (-.64)	-.10 (-1.85)	-.01 (-.08)	-.02 (-1.17)
C-dummy		-.04 (-2.20)			
Number of observations	3324	3324	206	395	2723
R ²	.06	.06	.20	.20	.09

Source: Same as Table 3

the dummy variable, C-dummy, is 1 for Group 1 (1-5 chaebols), 2 for Group 2 (6-30 chaebols) and 3 for Group 3 (independent firms). C-dummy will have a negative value if chaebol firms have an advantage in access to the financial market. As expected, the parameter for C-dummy has a negative value, which is statistically significant.

Regression of subsamples reveals that our model does not fit well in the case of Group 2. This fact may indicate that these firms made investment decisions without paying enough attention to key variables affecting profitability of investments.

[Table 5] Capital Account Liberalization and Deregulation (1987-1996)

Variable	All	All	Group 1: 1-5 Chaebols	Group 2: 6-30 Chaebols	Group 3: Independent
C	-.11 (-.94)	.07 (.45)	-.33 (-1.21)	-.09 (-.20)	-.05 (-.34)
SK	.02 (3.77)	.02 (3.76)	.00 (.01)	.02 (.52)	.03 (5.06)
SK ₋₁	.02 (2.80)	.02 (2.80)	.04 (1.96)	.06 (1.75)	.00 (.56)
ROR	-1.96 (-7.86)	-1.96 (-7.86)	-4.76 (-5.22)	1.59 (1.63)	-1.09 (-6.56)
ROR ₋₁	1.57 (6.41)	1.58 (6.46)	3.28 (3.66)	-1.52 (-1.55)	1.10 (5.52)
CFK	.07 (1.41)	.07 (1.41)	.84 (3.17)	-.56 (-5.69)	.08 (4.55)
CFK ₋₁	-.14 (-2.86)	-.14 (-2.83)	-.73 (-2.47)	-.24 (-2.33)	-.05 (-1.60)
TDK	-.00 (-.31)	-.00 (-.33)	.02 (1.01)	-.00 (-.62)	-.00 (-.23)
SIZE	.03 (2.06)	.02 (1.07)	.06 (1.66)	.03 (.54)	.02 (1.11)
DRSP	.00 (.14)	.00 (.16)	-.10 (-1.80)	.01 (.21)	-.00 (-.28)
C-dummy		-.02 (-1.86)			
L-dummy	-.08 (-3.71)	-.08 (-3.64)	-.06 (-1.14)	-.06 (-.80)	-.07 (-2.86)
S-dummy	.01 (.23)	.01 (.31)	.00 (.06)	.06 (.73)	.01 (.58)
Numbr of observations	3324	3324	206	395	2723
R ²	.07	.07	.21	.21	.09

Source: Same as Table 3

[Table 5] summarizes the regression results testing the significance of capital account liberalization and deregulation of various restrictions on chaebols. L-dummy, representing capital account liberalization, has 1 for the period between 1992 and 1996, and 0 otherwise.¹⁰ S-dummy, which represents deregulation and changes in industrial policy, has 1 for the period between 1994 and 1996, and 0 otherwise.

As shown in [Table 5], L-dummy has a negative coefficient, and it is statistically significant. Therefore, we do not find evidence for a positive linkage between capital account liberalization and overinvestment. Meanwhile, the S-dummy has a positive coefficient, though it is not statistically significant. This finding suggests that the role of deregulation between 1994 and 1996 needs further examination. Now, we are ready to consider the problem of overinvestment by examining forecast errors of regression. After estimating the investment equation using the sample period of 1990-93, forecast errors are drawn for the period of 1994-96.¹¹ The year 1990 marks a reversion of the current account balance from positive to negative, and the business cycle also showed a downturn. Therefore, it would be reasonable to presume that there was a structural change in investment decisions.

[Table 6] summarizes characteristics of forecast errors. Overinvestment is defined as a case in which a forecast error has the positive sign and its size is larger than a standard error. Likewise, underinvestment is defined as the opposite case in which a forecast error has the negative sign and its size is larger than a standard error.

[Table 6] Forecast Errors (1994-1996)

Group	Forecast Error>0		Forecast Error<0		Number of Observations
	all	Over-investment	all	Under-Investment	
Group1: 1-5 Chaebols	40	7	28	2	68
Group 2: 6-30 Chaebols	55	10	95	1	150
Group 3: Independent	324	51	646	24	970

Note: Overinvestment (underinvestment) is the case where a forecast error has the positive (negative) sign and its size is larger than a standard error.

¹⁰ It is another issue how to measure capital account liberalization. Most studies focus on restrictions on payments for capital transactions using data published by the IMF. According to the Chinn-Ito financial openness variable (2002), based on such an approach, Korea's openness did not change during 1988-1994.

¹¹ Regressions for the period of 1990-93 are reported in Table A.1 in the appendix.

As shown in Table 6, it is Group 1, which shows dominance in positive forecast errors. 40 out of 68 observations have positive errors, while 28 have negative values. Moreover, 7 out of 40 positive forecast errors are statistically significant in the sense that they are larger than one standard error. These 7 observations represent overinvestment.

In the case of Group 2, the number of positive forecast errors is smaller than that of negative forecast errors. However, 10 observations show overinvestment, while just one indicates underinvestment. As for Group 3, there are 51 observations of overinvestment and 24 of underinvestment.¹²

Industrial distribution of overinvestment differs depending on the specific group (Table <A.2> in the Appendix). In Group 1, overinvestment centers on electronic and communication equipment industries, which include the semi-conductor industry. Group 2 mainly overinvested in basic metals and other transport equipment industries (e.g. shipbuilding). Underinvestment for both groups was very small. As for Group 3, chemical, basic metals, fabricated metals, and electronic & communication equipment industries appear to be peculiar in overinvestment.

Overinvestment during 1994-1996 period appears to be robust to the sample period for estimation. When we use the regression over the sample period of 1987-1993, the number of positive forecast errors substantially decreases so that the mean of the forecast errors becomes negative. Nevertheless, overinvestment measured by the significantly positive forecast error remains apparent for chaebol firms.

IV. CONCLUSION

In this paper, we have tried to find evidence of overinvestment by Korean firms, which was often criticized as one of the main causes for the Korean financial crisis in 1997. Using the data on investment and its determinants for listed manufacturing Korean firms, we examined whether actual investment during 1994 and 1996 was higher than forecasted by an econometric model of investment. The major findings of this paper may be summarized as follows.

Firstly, overinvestment was found most frequently for chaebol firms. We found that 10% of firms affiliated with the top 5 chaebols overinvested during 1994 and 1996. As for the firms belonging to the top 6-30 largest conglomerates, 7% of those overinvested during the same period. As for firms with no affiliation

¹² The distribution of forecast errors and their statistical characteristics indicate more differences among three groups. In Group 1, the mean value for forecast errors is .10 and the distribution is skewed toward the positive side. In Group 2, the mean value for forecast errors is 0.7. It also shows a tendency for a higher investment rate than predicted. On the other hand, the mean value for Group 3 is negative, and more observations show negative values for forecast errors. In sum, chaebol affiliates show a general tendency for higher investment than the trend predicted by its determinants.

with chaebols, a 5% overinvestment ratio was observed. The actual investment rate substantially increased during 1994 and 1996. Therefore, we may conclude that conglomerate firms led the increase in investment, which was excessive to a certain extent. Meanwhile, overinvestment by chaebols was most evident in a few industries showing viable exports in the 1990s. The top 5 chaebol firms overinvested in electronic and communication equipment (semi-conductor) industries. The top 6-30 chaebol firms mainly overinvested in basic metals and other transport equipment (ship) industries. Underinvestment for both groups was only negligible.

Secondly, capital account liberalization was not found critical in inducing overinvestment. This finding is in stark contrast to the common view, which emphasizes that financial liberalization in the first half of the 1990s ushered in overborrowing and overinvestment by chaebols in Korea. As a matter of fact, there was no drastic measure for financial liberalization in the 1990s, except for opening of the stock market to foreign investors. Of course, we do not deny an increase in capital inflows, mainly through borrowing by the financial intermediaries. The sudden increase in capital inflows during 1994 and 1996 could be explained by push factors in international capital markets rather than pull factors in the Korean economy. Our empirical test showed that the investment ratio did not show any systematic increase in response to the Korean governments effort to open up capital market gradually starting in 1992.

Thirdly, our evidence of overinvestment by chaebols supports the view that loosening strict restrictions on lending in the financial sector to chaebols backfired. Under the catchphrase of globalization, the Korean government allowed greater freedom in investment decision for conglomerates. In particular, promotion of specialization policy for chaebols, which encouraged chaebols to choose two or three major industries to operate, worked as an excuse for overborrowing from the financial sector. If this is the case, the Korean crisis was caused by structural weaknesses in corporate and financial sectors. Highly leveraged firms continued to borrow in order to expand, while the financial sector believed that they were too big to fail.

Our findings confirm needs for structural reform in corporate and financial sectors in Korea. In order to prevent the recurrence of a financial crisis, investment decisions should be determined by the profitability of each project. The financial sector should adopt advanced methods of evaluation and supervision for lending. Also, the government should strengthen its supervision of the financial sector, and further promote transparency of corporate financial structures. It remains to be seen how the 1997 crisis has affected overborrowing-overinvestment in East Asia.

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APPENDIX

[Table A.1] Regression of Investment Function (1990-93)

Variable	Group 1: 1-5 chabols	Group 2: 6-30 chabols	Group 3: Independent
C	.1181 (.35)	-.3618 (-.76)	.0603 (.27)
SK	-.0719 (-2.49)	-.0396 (-.93)	.0210 (2.01)
SK ₋₁	.0729 (2.29)	.0539 (1.30)	.0226 (2.35)
ROR	-2.0745 (-1.93)	-2.2392 (-1.89)	-3.1286 (-7.40)
ROR ₋₁	.9093 (.86)	2.1446 (1.71)	2.7495 (6.67)
CFK	-.7374 (-1.83)	.0504 (.16)	.2992 (3.15)
CFK ₋₁	.5642 (1.43)	.1124 (-2.42)	-.2595 (-2.77)
TDK	-.0189 (-1.21)	-.0002 (-.63)	.0004 (.60)
SIZE	.0319 (.83)	.0619 (1.10)	.0060 (.21)
DRSP	.0083 (.08)	-.0260 (-.31)	.0017 (.05)
L-Dummy	-.0889 (-1.45)	-.0609 (-.81)	-.1058 (-2.97)
Number of observations	85	168	1195
R ²	.3298	.0945	.1153

Source: Korea Listed Companies Associations, 2003 (on line).

[Table A.2] Industrial Distribution of Overinvestment and Underinvestment

Industry	Overinvestment			Underinvestment		
	Group1	Group2	Group3	Group1	Group2	Group3
Food and Beverages	1		2			
Textiles			4			2
Apparel and Fur articles			4			3
Leather, luggage and footwear						
Wood products except furniture						
Pulp and paper products			4			2
Publishing and printing			1			
Coke, refined petroleum products			1		1	
Chemicals and chemical products		2	10			1
Rubber and plastic products			2			
Non-metallic mineral products			2			
Basic metals		5	7			2
Fabricated metal products			4			
Machinery and equipment			1			
Computers and office machinery			1			
Electrical machinery and apparatuses	1	1	2	1		1
Electronic components, radio, TV and communication equipment	5		4	1		13
Medical, precision, and optical instruments						
Motor vehicles and trailers						
Other transport equipment		2	2			
Furniture and manufacturing n.e.c.						
Total	7	10	51	2	1	24

Note: The classification of chaebol affiliates is based on 1996 data.