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THE FINANCIAL CRISIS IN NORTHEAST ASIA AND SUSTAINABLE RECOVERY

Tom Byrne*

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I. Introduction

II. Macroeconomic Effects and Outlook

III. The Crisis and Government Finances

IV. Financial Sector Performance during the Global Crisis

V. Conclusion

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I. Introduction

The three major economies in Northeast Asia have not escaped damage from the Atlantic-centered financial crisis and Great Recession. Japan has suffered the most in terms of employment and economic growth, which is ironic because it is less open to trade and investment than either Korea or China. China seems to be handling the crisis best, but appearances would be deceiving if nascent asset bubbles and the credit boom are not arrested. Korea has navigated the Lehman credit panic and is well positioned for a steady, sustainable recovery.

The financial sectors in these three Northeast Asia economies are better positioned to intermediate savings and extend credit that can foster an economic recovery than those in the United States or the European Union (EU). That is obvious. But it also is worth noting that this is because banks, regulators, and corporations have learned from mistakes made in the 1997 Asian financial crisis. Stress tests conducted by Moody’s suggest that asset quality will deteriorate from the fallout of the global crisis, but only marginally in the central case scenario. And even in a worst-case scenario, each system will not be materially damaged. Large-scale government intervention will not be necessary. Banking sector consolidation on the scale seen in the wake of the 1997 crises in Japan and Korea is not in the cards. And in another contrast with 1997, Chinese banks, instead of hunkering down, are expanding internationally even as some Western banks have been forced to undo their expansion in the world’s fastest-growing and soon to be second-largest national economy.

The government’s balance sheet is not a constraint on recovery in 2010 for Japan, China and Korea, but it is a risk for Japan over the longer term. However, the greatest challenge to sustainable recovery to previous trend growth rates may not lie within the three large Northeast Asian economies; instead, it may be external. As the United States tightens its belt to live within its financeable means, global rebalancing would disrupt the export-led or -dependent economies in the near term and dampen their growth over the long term.

II. Macroeconomic Effects and Outlook

The seizure of and panic in the international dollar funding market upon the 15 September 2008 bankruptcy of Lehman Brothers helped transform the U.S. recession into a deep global recession. The global economic outlook progressively deteriorated through late 2008 and early 2009 as reflected in an unprecedented
The bottoming out of the collapse in the major global economies in the first half of 2009 was followed by tepid signs of recovery in the second half and stronger signs in early 2010. This sense of recovery is reflected in the upward revisions made by the IMF in its October 2009 World Economic Outlook and in its January 2010 update. The long-term effects of the Great Recession on the potential growth rates of the major economies are murky, but it is likely that the growth path has been shifted downward. A challenge will be for the United States, the EU, and other major economies to restore productivity-driven growth, rather than leverage-driven growth, before their demographic pressures present significant new challenges to growth and public finances. This means a decade from now in the United States.

**East Asian GDP Growth Takes a Beating but Is Not Knocked Out**

The three major Northeast Asian economies have taken a beating as the collapse in demand for their exports spread throughout their economies, with the collapse in real GDP growth rates exceeding that which occurred with the 2001 U.S. recession (Figure 1). The effects are mixed, however, when referenced to the 1997 Asian financial crisis. The infection this time is milder for Korea but is more severe for Japan. China is suffering, but not as much as Japan, if changes in pre-2008 growth rates is the reference point used. In early 2008 it appeared that all three of these economies would weather the storm fairly well. The most urgent challenge then was inflation driven by the spike in oil and food prices. Those who believed in decoupling were not discredited until the post-Lehman panic set in in the global credit markets in late 2008.

As the gloom receded during the summer of 2009, forecasts were revised upward. The small, open, and advanced economies of Singapore and Hong Kong led the way most dramatically. Sharp rebounds in growth occurred as 2009 progressed, although these followed almost equally precipitous declines in the final quarter of 2008 and first quarter of 2009. The Australian economy skirted recession by recording positive, 2.0 percent growth in 2009. This reflected the residual strength in China’s economy, which provides a strong source of external demand for Australia’s mining commodities. But it also reflected the efficacy of exceptional measures taken by the central bank and government to stabilize the country’s financial sector.
Figure 1: GDP Growth in Northeast Asia, 1994–2010

Sources: International Monetary Fund; Moody’s Investor Service.

The Case of Korea

Forecasts originally put Korean real GDP growth at around 4 percent for 2009. These were progressively lowered to a nadir of -4 percent for the most part, although pessimistic observers saw growth declining by as much as 5 percent or 6 percent. “Green shoots” took hold early in Korea, and for the year as a whole real GDP eked out a positive 0.2 percent growth rate in 2009. The sharp contraction in investment and exports has driven down the growth rate. Although the dollar value of merchandise exports fell around 13 percent in 2009, the decline in volume terms was less severe but was still a drag on GDP growth.

The outlook for 2010 is for the Korean economy to grow 4 to 5 percent. Much depends on the strength of the global recovery, yet export growth will likely muster high, single-digit positive growth, in part because of the better economic conditions in East Asia.

The Case of China

While China achieved its economically and politically sensitive 8 percent real GDP growth target in 2009, and then some, growth did sharply decelerate from the 13 percent rate of growth in the precrisis year of 2007. The slowdown in China’s growth rate from 2007 to 2009 may be only slightly less steep than Korea’s, about four percentage points. The government’s budgetary stimulus
and use of the state-owned banking system, where total credit to local governments and to the state-owned enterprises surged an astonishing 32 percent last year, has supported domestic demand-driven growth, especially investment in infrastructure.

It was the sharp decline in exports that accounted for the drop in the overall growth rate in 2009. National account statistics are not well developed in China, but Moody’s estimate is that net exports had contributed about three percentage points of growth before the crisis, but this year net exports are removing three percentage points of growth. Like Korea, the dollar value of China’s exports may decline sharply, only a bit steeper by almost 16 percent in 2009.

China’s economic growth will likely pick up in 2010. But the extent to which it does will be determined on the upside by global demand for China’s exports, and on the downside by the degree to which the authorities wind down the economic stimulus program. With overcapacity and price deflation currently prevailing, inflationary pressures are distant. This supports the authorities’ stance of maintaining economic stimulus in 2010.

**The Case of Japan**

The Japanese economy hit bottom in the first quarter of calendar year 2009. There are favorable signs of recovery, but momentum is frail. At midyear corporate bankruptcies declined for the first time in a year as the default rate of small- and medium-size enterprises (SMEs) has peaked, apparently.

The recovery, however, is from a very low base to which the economy has sunk. Like the United States, Japan is in its deepest recession since the 1940s. Unemployment hit a historical peak of 5.9 percent in August 2009 although it moderated slightly late in 2009. The combined effects of price deflation and economic contraction will produce a fall in GDP of almost 6 percent in calendar 2009, or more than 3 percent again in fiscal year 2009 as in FY 2008 (beginning April).

The collapse in merchandise exports, 33 percent in 2009, is more severe in Japan than in Korea or China, as much of Japan’s exports are durable household and investment goods, purchases of which have been sharply curtailed in the United States and EU.

The fall in output is worse than in the United States or in any other large, major economy in Europe. Japan’s real economy has not decoupled from that of the United States.
The growth outlook for Japan is more uncertain than for China or Korea. Unemployment will likely remain high as the dynamic part of the country’s economy, the export industries, will continue to remain adversely affected by fragile global economic conditions. Moreover, the Bank of Japan expects that deflationary pressures will persist into 2011. This will depress domestic demand.

**Figure 2: Rate of Unemployment in Japan and Korea, 1994-2009, percentage**

Source: International Monetary Fund.

**III. The Crisis and Government Finances**

If there is one area where the emerging-market Asian economies have decoupled from the advanced countries, it is in government finances. The fiscal effects of the global recession on Korea and China are very much muted compared with Japan and, especially, the United States and most EU countries. Figure 3 shows the astonishing increase in deficits and government debt in the United States and the United Kingdom. Never before in peacetime have government finances deteriorated so drastically and so abruptly. The collapse in tax revenues, the fiscal stimulus, and financial as well as corporate sector bailouts account for the ballooning of government debt.

The accumulation on Japan’s government debt overhang is similar in magnitude to that in the United States and the UK. The toll on government finances is due to the effects of the severe recession alone. Financial sector bailouts have not impacted the Japanese government budget or debt, in contrast with the 1997 and 1998 financial crisis.
Figure 3: Effects of the Financial Crisis on Advanced-Country Deficits and Debt

Source: International Monetary Fund, Eurostat, and Moody’s estimates.
Among member countries of the Organization for Economic Cooperation and Development, Korea has the largest fiscal stimulus program as a share of GDP, yet its effect is not as drastic on increasing government debt. One reason is that the recession will be rather mild in Korea in 2009. Korea’s budget deficit widened to only 2.1 percent of GDP in 2009, but it will decline steadily during the next several years to a balanced position by 2013 or 2014.

China’s government budget deficits was only around 3 percent of GDP in 2009 and probably a similar or slightly lower level in 2010. The rebound in tax revenues removes downside risk to the fiscal outlook. Figure 4 shows the increase in government debt estimated for the crisis period, 2008–2010, for selected Asian economies. Except for Japan, East Asian debt accumulation is much less than seen in some advanced economies.

**Figure 4: Effects of the Financial Crisis on East Asian Government Debt, as percentage of GDP**

![Figure 4: Effects of the Financial Crisis on East Asian Government Debt, as percentage of GDP](source: Moody’s Investor Service.)

As severe as the global recession is on the Korean economy, the fiscal effects pale compared with those from the 1997 Asian financial crisis. Public sector debt spiked to more than 50 percent of GDP from 10 percent of GDP before the crisis for a brief period, taking into account IMF, World Bank, and financial sector bailouts. However, the lingering effects of the massive financial sector rescue have kept government debt relatively elevated at 30 percent of GDP as Korea Asset Management Corporation (KAMCO) and Korea Deposit Insurance...
Corporation (KDIC) bonds were gradually fiscalized directly onto the central government’s balance sheet.

**IV. Financial Sector Performance during the Global Crisis**

Just as government finances in emerging-market Northeast Asia do not pose the risks to recovery that are seen in some advanced economies, financial sectors are proving resistant and will play a role in, or will not hinder, recovery.

**The Case of Korea**

Korean banks’ credit fundamentals have come under pressure, but no major deterioration is expected—if the global recession has indeed bottomed out and a gradual improvement continues (see Table 1). The largest Korean commercial banks’ intrinsic bank financial strength ratings (BFSRs) were lowered to C-, a notch below the global average rating of C.1 BFSRs of the policy banks—namely, Industrial Bank of Korea (IBK), National Agricultural Cooperative Federation (NACF), and Suhyup Bank— are lower, yet the weighted system average for the rated Korean banks is C-.

**Table 1: Korean Bank Ratings**

<table>
<thead>
<tr>
<th></th>
<th>Pre-1997 crisis</th>
<th>Peak 1997 crisis</th>
<th>Current</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FC senior unsecured debt</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td>A3</td>
<td>Ba3</td>
<td>A2</td>
</tr>
<tr>
<td>Range</td>
<td>A1 to Baa3</td>
<td>Ba1 to B1</td>
<td>A2</td>
</tr>
<tr>
<td><strong>FC long-term deposit</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td>A3</td>
<td>Caa1</td>
<td>A2</td>
</tr>
<tr>
<td>Range</td>
<td>A1 to Baa3</td>
<td>Caa1</td>
<td>A2 to A3</td>
</tr>
<tr>
<td><strong>BFSR</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td>D</td>
<td>E+</td>
<td>C-</td>
</tr>
<tr>
<td>Range</td>
<td>C+ to E</td>
<td>D to E</td>
<td>C- to D-</td>
</tr>
</tbody>
</table>

Source: Moody’s Investor Service

Note: BFSR = bank financial strength rating; FC = foreign currency.

1 Moody’s BFSRs range from A to E, with A denoting very strong standalone not requiring exceptional outside support from shareholders or the government at the top end of the scale, and E denoting very weak fundamentals likely requiring support at some point in the near term. C’ is the global average and denotes moderate strength.
Nonperforming loans (NPLs) have declined to low levels, to 1.5 percent of total loans, from double-digit levels after the 1997 crisis, but this indicator is backward looking. Forward-looking stress tests conducted by Moody’s suggest that bank capital is adequate under the central scenario, which is aligned with our macroeconomic forecast over an 18-month horizon. We also do not see a need for capital even under our worst-case scenario. Stress tests seek to replicate the worst conditions going back to the 2003 credit card crisis, the 2001 U.S. recession, or the 1997 Asian financial crisis, but they include modifications in the analysis to take into account the reduction in corporate leverage and improved bank governance, for example.

The most vulnerable assets of banks will be credit card exposures and loans to the construction and shipping sectors (Table 2). Banks’ loans to SM Es are not considered to be as vulnerable. This is an interesting side note as many analysts and commentators have flagged this sector as a potential source of the next financial crisis in Korea. Total expected losses (calculated by probability of default in each asset category multiplied by the historical loss-given default) are a rather modest 2.5 percent in the base case and a moderate 7.6 percent in the worst case. Note that banks’ NPLs are currently lower than 2 percent of banks’ assets.

<table>
<thead>
<tr>
<th>Type of loss</th>
<th>Base case (%)</th>
<th>Worse case (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit card</td>
<td>6.0</td>
<td>20.0</td>
</tr>
<tr>
<td>Construction</td>
<td>5.5</td>
<td>16.0</td>
</tr>
<tr>
<td>Shipping</td>
<td>5.5</td>
<td>16.0</td>
</tr>
<tr>
<td>Small- and medium-size enterprise (SME)</td>
<td>3.5</td>
<td>9.8</td>
</tr>
<tr>
<td>Large corporate</td>
<td>1.5</td>
<td>6.5</td>
</tr>
<tr>
<td>Others(^1)</td>
<td>0.4–2.5</td>
<td>1.5–9.6</td>
</tr>
<tr>
<td>Moody’s rated banks – average</td>
<td>2.5</td>
<td>7.6</td>
</tr>
</tbody>
</table>

Source: Moody’s Investor Service.
\(^1\) Includes residential mortgages, real estate, nonhousing loans, other loans, and credit guaranteed SM Es.

The safest sectors are residential mortgages and large corporations, namely the chaebol, with residential mortgages much sounder than corporations. This is good news for the banks, as household debt rose to 76 percent of GDP and to 140 percent of disposable income in 2009 (the latter level is similar to that of households in the United States); half of household loans were housing-related loans (MOSF 2009). The relative soundness of chaebol debt now is in sharp
contrast with the exceptional weakness of the chaebol sector in 1997, the collapse of which contributed greatly to the intense economic dislocation in subsequent years.

Korean banks have, however, developed vulnerability in their lack of liquidity provided by a stable deposit funding. This is reflected in the high systemic loan-to-deposit ratios, which deteriorated as the deposit base stagnated in the early 2000s (Figure 5). A major source of funding for Korean banks, around 10–12 percent in early 2009, was in foreign currency, namely dollars, from offshore capital markets. Korean banks were highly exposed to the seizure in the international dollar markets from the Lehman panic. Only the relatively high level of official foreign exchange reserves in the Bank of Korea (BOK), some of which were made available to the banking system; a government guarantee of external debt of domestic banks; and an exceptional, $30 billion BOK swap arrangement with the U.S. Federal Reserve (which was made available to the Singaporean, Mexican, and Brazilian central banks as well) prevented a foreign exchange-induced banking crisis. In the Asia-Pacific area, Australian banks also have relatively high loan-to-deposit ratios, but they funded themselves for the long term as the financial crisis unfolded in 2008 and had more readily available offshore capital market funding because of their greater intrinsic strength and the Aaa qualities of the Australian government.

Figure 5: Disintermediation of Deposits and Intense Market Share Competition in Korea, 1997-2008, in trillions of Korean won and percentage

Source: Bank of Korea, Financial Supervisory Service.
The Case of China

Chinese banks entered the crisis in relatively good shape domestically, as their performance tracked that of the hypercharged performance of the country’s economy. In the depths of the global crisis in early 2009, the Industrial and Commercial Bank of China (ICBC) emerged as the world’s largest bank as measured by market capitalization, deposits, and profits. The relative health of Chinese banks (compared with their past and with many banks in the advanced economies) is also due to government interventions in the late 1990s that hived off the large chunk of NPLs in the state-owned banks into several state-owned asset management companies.

The policy-induced credit boom set in motion in November 2008 has seen a 32 percent increase in total lending in 2009 compared with just 12 percent in 2008. The astonishing surge in lending raises concerns over asset quality and capital adequacy. Although there was no immediate deterioration in banks’ credit fundamentals in 2009, NPLs actually declined in absolute terms and relative to total loans, their ratings could come under pressure if the surge continues too much longer. Banks’ balance sheets have been stretched, with capital adequacy and loan-to-deposit ratios approaching regulatory thresholds, although such levels are higher than Bank for International Settlements–mandated thresholds. The China Banking Regulatory Commission (CBRC) has expressed concerns, but the ultimate arbiter of policies is the State Council, which has a near-term policy priority of reviving growth and maintaining employment and social stability.

Chinese banks had an adequate amount of capital entering 2009, but by the end of last year it was clear that the major banks would need additional capital to maintain Tier I levels at a prudent level of 9 (Table 3). In addition, loan loss provisions have moved up to 150 percent, a level that the CBRC believed in late 2009 would adequately cover future NPLs from the credit surge. NPLs are as low as in the Korean system—fewer than 2 percent of loans—while banks remain profitable in the economic downturn.

Our expectation is that loan growth will decelerate to 20 percent in 2010, a level that would be consistent with 9 percent real GDP growth. An overshooting of the economic stimulus strategy, or an undershooting of economic growth, would add to concerns over Chinese banks’ asset quality and the soundness of their credit fundamentals.

Chinese banks have not hunkered down, but have expanded in the midst of the crisis. China Merchant Bank, a joint-stock bank not totally owned by the state,
Table 3: Northeast Asia Bank Ratings

<table>
<thead>
<tr>
<th>Country</th>
<th>Average BFSR</th>
<th>CAR BIS ratio</th>
<th>CAR BIS Tier 1 ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Korea</td>
<td>C’</td>
<td>13.7</td>
<td>10.3</td>
</tr>
<tr>
<td>China</td>
<td>D-</td>
<td>12.0</td>
<td>9.6</td>
</tr>
<tr>
<td>Japan¹</td>
<td>C</td>
<td>10.6</td>
<td>8.3</td>
</tr>
</tbody>
</table>

Source: Moody’s Investor Service.
Note: For Japan, the ratios are the average of 6 city banks, 4 trust banks, 4 other major banks, and 108 regional banks.
Note: BFSR = bank financial strength rating; BIS = Bank for International Settlements; CAR = capital adequacy ratio.

became the first Chinese bank to reenter the United States in almost two decades. This was closely followed by ICBC and China Construction Bank, the largest and one of the largest state-owned banks. China had first entered the U.S. banking market back in 1982, not long after Sino-U.S. ties were normalized in 1979, but activity stopped with passage of the U.S. Foreign Bank Supervision Enhancement Act of 1991, which tightened regulatory oversight of foreign bank entities.

In contrast, foreign banks’ loan balances declined sharply in 2009. For example, Bank of East Asia’s lending fell 6 percent in the first half of the year. Part of the reason for the decline in lending was prudential — banks were unwilling to loosen credit standards — and part was because foreign banks are at a disadvantage in competing for infrastructure finance.

The Case of Japan

Of the three Northeast Asian banking systems, Japan’s is the only one on which Moody’s is currently retaining a negative outlook. The reasons are largely threefold — consistently low profitability through economic cycles, net interest income is not commensurate with lending and risk taking, and insufficient capital adequacy.

In FY 2008 (end March 2009) the majority of large Japanese banks experienced annual losses for the first time since FY 2004. The major reasons were a sharp decrease in fees, a sharp rise in credit expenses, and substantial impairment losses from their holdings of equities. The recovery in the equity market since mid-2009 and the abatement in corporate bankruptcies in recent months suggest that the worst is over.

A limited number of banks hold large amounts of foreign-originated structured finance securities that have incurred significant losses. Some have kept those
securities on their balance sheets, meaning unrealized losses that are putting pressure on their capital. Nonetheless, additional losses from those securities will not significantly affect Japanese banks’ credit fundamentals or their ratings.

Although Japanese banks can likely weather the storms coming from the other side of the globe, loan growth will likely remain anemic. The economy’s relapse into deflation also bodes ill for a pickup in credit demand. Moreover, the proposal by Shizuka Kamei, the new extraordinary minister (minister for financial and postal services), to introduce a loan moratorium bill added a large dose of regulatory uncertainty which inhibits the flow of credit in the economy.

Moody’s does not expect any significant change in the business model of Japanese banks. Large banks’ substantial equity holdings will not change much, and weak corporate funding requirements will continue to prevail. The low interest rate environment and banks’ low profitability will not change much. However, Japanese banks are not troubled by overleveraged debt problems of the household sector, as U.S. and EU banks are. Japanese banks continue to benefit from a large deposit base as the loan-to-deposit ratio is below 90 percent. In the absence of the need for a radical transformation of their business model or a substantial deleveraging of portfolios, Japanese banks will continue to muddle through.

V. Conclusion

“Commercial credit is the creation of modern times and belongs in its highest perfection only to the most enlightened and best governed nations. Credit is the vital air of the system of modern commerce. It has done more—a thousand times more—to enrich nations than all the mines of the world.”

— Daniel Webster
Speech to the U.S. Senate, 18 March 1834
The three major economies in Northeast Asia have not experienced a financial crisis as the United States and the EU are undergoing; neither has there been a reprise of 1997 for the Korean and Japanese systems. Rather, their economies are being buffeted by the global recession, but their banking systems are proving to be relatively resilient.

Among the three major Northeast Asian economies, China and Korea are better positioned than Japan to navigate a sustainable recovery over the near to medium term and probably longer. Neither China nor Korea is burdened with a large overhang of government debt, the refinancing of which diverts credit from more productive uses in the private sector and threatens to drive up interest rates, should the strong domestic bias of institutional investors and banks shift. That could happen should confidence in government policies sag.

In addition, Korea and China, especially, have banking systems that function well—in China’s case extraordinarily well—in intermediating the high amount of savings in the system into the businesses and households. In contrast with the surge in government-encouraged bank lending in China, Korean bank lending slowed sharply in 2009. Government guarantees on SME borrowings as part of the Korean fiscal stimulus program may have prevented a contraction. Anemic credit growth in Japan relapsed into a contraction in loan growth during the darkest months of the global financial crisis and recession last year (Table 4).

### Table 4: Credit Growth to the Private Sector; Korea, China, Japan and Selected Pacific Rim Countries, 2008 and 2009, in percentage of change

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>14.0</td>
<td>29.8</td>
</tr>
<tr>
<td>Japan</td>
<td>1.1</td>
<td>-2.5</td>
</tr>
<tr>
<td>Korea</td>
<td>14.9</td>
<td>3.1</td>
</tr>
<tr>
<td>Indonesia</td>
<td>30.7</td>
<td>2.6</td>
</tr>
<tr>
<td>Thailand</td>
<td>8.8</td>
<td>0.1</td>
</tr>
<tr>
<td>United States</td>
<td>2.3</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Note: Depository corporations claims on the private sector.
All fiscal stimulus programs by definition and by their exceptional nature are not sustainable. Therefore, as the stimulus measures are wound down, economic growth prospects will become increasingly sensitive to export demand. But this will not fill the sails of the economy until the world’s largest economies, the United States and the EU, heal themselves. Until then China and Korea may fare better as domestic demand-driven growth has played a larger role even absent fiscal stimulus in those two countries, while in Japan it never really emerged as a steady drive of growth in the post-bubble era.

Over the longer term, the ability of both Chinese and Korean corporations to invest in new industrial capacity, and of those governments to invest in infrastructure, will help boost productivity as the ultimate driver of growth. Moreover, neither China nor Korea has an imminent demographic problem from a fast-aging population that imposes additional fiscal burdens and saps economic dynamism. Long-term prospects for China and Korea, therefore, remain more robust than those of Japan. Indeed, the Japanese economy may have slipped into third place in terms of scale, behind not only the US but also China in 2009.

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