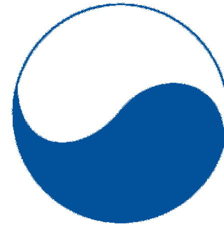
Korea's Economy 2005



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STRUCTURAL REFORM

RESPONSE TO FINANCIAL AND ECONOMIC DISTRESS: SOUTH KOREA AND JAPAN

by Thomas F. Cargill and Hugh Patrick

Introduction

During the past three decades the economies of South Korea (hereafter, Korea) and Japan have been in transition from rigidly regulated and administratively controlled structures toward more open, transparent, and competitive structures. The transition is part of a broad, global liberalization and internationalization process started in the 1970s involving a wide range of developed and developing economies. Japan commenced the process about a decade earlier than Korea, but by the mid-1980s both countries could point to a number of reforms being gradually introduced that were designed to liberalize their economies, especially their financial systems. The transition has not been smooth, but Korea and Japan now operate with more openness, transparency, and competition than they exhibited throughout their postwar, pre-reform history.

The transition is in its third decade and is yet to be completed. Nonetheless, sufficient time has passed to be able to offer a comparative perspective about how each has managed the process and, especially, how each has responded to the shocks and subsequent economic and financial distress to which they have been subjected. Japan's distress commenced with the collapse of equity and land price bubbles in the early 1990s, followed by more than a decade of economic and financial poor performance and malaise. It was only in late 2003 and the first half of 2004 that Japan's economy showed meaningful improvement. While many observers continue to raise concerns about the sustainability of the current recovery, policymakers are cautiously optimistic that Japan may have ended what some call "the world's longest-running crisis." In contrast, Korea experienced a sharp increase in economic and financial distress in response to the Asian financial crisis of 1997; but by 1999 Korea's economy had recovered, and Korea had under way a wide range of major reforms.

The differing response is especially interesting when one considers the similarity of the two financial regimes, the adoption of liberalization in both countries as official policy, and the same access to economic theory and policy tools to use to understand the emergence of economic and financial distress and the management of that distress.

In this paper we first lay out the basic elements of the pre-reform Korean and Japanese financial regimes. We then explain how the lack of a meaningful commitment to financial reform in each country increased the potential of economic and financial distress in response to the shock that occurred. The next section offers several explanations to account for Korea's quicker and more successful response and better policy outcomes. In the conclusion, we assess both countries' successes and ongoing challenges.

The Pre-Reform Financial Regimes of Korea and Japan

Japan's influence on financial-system development throughout Asia has been significant. Korea, more than any other Asian economy, modeled its financial institutions on Japan. In fact, Korea's financial regime resembled Japan's early postwar regime rather closely in terms of government's rather rigid administrative control over interest rates, entry and exit, and policy guidance. However, the Korean government extensively influenced the allocation of credit to a much higher degree than Japan's government. The majority of funds in Japan was allocated through private banks with only "window guidance" limits imposed by the Bank of Japan on the overall growth of bank lending. The Korean government, in contrast, imposed a wide

range of credit allocation requirements on banks, which were nationalized until 1982, and on central bank lending.

Korea's financial regime was designed to support the large *chaebol,* while small businesses were forced to rely on the informal curb market. Japan's prewar counterpart, the family-owned *zaibatsu* large business groups, had been dissolved by U.S. policy during the postwar occupation of Japan, and the individual firms came under management control. Unlike Korea, Japan's financial regime provided official access to small and medium-sized businesses. Japan's economic development was essentially self-financed out of domestic saving, while Korea relied on capital inflows to finance much economic development. While Japan ran current account surpluses, Korea ran persistent current account deficits. By the mid-1990s Japan had long been the world's largest creditor. Korea was a moderate net debtor internationally but had very large short-term foreign currency borrowings being used to finance domestic investment projects.

Despite these differences, the two regimes were fundamentally identical in their view that finance was an instrument of industrial policy; that funds should be transferred through banking institutions; and that pervasive deposit guarantees, nontransparency, and restraints on competition should be used to limit bankruptcy. Reliance on these characteristics would come to clash with efforts to liberalize the financial regimes in both countries and render both particularly susceptible to shocks.

Korean and Japanese Financial Transition: Fundamentally Flawed and Incomplete

Japan in the late 1970s and Korea in the early 1980s experienced a new set of domestic and international economic, technological, and political forces that conflicted with their respective rigid, administratively controlled financial regimes. Each commenced an official, gradual policy of liberalization focused on the financial system, with obvious implications for the real sector.

Over time, Korea and Japan made a number of institutional changes: interest rates became more market sensitive, restrictions on the inflow and outflow of capital were relaxed, money and capital markets began to develop, and financial institutions were given increased asset diversification powers. Despite these achievements, however, the official liberalization process was slow and fundamentally flawed and incomplete.

During this period there was little meaningful commitment to financial-system liberalization in either Korea or Japan, and in many cases financial reform was primarily in response to political pressure from the United States and Europe. Korea and Japan were not convinced their financial regimes needed redesign, given the successful economic growth both countries achieved under their pre-reform regimes. Korea in the 1990s saw financial reform as the price to be paid for admittance to the Organization for Economic Cooperation and Development. Both Korea and Japan saw financial reform as necessary to continue to be active participants in a liberalizing world financial system and economy.

Consequently, both countries pursued financial liberalization policies without reforming the key elements of their pre-reform regimes. In particular, pre-reform regimes relied on nontransparency, comprehensive deposit guarantees, and limits on bankruptcy in both the real and financial sectors to provide a foundation for economic development. Economic growth was predicated on export growth, particularly in Korea. In hindsight, these structures were not sustainable for at least two reasons.

First, Korea and Japan had been able to insulate their economies while they pursued export growth only as long as they remained economically small. Successful development and growth, however, made this more difficult over time. By the 1970s and 1980s, both Japan and Korea attracted increasing criticism for what much of the world regarded as a one-way, mercantilist approach to international trade. At the same time, market forces were becoming more powerful throughout the world, and the United States, the United Kingdom, and some European countries became vocal advocates of liberalization in general, They pressed Japan and Korea in particular because they were experiencing trade imbalances with them.

Second, financial regimes based on preventing or restraining bankruptcy are initially capable of generating rapid economic growth because weak companies

and their capital are not destroyed by bankruptcy, but these regimes will eventually fall behind regimes that use bankruptcy effectively to reallocate the resources of inefficient, insolvent companies. Like the albatross around the neck of the ancient mariner in Coleridge's "Rime of the Ancient Mariner," the accumulation of capital that is inefficiently allocated slows economic growth.[1] This second factor is in addition to and a variation of the argument that Asian economies would eventually experience diminishing returns to investment and labor and, thus, that rapid economic growth would slow over time.

In the late 1980s, Korea and Japan did not appear to have reached a point where the economy was threatened by accumulating capital inefficiency or diminishing returns to investment and labor; however, they had both reached the stage that threatened other economies with trade imbalances. Korea and Japan both responded in part to outside pressure to liberalize.

Their unwillingness to reform key elements of the old regime, however, created an accident-waiting-to-happen situation: a shock to the system would be met by denial and, when denial was no longer credible, by understatement. At some point the financial and economic distress would force a policy response, but the foundation of the system ensured that forgiveness and forbearance would be the preferred policy response. Nontransparency made forgiveness and forbearance easy to implement, and forgiveness and forbearance postponed any implementation of corporate restructuring measures, including bankruptcy. Forgiveness and forbearance more often than not led to larger economic and political resolution costs.

This pattern fits the Japanese case fairly well and contributes to understanding why the Japanese economy has remained distressed for more than a decade since 1991. However, it does not fit the Korean situation nearly so well. Japan's response to the collapse of asset prices was one of denial, understatement, forgiveness, and forbearance that continued for far too long. In 1999, Japan finally shifted to a policy of less reliance on forgiveness and forbearance, and toward a willingness to close financial institutions and require more aggressive resolution of nonperforming-loan and nonperforming-borrower problems. In contrast, Korea's reaction to the shock of the Asian financial crisis was much more rapid; after a difficult 1998, the economy recovered, nonperforming loans declined, and institutional reform moved ahead relatively rapidly.

Accounting for the Difference

Korea's macroeconomic policy and structural reforms in response to the economic and financial distress brought about by the Asian financial crisis in 1997 far surpassed the slow and lethargic response of Japan to the collapse of asset prices in 1990 and 1991. A recent International Monetary Fund (IMF)/World Bank review of Korea's financial sector outlines a number of problems that remain unresolved in Korea but concludes that, since 1997–1998, Korea has made major progress in financial and corporate reform and has generated impressive macroeconomic performance.[2] This outcome stands in contrast with Japan. Japan has been extraordinarily slow to reform its financial and corporate sectors, real gross domestic product (GDP) has increased on a year-to-year basis at a rate of only about 1 percent—substantially below potential—and, since 1994, the level of prices has declined and deflation has persisted. In 2001, the government of Junichiro Koizumi established a more aggressive policy toward financial reform and supported the Bank of Japan's adoption of a more aggressive monetary policy. In 2003 and especially 2004, the benefits of

1. The role of bankruptcy in Western and Asian financial regimes is modeled in Thomas F. Cargill and Elliott Parker, "Asian Finance and the Role of Bankruptcy: A Model of the Transition Costs of Financial Liberalization," *Journal of Asian Economics* 13 (2002): 297–318.

2. "Financial Sector Assessment: Korea," IMF–World Bank Financial Sector Assessment Program Report no. 26176 (Washington, D.C.: World Bank, June 2003), http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2003/06/19/000012009_20030619134312/Rendered/PDF/261761KO1Fin0Sect0Ass1SECM200310293.pdf. A more critical appraisal is provided by Hong-Bum Kim and Chung H. Lee, "Post-Crisis Financial Reform in Korea: A Critical Appraisal," working paper no. 04-10, University of Hawai'i at Manoa, Honolulu, 2004, www.economics.hawaii.edu/research/workingpapers/WP_04-10.pdf.

the more aggressive financial reform and an easier monetary policy became apparent although it appears that deflation will not end until sometime in 2006.[3]

Five factors account for the difference: central bank policy; potential for capital outflows; IMF pressure; leadership; and the degree of economic and financial distress combined with geopolitical considerations.

Central bank policy. The Bank of Korea has not permitted the price level to decline for any length of time, but the Bank of Japan conducted policy that generated disinflation in the first half of the 1990s and deflation in the second half of the 1990s. By any reasonable standard, Bank of Japan policy was tight in the early and mid-1990s, while Bank of Korea policy since 1999 has been sufficiently expansionary to prevent deflation. The different monetary policy outcome cannot be attributed to the institutional relationship of each central bank to the government because both the Bank of Korea and the Bank of Japan were formally dependent before 1998, when both were redesigned to provide enhanced formal independence. One difference in institutional design, however, might help explain the different policy outcomes.[4] The Bank of Korea has operated under an inflation-target framework since 1998, but the Bank of Japan is not subject to any formal target although price stability is one of the two formal responsibilities assigned to the Bank of Japan by the June 1997 revision of the Bank of Japan Law. This institutional difference is not trivial, but other factors are more important, in particular the persistent lack of aggregate demand in Japan, a problem Korea has handled much better.

The disinflation and deflation in Japan have had a significant adverse effect on the real and financial sectors. Deflation is not simply the reverse of inflation. Because nominal interest rates are bounded from below by zero, deflation increases the real interest rate and reduces consumption and investment. Higher real interest rates increase the cost of servicing debt, which increases bankruptcy, which in turn increases bank lending risk and reduces the money multiplier. Because deflation is less likely than inflation, deflation is accompanied by greater resistance to adjusting nominal contracts downward, thereby increasing the length of time actual output remains below the potential output level. Deflation increases the demand for money as the public substitutes cash for holding commodities, the prices of which are declining.

These factors combine to generate what is labeled a discontinuity in monetary policy.[5] This phrase is preferred over the more common liquidity-trap concept because, although monetary policy can remain potent, the longer deflation persists the more difficult it is to reverse the discontinuity. Deflationary monetary policy reduces aggregate demand, reduces demand for credit, and increases bankruptcy. Increased bankruptcy reduces the money multiplier, and deflation reduces velocity, both of which require increasing degrees of expansionary monetary policy to reverse the process.

Potential for capital outflows. Korea relied significantly on external borrowing to finance its development, whereas Japan's development was self-financed. Korea's problem was that it moved too fast in the early 1990s toward liberalizing the external sector and internationalizing the domestic banking system without adequate development of the financial regulatory and supervisory regime. Korean financial institutions and companies had engaged in two major mismatches: borrowing foreign currencies in the short term and exchanging them into *won,* and making short-term *won* loans to finance long-term fixed investments, including property. Combined with a low level of international reserves, Korea's financial system was susceptible to sudden withdrawals by foreign lenders as well as domestic capital flight. In contrast, Japan was not dependent on external funding: Japanese

3. Hugh Patrick, "The Japanese Economy: Sustained Recovery and Growth Not Yet Assured," in *Annual Report 2003–2004* (New York: Columbia University, Center on Japanese Economy and Business, October 2004).

4. Thomas F. Cargill, "A Tale of Two Monetary Policies—Korea and Japan," FRBSF Economic Letter (San Francisco: Federal Reserve Bank of San Francisco, 15 April 2005), www.frbsf.org/publications/economics/letter/2005/el2005-07.html.

5. Cargill and Parker, "Asian Finance and the Role of Bankruptcy."

banks did not have a heavy net reliance on dollar borrowing, and Japan held large amounts of international reserves. Despite Japan's decade-long period of economic and financial distress, capital flight was never a problem.

Not only the potentiality for but the actuality of a foreign exchange crisis leading to a domestic financial crisis forced Korea to deal with underlying causes quickly because it was so dependent on foreign funding. As with the other Asian-crisis countries, Korea's financial crisis was precipitated by foreign banks and other financial institutions withdrawing their loans to Korea. The contrast with Japan, which faces no such foreign pressures, is stark. Japan's financial crisis in late 1997–early 1998 was homegrown, and it could be dealt with on domestic terms and timetables.

IMF pressure. This international context provides another prism for understanding the differences between Korea and Japan. Capital flight was intensified when it became obvious the Bank of Korea held insufficient international reserves to limit rapid *won* depreciation. The situation deteriorated rapidly in late 1997. In July of 1997, the IMF had recommended major reforms to Korea and the possible need for IMF funding assistance; however, Korean officials rejected the IMF's position. By November 1997, the situation changed dramatically, and Korea was forced to seek an unprecedented IMF-coordinated financial support package of $58 billion in exchange for, inter alia, commitments to revise the Bank of Korea Act, establish the Financial Supervisory Commission as a new regulatory agency, and aggressively pursue financial and real sector reforms.

IMF assistance provided a very useful scapegoat for Korean policymakers who advocated reform. There were many advocates of reform in Korea, but they had lacked political power to overcome the resistance of the *chaebol,* the Ministry of Finance and Economy establishment, and the large banks. The IMF was the catalyst that made reform politically acceptable; the establishment could blame the IMF and deflect hostility from itself, which rendered reform more acceptable domestically.

IMF pressure was absent in Japan in the 1990s. Japan did not experience capital flight; even in late 1997 and early 1998, Japan's economic and financial distress was not as intense as that experienced by Korea. Japan remained economically strong and had no need of IMF assistance. Neither the IMF nor any other international agency was in a position to exert much pressure on Japan.

Leadership. The Liberal Democratic Party (LDP) dominated Japanese politics from 1955 to 1993, when the LDP lost its majority in the lower house. Since its return to power in 1996, the LDP has had to depend on successive coalitions with other parties; at the same time the coherence of its system of factions weakened seriously. Japan in the 1990s experienced on average one prime minister per year until 2001. Prime Minister Junichiro Koizumi then came to power with an agenda and a popular mandate to resolve the economic and financial distress. Until Koizumi, the government had not offered a full-fledged, comprehensive plan to reform the financial system. Although the LDP, with Hashimoto as prime minister, returned to power in October 1996 on a reform platform, including the Japanese-style big-bang program of capital market liberalization, the policies of that time did not include any systematic effort to reform the banks and resolve their burgeoning nonperforming-loan problems. Moreover, it was optimistically and incorrectly assumed that economic recovery was well under way. The Hashimoto government disastrously shifted from fiscal ease to fiscal restraint, a swing of 2 percentage points of GDP aggregate demand. Koizumi has provided much needed political leadership; with his leadership and a shift in Bank of Japan policy toward greater ease in late 2002, Japan appeared to have achieved a turning point.

In contrast, Korea had developed an overall plan for financial reform prior to its crisis. In January 1997, President Kim Young-sam announced a new initiative to pursue liberalization more aggressively, and he established the Presidential Commission for Financial Reform. The slowdown in economic growth in 1996 and the continuing nonperforming-loan problem in the banking system provided the motivation for the commission.

The presidential commission officially started operations on 22 January 1997, with 31 members appointed to represent manufacturing, finance, and academia; it also included 15 specialist members representing a wide range of institutions. The commission's activi-

ties were coordinated by representatives of the Ministry of Finance and Economy (two coordinators) and the Fair Trade Commission (one coordinator). Two reports were published, in April and June of 1997, in which the commission recommended a broad range of reforms to liberalize and modernize Korea's financial system, including a recommendation to redesign the Bank of Korea. The commission's reports came at an appropriate point in Korea's history because they coincided with the shock of the Asian financial crisis; as a result, a road map for reform was available.

Magnitude of the shock and geopolitical considerations. Japan's economy began to stagnate in the early 1990s; however, except for 1998, Japan's economy for much of the period has continued to grow, although at rates only slightly above zero. The average standard of living remains high, and the high level of international reserves makes capital flight unlikely. In broad perspective, Japan has not perceived itself in crisis other than for the period from late 1997 through the first part of 1998. In fact, this short period represents the only period of perceived crisis within a 15-year period of economic growth well below potential. Nor has Japan been preoccupied with national security issues, although the 1998 test flight of a North Korean missile over Japan started a process to reevaluate Japan's national security situation. In contrast, Korea experienced a much larger shock in 1998 in the context of an economy that had been growing until the time of the shock. The psychological and economic shock to Korea was larger. Korea's real GDP declined 6.1 percent in 1998, compared with the much smaller 1.1 percent decline in Japan's real GDP. In addition, Korea had long been preoccupied with national security concerns, elevated by its proximity to North Korea. The North Korea situation combined with the suddenness and intensity of the decline in 1998 generated a real sense of crisis lacking in Japan; hence, Korea was more receptive to reform.

Conclusion

The financial regimes of Korea and Japan have had many similar elements. Well prior to 1997 both had engaged in a gradual financial liberalization and reform based on outmoded policies and perceptions. In a real sense, in each a financial crisis was an accident waiting to happen if a substantial shock occurred. And the shocks did occur: the foreign exchange, capital flight crisis in Korea in late 1997 and the domestic-generated shock in Japan in late 1997 as the consequences of policy forbearance and inertia following the burst asset bubbles finally caught up with the financial system.

Korean policymakers responded rapidly and wholeheartedly to their financial crisis, and major reform programs were quickly put in place. They had no choice. Without the IMF program, conditional upon these reforms, the crisis would have been far more severe. In contrast, because Japan's financial crisis had no significant international dimensions, Japanese policymakers had more options. They could engage—for a while at least—in further partial, remedial, less immediately painful policies of support combined with forbearance. And they did.

Accordingly, Korea's postcrisis policies of financial reform have been far more far reaching, comprehensive, swift, and successful than Japan's. However, that should be scant cause for congratulations for Korea, and certainly no cause for complacency. Japan's financial reform process has been extraordinarily slow and ultimately very costly, not only directly to its taxpayers but to all citizens because of the slow rate of economic growth that has resulted. Compared with Japan, Korean financial reform looks good. Compared with what still needs to be achieved, Korea has made progress but is still only two-thirds there.

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