FRBSF ECONOMIC LETTER

Number 2005-07, April 15, 2005

A Tale of Two Monetary Policies: Korea and Japan

In most countries' experience, the course of financial liberalization—much like the course of true love in Shakespeare—"never did run smooth." The process of reforming an economy from one where the government takes the lead in allocating financial and real resources to one where market forces determine economic outcomes can involve choices and consequences that are painful and costly.

This *Economic Letter* focuses on recent developments in two major economies in Asia—South Korea and Japan—to highlight some of the differences in their progress and to suggest that the differences might be due in part to different monetary policy outcomes. Both countries have had to negotiate two stumbling blocks to financial liberalization, with differing outcomes. The first stumbling block is switching from a regime that limits bankruptcy to one that permits it; such a shift can involve high costs in terms of lost output, and therefore it is likely to lead policymakers to put it off as long as possible. It appears, however, that South Korea has moved more aggressively since 1998 than Japan to liberalize and resolve nonperforming loan problems. The second stumbling block is a failure to achieve price stability through the conduct of monetary policy. Here again, South Korea appears to have performed better and, as a result, has exhibited better macroeconomic performance (Cargill and Patrick 2005 review a number of economic and noneconomic factors that account for the difference in macroeconomic performance). Better macroeconomic performance makes it easier to shift toward a system that permits greater bankruptcy and resolves nonperforming loans. Though the Bank of Korea (BoK) operates with less formal independence than the Bank of Japan (BoJ), the BoK's inflation-targeting regime appears to have contributed to better price stability and, hence, to better macroeconomic performance.

The role of bankruptcy

The role of bankruptcy, which obviously reflects a country's attitudes, cultural values, and historical experiences, is critically important in the process of financial liberalization. The reason is that bankruptcy, more than any other characteristic, reflects a country's willingness to allow market forces to ration capital. For example, the U.S., even before it began to move toward liberalization some 30 years ago, had a market-directed financial regime that was designed to evaluate credit, to monitor credit, and most importantly, to impose bankruptcy as a penalty for the inefficient use of credit. Specifically, the concept of "creative destruction" (Schumpeter 1975) was at the center of the financial system to ensure that old technology would be replaced by new technology. Schumpeterian creative destruction requires a well-developed and transparent financial system able to impose bankruptcy in the context of a well-developed legal system capable of enforcing transparent property rights contracts.

In contrast, Korean and Japanese regimes were founded on state-directed institutions designed to limit bankruptcy and avoid the perceived instability of the creative destruction process—that is, they were designed to be "patient." These institutions included complete government deposit guarantees, nontransparency, limits on open money and capital markets, and most important, the use of bank finance in the context of close bank-firm relationships, a key characteristic of Korean and Japanese finance. "Company groups," referred to in Korea as *chaebol* and in Japan as *keiretsu*, represent vertically and horizontally related companies organized around one or more financial institutions, usually banks. In Korea the banks have played a passive role, while in Japan the banks have played a leadership role. (Note that these types of industrial organizations would not be permitted in the U.S. legal system.)

The problem with basing economic and financial development on limiting bankruptcy is that it is subject to "time inconsistency." Specifically, although limiting bankruptcy generates rapid capital accumulation and economic growth in the short run, in the long run the approach is unsustainable because of the accumulated costs of letting inefficient enterprises continue to operate.

Cargill and Parker (2002) illustrate this point in a three-sector (agriculture, manufacturing, and finance) development model. The financial regime is bifurcated into a market-directed version that permits bankruptcy and a state-directed version that limits bankruptcy. The state-directed path results in faster

capital accumulation at first, but eventually capital accumulation declines relative to the market-directed path. The market-directed path destroys inefficient capital in the initial stages of development and hence ends up with more efficient capital in the latter stages. The state-directed path accumulates more capital, but the capital stock is weighted down by an increasing proportion of inefficient capital. Much like the albatross around the mariner's neck in *Rime of the Ancient Mariner*, limiting bankruptcy ultimately slows economic growth. Moreover, the costs in terms of lost output of shifting from a state-directed to a market-directed path increase over time. This may help explain why financial liberalization has been so difficult for Korea and Japan.

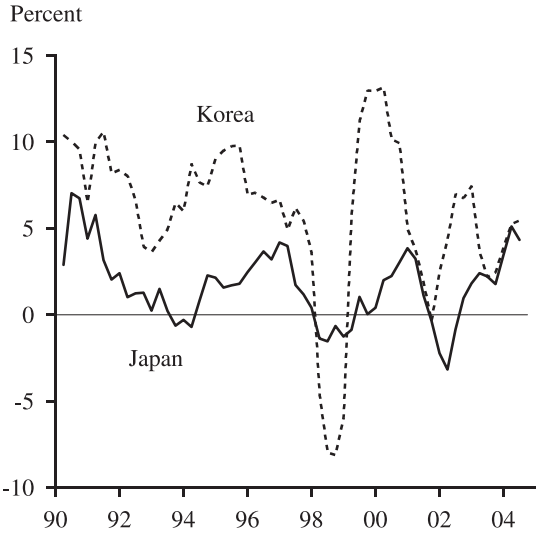
Korea appears to have achieved better policy outcomes

Korean and Japanese finance share many common elements, especially in regard to limiting the role of bankruptcy, and, as such, both are subject to the same constraints in shifting to a more market-directed regime. Despite this commonality, however, Korea appears to have progressed further than Japan since the Asian financial crises of 1997-1998. In response to the crises and the IMF-imposed austerity program, Korea recapitalized its banking system, reduced nonperforming loans, and initiated corporate governance reforms. While not all observers believe Korea has effectively dealt with its structural problems (e.g., Kim and Lee 2004 and World Bank 2003), compared to Japan, Korea appears to have moved further in a shorter period of time. Only in the last year or so has Japan been able to reduce the large amounts of nonperforming loans and borrowers that plagued the economy since the early 1990s, and only since 2003 has the economy showed signs of recovery. Even this positive development is tempered by news about consumer spending and GDP in the latter part of 2004 indicating that recovery is still not firmly in place after almost 14 years of declining, stagnant, or low growth. The better macroeconomic performance in Korea relative to Japan with the exception of the crisis in 1997/98 (see Figure 1) makes it easier to implement structural reform and may be one among many economic and noneconomic reasons for the better policy outcomes.

The importance of price stability

For most of the post-war period, discussions about price stability have been cast in terms of avoiding inflation. But price stability means not only avoiding inflation, but also avoiding deflation. Japan's recent experience represents a modern example of a deflationary environment, though it is nowhere near the scale experienced in the U.S. in the 1930s.

Figure 1
Real GDP growth



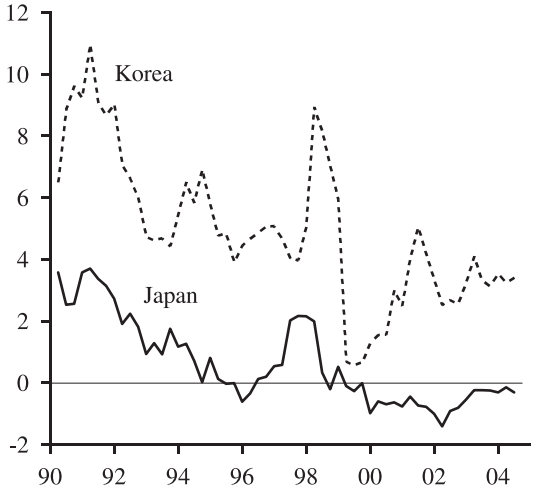
Source: International Financial Statistics, IMF.

Economic theory suggests that, like anticipated inflation, anticipated deflation should have minimal real effects as long as economic contracts can be adjusted. This may not be correct, however. First, deflation increases the cost of servicing fixed or quasi-fixed interest debt. Second, deflation increases the real interest rate if the nominal rate is close to or equal to zero and thus offers an incentive to postpone spending. Third, deflation can increase the demand for money by encouraging the substitution of cash balances for commodities. Fourth, deflation reduces the value of the money multiplier because banks become more averse to lending as borrowers encounter greater difficulty servicing the existing debt. Fifth, the longer the deflation process, the more aggressive monetary policy needs to be to reverse the process and establish positive price expectations.

With respect to the fifth point, it has become common to refer to deflation as creating a "liquidity trap" in which monetary policy loses its ability to stimulate demand through lowering interest rates. However, Cargill and Parker (2004) argue that the current situation in Japan is better described as presenting a "monetary policy discontinuity," because monetary policy is still capable of raising inflationary expectations. The argument instead is that the longer the deflation, the more difficult it is to reverse, because deflation reduces aggregate demand, reduces the money multiplier, and increases the demand for money.

Korea has avoided long periods of declining prices while Japan experienced disinflation in the first half

Figure 2
CPI inflation
Percent



Source: International Financial Statistics, IMF.

of the 1990s and deflation from 1994 through 2004 (see Figure 2). The increase in CPI inflation in 1997 was due to an increase in the consumption tax from 3% to 5%.

Why the different monetary policy outcomes?
Although the BoK and the BoJ share common structural characteristics in terms of their formal relationships with their governments, there are subtle and important differences. Prior to 1998, the BoK and BoJ were considered to be among the world's most dependent central banks. Both were legally administered by their respective ministries of finance. Despite the BoJ's legal dependence on the Ministry of Finance however, it had achieved a degree of political independence understated by any independence index. This was not the case with the BoK.

The BoK and BoJ received enhanced legal independence in June 1997 and December 1997, respectively. The reasons ranged from a desire to bring the institutional design of the BoK and BoJ in line with international developments to specific political economy issues in Korea and Japan. The BoK did not achieve the same increase in formal independence as the BoJ. Based on one well-known method of measuring independence that attaches subjective weights to various parts of the enabling central bank legislation, the BoK's index increased from 0.27 to 0.33 while the BoJ's index increased from 0.17 to 0.38. By comparison, the Federal Reserve's index was 0.69. In addition, the BoK's independence was constrained by an inflation-target framework, while the BoJ was only required to achieve "price stability" without an explicit definition of it.

It is debatable whether the inflation-target framework in Korea versus the absence of a similar framework in Japan accounts entirely for the difference in monetary policy outcomes; however, the advantage of a target is that it represents an explicit anchor on which the public can base its price expectations. It should be noted that it was only when the BoJ came under pressure from Prime Minister Koizumi and the Diet in 2002, with the implied threat of imposing an inflation target, that the BoJ significantly changed operating policy, shifting to quantitative easing and becoming more vocal about reversing the decline in prices. The outcome was an improvement in the economy in 2004 and a deceleration of deflation with projections of positive price movements in 2005.

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Index to Recent Issues of *FRBSF Economic Letter*

DATE	NUMBER	TITLE	AUTHOR
9/10	04-25	Exchange Rate Movements and the U.S. International Balance Sheet	Cavallo
9/17	04-26	Supervising Interest Rate Risk Management	Lopez
10/1	04-27	House Prices and Fundamental Value	Krainer/Wei
10/8	04-28	Gauging the Market's Expectations about Monetary Policy	Kwan
10/22	04-29	Consumer Sentiment and the Media	Doms
10/29	04-30	Inflation-Induced Valuation Errors in the Stock Market	Lansing
11/5	04-31	Reflections on China's Economy	Yellen
11/12	04-32	Does Locale Affect R&D Productivity? The Case of Pharmaceuticals	Kyle
11/19	04-33	Easing Out of the Bank of Japan's Monetary Easing Policy	Spiegel
11/26	04-34	Outsourcing by Financial Services Firms: The Supervisory Response	Lopez
12/3	04-35	October 6, 1979	Walsh
12/10	04-36	What Determines the Credit Spread?	Krainer
12/17	04-37	Productivity Growth and the Retail Sector	Doms
12/24	04-38	After the Asian Financial Crisis: Can Rapid Credit Expansion ...	Valderrama
1/7	05-01	To Float or Not to Float? Exchange Rate Regimes and Shocks	Cavallo
1/21	05-02	Help-Wanted Advertising and Job Vacancies	Valletta
2/4	05-03	Emerging Markets and Macroeconomic Volatility: Conference Summary	Glick/Valderrama
2/18	05-04	Productivity and Inflation	Yellen
3/11	05-05	Gains in U.S. Productivity: Stopgap Measures or Lasting Change?	Daly/Furlong
4/8	05-06	Financial liberalization: How well has it worked for developing countries?	Aizenman