Institutional Transition and Transition Cost

: Assessing the Post 1997 Corporate Reform in South Korea

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1. Introduction[1]

This paper assesses the post-1997 corporate reform in Korea by investigating its benefits and costs to the economy. Apparently, there has been a significant advancement in the corporate reform. The corporate debt-equity ratio fell dramatically. Both internal and external corporate governance systems were overhauled. The macroeconomic recovery of the country also looks impressive. On a closer look, however, the reform has so far failed in achieving its stated aim, i.e., reducing financial risks in the corporate sector, whilst costs arising from attempting a radical institutional transition have been unduly magnified.

We argue that this disappointing performance was mainly because the reform has created a vacuum in the risk-taking function in the economy, which the 'reformers' neglected or at best under-estimated in their lopsided concern for perceived benefits of the reform. We analyse the continued credit crunch in the corporate sector in this regard. In this analysis, the reform was misdirected from the beginning and what is required for Korea is a change in the direction of the reform, not a speedier and fuller implementation of the current reform as the 'reformers' would argue.

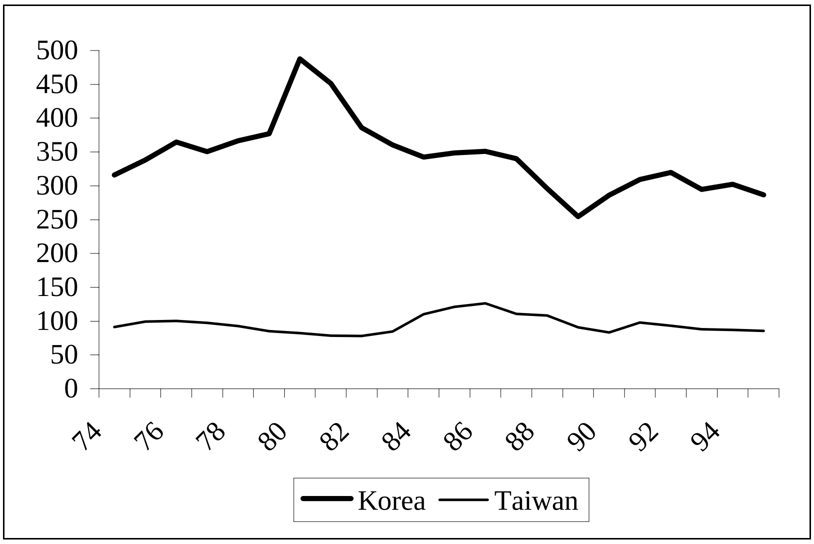
2. The Post-1997 Corporate Reform in Korea

The structure of 'high debt with thin profit margin' was a major target of the corporate reform in Korea after the financial crisis in 1997. The Korean corporate sector was characterised by a relatively high debt-equity ratio in comparison with its counterparts in East Asia like Taiwan or Singapore (figure 1). This heavy reliance on debts in corporate financing was translated into a low ordinary profit rate because it

[1] Part of this paper will appear in Shin & Chang (2002).

paid a larger portion of operating profit for financial expenses, despite the fact that it maintained one of the highest operating profit rates in the world (table 1).[2]

Figure 1. Debt-Equity Ratio of Manufacturing Firms in East Asia
(%)



Source: BOK website, Fields (1995: 108, table 4-5),
Bank of China in Taiwan, quoted in BOK (1999a)
Singapore's figure is 123.3% on average during 1980-1991
(Demigruc-Kunt & Maksimovic's 1996)

This structure of 'high debt with thin profit margin' is certainly a factor that makes an economy potentially vulnerable to external financial shocks: if banks become, for whatever reasons, uncertain of the firms' ability to repay their loans, they stop renewing or even call in existing loans and the firms suddenly fall into a liquidity crunch. In fact, the financial crisis in 1997 was paralleled with a big drop of the ordinary profit rate in the manufacturing sector to a minus level (minus 0.3%) (BOK 1999).

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[2] Ordinary profit is a profit after deducting interest payments and other financial expenses from operating profit.

Table 1. Structure of Profit in the Manufacturing Sector in Korea, Japan, the USA and Taiwan
(%, average during 1988-97)*

	Korea**	USA	Japan	Taiwan
Operating income to Sales	7.0 (7.1)	6.6	3.3	6.5
Ordinary income to Sales	2.1 (2.7)	4.2***	3.3	4.5
Financial expenses to Sales	5.6 (5.3)	n.a.	n.a.	2.1

* Taiwan's figures are for 1986-1995
** Figures in parentheses are for 1986-1995
*** Net profits
Source: BOK website, BOK (2000), Chang & Park (1999)

The corporate reform was geared to correcting this 'structural' weakness. At the more symptomatic level, a radical reduction of corporate debt was attempted. The Korean government mandated the 5 largest *chaebols*, the family-owned diversified business groups, to reduce their debt ratios, which stood at 473% on average at the end of 1997, to below 200% by the end of 1999.[3] Along with this reduction in corporate debt-equity ratio, the 'Big Deal' programme (the business swaps among the *chaebols* operating in overlapping industries), and the 'Workout' programme (the bank-sponsored rehabilitation programme for ailing firms) were carried out as *ex post* measures to resolve over-capacity and financial messes after the financial crisis.

At the more fundamental level, radical changes in external and internal governance mechanisms were carried out. It was believed that the previous state-banks-

[3] The 5 largest *chaebols* actually 'over-achieved' the target by reducing it to 235% in 1998 and to 148.9% in 1999. The ratio for the 30 largest *chaebols* also went below 200% in 2000. The debt-equity ratio of the manufacturing sector as a whole consequently fell from 396% in 1997 to 214% in 1999 and to 210.5% in 2000, the lowest since 1968 .

chaebols nexus allowed the Korean corporate sector to take financial risks more than it deserved, leveraging on the support from the state and banks as well as the internal transaction mechanism within the business group. Therefore, the corporate reform included the following elements: (1) The state retreated from the role of promoting industries by abolishing remaining industrial policy tools and fully opening both products and services markets. (2) In this process of redefining the role of the state, financial regulations were strengthened substantially by introducing the Basle capital adequacy ratios (the so-called BIS ratios) or other new regulation standards, and the financial sector was assigned the role of the nerve centre of the economy. (3) Fair trading regulations were also strengthened to check 'unfair' expansion of the *chaebols* and companies were required to compete as independent units, rather than as members of business groups. (4) Changes in internal corporate governance were made in order to reflect more closely the shareholders' point of view in the running of the companies. These included the introduction of outside directors system, strengthening of minority shareholders' right, changes in accounting standards, and so on.

As a result, the external and internal institutional structures of the Korean corporate sector was, at least at the formal level, re-moulded into an essentially Anglo-American one based on minimal state, arms'-length contractual relationships, and focus on short-term financial profitability. By attempting 'fundamentally' to reform institutional environment of the corporate sector, the IMF programme applied to Korea was the deepest and broadest one ever experimented in crisis-hit countries.

3. Transition Cost in the Post-1997 Corporate Reform

There are certainly some benefits to the economy from this corporate reform. The most conspicuous one would be the establishment of a strong ‘check and balance’ system between financial institutions, companies, and shareholders, which may help reduce some of the worst abuses of the system. Financial institutions are no longer allowed to keep accumulating non-performing loans (NPLs) as they are now forced to close or merge if they do not maintain minimum BIS ratios. It has also become difficult for the *chaebol* ‘owners’ to dictate the running of companies due to the increased transparency and the strengthening of the right of minority shareholders.

However, the reduction in financial risk of the system, the very aim of the reform, was not quite realised. For instance, even with a radical reduction of corporate debt-equity ratio, the problem of ‘thin profit margin’ in the corporate sector transformed only into that of ‘thinner profit margin’. The ordinary profit rate of the manufacturing sector recovered to 1.68% in 1999, from negative figures in 1997 and 1998, but it slipped again to 1.29% in 2000 (figure 2). The average ordinary profit rate for the two years of vigorous economic recovery after the crisis, during which the Korean economy expanded at the annual rate of 9.8%, was only around half of the historical average before the financial crisis (2.8% during 1973-1996). If we include the figure for 2001, the year of sharp economic slowdown, the average is even worse at 1.12%. As far as the balance sheet of the corporate sector is concerned, its financial vulnerability has actually become worse even after the corporate reform.

Figure 2. Trend of Profitability in the Manufacturing Sector in Korea

Source: BOK website

Some benefits claimed by the IMF and the Korean government as the results of the reform are also misplaced in our view. For instance, the short-term economic recovery in 1999 and 2000 is more a consequence of adopting aggressive Keynesian policy than that of implementing economic reform and thereby restoring the 'investors' confidence'.[4] Similarly, the return of FDI from late 1998 was less due to the 'restoration of investors' confidence' encouraged by Korea's commitment to reform than due to the increasing prospect of the economic recovery (more on this later).

[4] For details, see Shin & Chang (2002, section 3.3).

On the other hand, substantial 'transition costs' have incurred in implementing this radical institutional transition.[5] Table 2 shows a rough picture of transition costs in the form of new NPLs created in the economy. The Korean government and the IMF often emphasise the reduction of NPLs as a major achievement of the reform programme. But this claim applies only to those *within the financial sector*, which shot up to 136.3 trillion won (US$113.5 billion), or 21.8% of total loans, in June 1998, was reduced to 66.7 trillion won (11.3%) at the end of 1999, and 59.5 trillion won (9.6%) in March 2001. This reduction was mainly due to unprecedented injections of public funds and pressure from the government over financial institutions to improve their short-term balance sheets by disposing their assets.

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[5] The concept of 'transition cost' was first proposed by Khan (1995). He uses it mainly in relation with political costs involved in institutional change. It seems to us the concept can be also applied to understanding economic costs incurred in the process of radical institutional transition even we there are no serious political and social costs, as in the case of Korea.

Table 2. Changes in Non-Performing Loans after the Financial Crisis
(trillion won, %)

	Dec. 1997	June 1998	Dec. 1998	June 1999	Dec. 1999	June 2000	Dec 2000	March 2001
Banks	31.6	40.0	33.7	37.1	39.7	56.5	42.1	38.1
Non-banks	12.0	23.6	26.5	26.3	27.0	26.0	22.5	21.4
Total (A)	43.6 (86.4)	63.6 (136.3)	60.2 (102.7)	63.4 (84.4)	66.7	82.5	64.6	59.5
Ratio of NPLs (%)	6.7 (13.2)	10.2 (21.8)	10.4 (17.7)	11.3 (15.0)	11.3	13.6	10.4	9.6
Accumulate purchase of NPLs by public funds (B)	11.0	13.8	44.0	46.1	56.0	81.5	95.2	90.6
Accumulate disposal of NPLs by financial institutions (C)	0	0	6.0	-	52.0	-	73.0	-
Accumulate NPLs when purchase or disposition were not made (A+B+C)	97.4	150.1	152.7	-	174.7	-	232.8	-

Source: Adapted and calculated from PFOC (2000; 2001) and FSC website.
Note: Figures in parentheses represent amount of NPLs or ratios of NPLs to total loans when forward looking criteria (FLC) is applied. The FTC began using FLC from the end of 1999 in reporting NPLs.

However, an often-neglected fact is that the amount of NPLs *in the national economy* has kept increasing. The accumulated total of NPLs, which includes those driven out of the financial system through purchase by public funds or through disposition by financial institutions in the form of sales to private investors, liquidation and so on, increased from 97.4 trillion won at the end of 1997 to 232.8 trillion won at the end 2000. During the three years after the financial crisis, 135.4 trillion won

(US$112.8 billion) of *new NPLs* was created in the economy. And the increase in NPLs continued in 2001.[6]

It is impossible to determine objectively how much of this increase in NPLs in the economy was due to *ex post* realisation of the latent troubles within the corporate sector accumulated before the crisis or due to the difficulties created by the new economic environment. However, if we look at the financial flows from the financial sector to the corporate sector, the importance of the latter gains weight.

Table 3. External Financing of the Corporate Sector

(billion won)

	1996	*1997*	*1998*	*1999*	*2000*	*2001*
Total	118,769	118,022	27,664	51,755	66,531	51,939
Indirect Financing	33,231	43,375	-15,862	2,198	11,391	1,185
From Banks	16,676	15,184	259	15,525	23,348	3,381
From NBFIs	16,555	28,191	-16,550	-13,267	-11,997	-2,377
Direct Financing	56,097	44,087	49,496	24,792	18,996	36,838
CPs	20,737	4,421	-11,678	-16,116	-1,133	4,210
Stocks	12,981	8,974	13,515	41,137	20,806	16,504
CBs	21,213	27,460	45,907	-2,827	-2,108	11,761
Foreign borrowing	12,383	6,563	-9,809	11,537	15,765	2,283
Others	17,059	23,997	3,839	13,228	20,380	11,633

Source: Flow of Funds, BOK website
Note : CP is corporate paper. CB is corporate bond. Others include corporate loans, government loans and so on

[6] For instance, according to BOK (2001), companies with lower than 100% of interest coverage ratio, that is, whose operating profit falls short of their interest payments obligations, have increased to 36.3% of listed manufacturing companies during the period of January to September 2001 from 27.6% during the same period in 2000.

As table 3 shows, a remarkable trend in corporate financing after the crisis and subsequent reform was an abrupt depletion of external funds available for the corporate sector. Even during the period of rapid economic recovery in 1999 and 2000, the external funds for the corporate sector was only around half of that available in 1997, and the situation became worse in 2001.

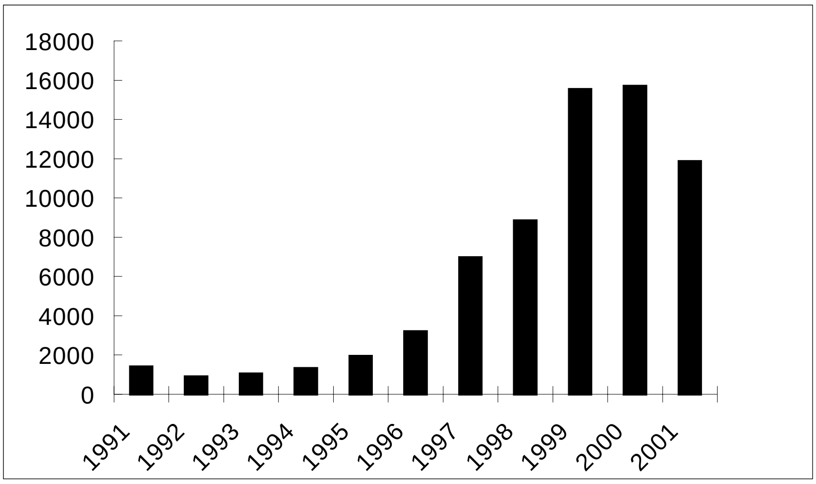
The main culprit here was the fall in ‘indirect financing’, i.e., the borrowing from financial institutions. In 1998 when the country was in the depth of the crisis, financial institutions *withdrew* 15.8 trillion won of loans from the corporate sector. Although indirect financing slowly began to recover, its level fell far short of the pre-crisis level. The amount of external financing available in 1999, at 2.2 trillion won, was only about 5% of the 1997 level (43.4 trillion won). In 2000, it was still only 26% (11.4 trillion won) of the 1997 level. As the economy began slowing down sharply in 2001 along with the recession in the world economy, indirect financing shrank dramatically again to 2.5% (1.2 trillion won) of what was available in 1997.

It seems to us that the credit crunch resulting from the sudden decrease in flow of funds from the financial sector to the corporate sector was an important factor in explaining the continuous increase in NPLs within the economy. Considering Korean companies’ thin profit margin and heavy reliance on external debts, few companies were able to survive this new financial system with extreme contractionary bias. The Korean government continually introduced policy measures to ease this credit crunch, but they were far from effective in normalising the financial flow because the fundamental logic of the new system dictated extremely risk-averse behaviour from financial institutions.

On top of NPLs that have been newly created during the period of restructuring, the loss from 'distress sales' of assets should be considered as transition costs incurred in Korea's institutional transition. The IMF and the Korean government have often cited the rise in inward FDI after the crisis as a major achievement of the reform programme. But this claim begs scrutiny.

First, as figure 3 shows, the rapid increase in FDI did not begin with post-crisis reforms. FDI was already on a rapidly increasing trend before the crisis, jumping by 68.4% in 1996 and by 115.6% in 1997. This implies that, even without corporate reforms and the government's efforts at attracting FDI after the crisis, overall market opening and relaxation of regulations on FDI, combined with the strong growth of the domestic economy, were enough to bring about a strong trend increase in FDI. There is no clear evidence that Korea needed those fundamental reforms to increase the volume of FDI.

Figure 3. Trend of FDI Inflow in Korea
(US$ million)



Source: MOCIE website.

Second, most of the increase in FDI was related with asset sales by Korean companies and financial institutions, and was not the result of ‘green field’ investments. Therefore, inward FDI increased sharply in 1998 (26.9%) and 1999 (75.5%), when the government pressure over domestic institutions to sell their assets was strong, and subsequently became stable in 2000 (1.0%) and fell sharply in 2001 (-24.4%). Asset sales in itself can hardly be regarded as a benefit to the economy. It can be beneficial to the economy only if those changes in ownership of the assets are translated into a better performance of the economy as a result of infusion of advanced technologies and management practices. But this positive effect of FDI to the economy is not in sight as yet, as the languishing sales and profitability figures of the corporate sector indicate. Moreover, if those assets were sold at heavily discounted prices as a result of ‘distress sales’ in a crisis situation, the difference between their ‘real’ value and their sale prices should be counted as costs to the economy, no matter how big the size of FDI was. In this regard, the Korean experience is very negative.

Of course, there is no objective way to measure the extent of discount in sales value of assets. Unless we gather all data on asset sales and future movement of their valuation, we are not able to estimate this. The counterfactual question, that is, what would have been the value of the assets if they were not sold, is also difficult to answer, and sharp differences of opinion will always remain.

However, it is the normal situation after a financial crisis that domestic companies and financial institutions usually have to engage in ‘distress sales’ to avoid liquidity constraints, while foreign investors are in no hurry to buy those assets and can take their time to choose. Considering this asymmetry of negotiation power between domestic institutions and foreign investors, it is more natural to suppose that the assets that the domestic institutions can sell in a crisis situation will be mostly those with exceptionally bright prospects and/or at bargain prices.

In the Korean case, this asymmetry was exacerbated by the government policy. The Korean government portrayed FDI as the 'saviour' for the crisis-hit economy as well as a new engine of growth for the future, and applied tremendous pressure on domestic institutions to sell their assets to foreigners quickly, while providing the latter with various financial incentives. For instance, in carrying out corporate reform, the government specifically requested the *chaebols* to detail the amount of *foreign money* that they are planning to bring in through asset sales by the end of 1999. So when the top 4 *chaebols* reported their 'successful' restructuring at the end of 1999, $10.82 billion of their assets were transferred to foreigners (SERI 2001).

Moreover, some assets over which the government had direct control were ear-marked for foreign sale to show the country's determination to attract foreign capital. The most important example of this was the sale of the Korea First Bank. The bank, a representative 'bad bank' thanks to its heavy exposure to the bankrupt Hanbo Group and Kia Group, was placed for foreign sale under the agreement with the IMF. Its controlling shares (50.99% of the total share) were sold to the sole bidder, Newbridge Capital, a U.S. investment bank, at 500 billion won at the end of 1999. Under the deal, the Korean government agreed to purchase all NPLs arising over the next 2-3 years. This means the U.S. investment bank could hardly lose from the deal – given that all NPLs will be cleaned up by public money, it would make profit as far as the share price of the Korea First Bank rise above its face value (5,000 won per share).[7] The Korea First Bank is already earning handsome profits. It recorded a 306.4 billion-won net profit in 2000 and a 200.2 billion-won net profit for the first half of 2001 alone (FSC website). The net profit made by Newbridge Capital for the one and half years is already more than its original investment.

A similar deal was struck in the sale of the Daewoo Motors to General Motors (GM). The creditor banks of Daewoo Motors, led by the state-owned Korea Development Bank (KDB), agreed to sell it under the following conditions in September 2001: (1) GM will set up a new company to acquire Daewoo Motors and put $400 million for 67% of the total share of the company; (2) This company will selectively acquire $1.2 billion of assets and $834 million of debts of Daewoo Motors, but not the whole company; (3) The company will pay $1.2 billion to the creditor banks by preferred stocks, not by cash, for the assets acquired; (4) The creditor banks will provide the new company with long-term loans up to $2 billion (KDB 2001).

For GM, this is a deal out of a dream. In this deal, it is to pay only $400 million to acquire the controlling share of Daewoo Motors, which was estimated to have 12.9 trillion won ($10.7 billion) of assets even according to a very conservative estimate.[8] It also avoided acquiring large part of bad assets of Daewoo Motors and the burden of them still remains on the shoulders of the creditor banks, and ultimately on the taxpayers, as the creditor banks are being injected with public funds. Moreover, as it is

[7] The Korean government purchased 12.46 trillion won ($10.3 billion) of NPLs and other assets from the Korea First Bank from the end 1999 to May 2001 (The Chosun Ilbo, 20 June 2001).

[8] This figure is from a valuation by auditors in August 1999 after the Daewoo Group was placed under the workout programme. The book value of the assets was 20.6 trillion won ($17.1 billion) in June 1999 (FSC 1999).

promised a large-scale injection of long-term capital by the creditor banks, which it is not obliged to repay if the new company goes bankrupt, GM will lose only the paid-in capital of $400 million even in the worst case scenario.

In contrast, the only way that the creditor banks can get their money back is by selling preferred stocks of the new company after the compulsory 10-year holding period. They are also to put $197 million of their own money to the new company as shareholders, owning the remaining 33% of the shares, and also have promised to provide long-term loans up to $2 billion.[9] The asymmetry in this deal can be put into perspective, if we compare this deal with the one when Hyundai Motors acquired Kia Motors in November 1998. Hyundai Motors paid 1.2 trillion won ($10 billion) of cash and took over 6 trillion won ($50 billion) of Kia's debt with no promise of long-term capital provision from creditor banks (Maeil Business Newspaper, 19 October 1998).

These highly asymmetric deals were made only because the Korean government had excluded the possibility of reviving those ailing banks and companies by mobilising domestic resources and capabilities. The sale of the Korea First Bank was stipulated in the agreement with the IMF and the Korean government felt obliged to keep the promise and regarded this as an important step to regain 'investor's confidence'. In the case of Daewoo Motors, it excluded the options of nationalising the company for fear of damaging its new-found image as a market-oriented government, while refusing to allow a take-over by other *chaebols* lest that it would bring allegations of favouritism or of the failure in its 'will' to reform the *chaebols*.

[9] This deal was finalised in April 2002 basically on similar terms, but with some changes that further favoured the GM (The Maeil Business News, 30 April 2002).

Thus seen, the Korean government ended up pushing for a number of deals that could be almost described as give-aways to foreign investors, which were based on, even in the most charitable interpretation, totally unrealistic expectations about the benefits that FDI can bring. Its dogmatic position on the benefits of FDI, which was supported by international organisations and academic circle, was a major source of ballooning the transition cost in Korea's institutional transition.

Along with the newly created NPLs and the losses from distress sales, the probable weakening of the competitiveness of the Korean corporate sector should be regarded as another form of transition cost resulting from the corporate reform. There are some signs of deterioration in competitiveness of the corporate sector. For instance, the operating profit rate in the manufacturing sector for the two years of vigorous recovery was 7.0% on average – slightly lower than the 7.2% average for 1990-1997, and then dropped sharply to 5.5% in 2001, the year of economic slowdown, resulting in the 6.5% on average for the three years. It looks like that there has been a downward shift in the trend of the operating profit rate (figure 2).[10]

The movement of the operating profit rate in the year of recession needs to be given a particular attention. In 1997, the year of financial crisis, the Korean corporate sector actually raised its operating profit rate to 8.2%, from 6.5% in 1996, to survive economic slowdown and increasing financial burdens. However, in 2001, the year of

[10] Sales growth rate has also deteriorated in a similar fashion. The figure in 1999 and 2000, the years of sharp macroeconomic turnaround was 11.6% on average, much lower than the average during 1990-1997, which was 14.5%. It also dropped significantly to 1.7% in 2001 following the economic slowdown, recording the lowest figure since 1961 except 1998 (0.7%), the year of severe economic contraction after the crisis. The

recession, there was a significant deterioration in operating profit rate. This implies that the Korean corporate sector has somehow lost its capacity to combat recession after the crisis.

One major candidate to explain this change is the strengthening of financial regulations over the corporate sector. As we mentioned above, the new financial regulations were highly biased against corporate lending and brought about continued credit crunch in the corporate sector after the crisis. When companies face liquidity constraints, they have less room to negotiate over prices of their products or hold up their production when market situation is bad, and are often required to sell their products at 'any' prices. This pressure certainly has had negative effect on their profitability.

What should be further noted is the pro-cyclical nature of new financial regulations over BIS ratios and corporate debt-equity ratios. In a recession, an increase in bankruptcy and fall in asset prices shrink the asset base of the financial institutions, which induces them to withdraw their loans from the corporate sector, if they are to meet the BIS standard, which makes the recession even worse. Also, in a recession, firms need to increase their borrowing in order to maintain their cash flows, as their sales decrease and raising money through stock issuance becomes difficult. However, the debt-equity ratio regulation precludes the possibility to ride out a short-term liquidity problem by increasing debts, which used to be a characteristic way of dealing with business cycles by Korean firms.

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average sales growth rate during the three post-crisis years (1999-2001) was therefore only 8.3%.

The stringent application of fair trading regulations, especially on internal transactions, is also a factor that will reduce (may have already reduced) the competitiveness of Korean firms by putting the *chaebols* under serious constraints in operating as business groups. To be sure, there can be negative effects of internal transactions, such as drainage of financial resources from healthy affiliates to unhealthy ones. However, internal transactions have positive effects, which have more than offset the negative ones in the case of Korea, such as economising on managerial resources, overcoming market uncertainties, allowing a longer-term perspective in investment and so on. By altogether banning internal transactions, the reform programme may have had destroyed the positive aspects of the group structure as well – a classic case of 'throwing the baby away with the bath water'.

Previously, internal transaction was a major source of the *chaebol's* strength in supporting new large-scale ventures, as evidenced by Samsung's entry into the semiconductor industry or Hyundai's entry into the shipbuilding industry. Owing to the ban on loan guarantee and other internal transactions, it is now almost impossible to set up such ventures by relying on support from profitable affiliates. Coupled with the stringent regulation on corporate debt-equity ratio, the restriction on internal transaction has substantially reduced financing options for the *chaebols.* And it is not likely that the growth in equity financing, the only remaining option for large-scale financing, will be sufficient to compensate for this constraint, at least in the near future.[11]

[11] Regarding this, a leading businessman in Korea, in an interview with one of the authors in August 2000, said the following: "It has been possible for major *chaebols* to mobilise a large amount of investment funds through internal mechanism without letting foreign competitors or foreign financial institutions know about their plans. The size and the speed of mobilisation of those resources were what foreign competitors feared most. But now, even the major *chaebols* (the 5 largest ones) have to go to the

The upshot of the argument above is as follows: The post-crisis corporate reform brought about few benefits to the economy except instituting a strong 'check and balance' system. On the other hand, huge transition costs have incurred mainly in the form of (1) creation of new NPLs, (2) distress sales of domestic assets, and (3) the weakening in competitiveness of the corporate sector. Although the exact size of the transition costs is difficult to calculate and any attempt to do it will be draw further controversies, we have provided some indicators and anecdotal evidence to grasp the rough picture of the transition cost.

4. The Vacuum in the Risk-Taking Function in the Economy

It seems to us that this disappointing performance of the corporate reform was mainly because it has created a vacuum in the risk-taking function in the economy, which the 'reformers' neglected or at best under-estimated in their lopsided concern for perceived benefits of the reform. In the new institutional framework, the state and the internal transaction mechanism within the business group withdrew from the risk-taking role in the economy and the financial sector emerged as the sole agent to assess and take risks in loan provisions. But its capability to do so was severely constrained in the context of the Korean economy.

First, since commercial banks were in the process of ongoing re-organisation and many of them were placed under the ownership of the government, their primary concern was to meet newly-introduced supervision standards which are in general

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international financial market if they need an investment over 1 trillion won (US$ 870 million)."

penalising corporate lending. They had little incentive to take high risks in corporate lending.

Secondly, related with the above, managers in financial institutions had little incentive to resolve problems of bad loans by reviving the troubled companies. If they let those companies fail now, the failure will be considered as a result of poor lending decisions by their predecessors, whereas they will be held responsible if the firms they extended loans fail. They therefore tend to underestimate the value of currently ailing firms and prefer selling them, often at a highly discounted price, or liquidating them to putting in efforts to turn them around. And this incentive becomes stronger if the assets related with ailing firms are already classified as NPLs and therefore provisions against them have been made.[12]

The Korean government and the IMF seem to have naively believed that, even without re-establishing its own internal risk-taking system, foreign investors would fill the vacuum if they were provided with ‘global standard’ institutional environment. But as we have pointed out before, this was not the case. As rational profit maximisers, foreign investors tended to exploit the situation of asymmetry in negotiation power for their own benefits and tried to maximise the extent of distress sales. The possible benefits resulting from their risk-taking activities with the assets purchased or their own ‘green field’ investments are yet to see.

A major reason why an economic system malfunctions after a radical reform, as in the case of Korea, is that economic institutions of a country are also produces of its own historical development, and therefore closely intertwined with other related

[12] This was well reflected in creditor banks’ preference of selling Daewoo Motors and Hynix to foreign buyers than turning around them with their own initiatives.

components of the economy such as composition of industries, developmental stage and other historical heritages of the country. It may be easier to change formal institutions overnight. But it is impossible to jump the developmental stage overnight or change the composition of industries overnight. When a radical institutional change is attempted, it is therefore possible that the changes conflict with the related components of the economic system. In our view, this conflict between new institutions and other components of the economic system was a major source of transition costs in Korea.

The reformers believe, at least implicitly, that transformation of the country into a high-income one would be automatically achieved only if the 'global standards' institutions they have introduced can be made to stick. However, the reform measures were principally geared to reducing financial risk of the system, even to the extent of over-killing the economy in the short run. Nowhere in the reform programme was the question of rebuilding an appropriate risk-taking mechanism and ensuring long-term growth considered.

In our view, what was needed for Korea after the crisis was not to try a transition to an idealised Anglo-American system but to build what we call a 'second-stage catching-up system', which the country had failed to do before the crisis. As a middle-income country whose catching-up still has a long way to go, Korea had to maintain basic characteristics of a catching-up economy, rather than to abandon the previous risk-taking system based on the state-banks-*chaebols* nexus altogether.[13] As a middle-income country whose economy has become increasingly mature and exposed to forces

[13] The country's per capita income is $9,628 in 2000, around one fourth that of that of the U.S.. According to Lee Jay-Min's (1999) estimate of 'relative backwardness', Korea in 1995, when country's per capita income reached $10,000, was approximately where

of globalisation, however, Korea also needed to adjust its system in the direction of responding to these new challenges.[14]

5. Conclusions

The corporate reform in Korea, as well as other IMF-sponsored reform programmes for crisis-hit countries, is premised on the supposition that there exists a 'global standard' institution, which, in reality, is an idealised Anglo-American system, towards which any country should move as fast as it can. The Korean experience after the reform, however, indicates that an experiment based on the supposition on the contrary has incurred (and will incur) huge transition cost in the economy without bringing about significant benefits.

We have argued that the transition costs were mainly a result of conflicts between newly-introduced institutions and the remaining components of the economic system, which created a vacuum in risk-taking function in the economy. When one designs institutional transition, the compatibility between new elements and old elements in the system should be seriously considered.

Our discussion naturally leads to pointing out the importance of diversity in institutions and incrementalism in institutional transition. The economy works in quite diverse ways across countries and the size of economic transition cost resulting from the imposition of a new institution varies greatly. There is no 'one-size-fits-all' solution to

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Japan was in the middle of the 1960s, when the Japanese catching-up system was most spectacular in its success.

[14] For details of this second-stage catching-up system for Korea, refer to Shin & Chang (2002, ch.5).

any institutions. A new risk-taking system for Korea should be re-built on the broad consideration of its institutional specificity, developmental stage, current challenges from international environment, and so on. This task is to find a ‘middle road’ appropriate to the country.

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