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Economic Conditions in Korea and Japan:
A Monetary Policymaker's Report

Each year, the President of the San Francisco Fed joins the Federal Reserve Board Governor responsible for liaison with Asia on a "fact-finding" trip to the region. These trips advance the Bank's broad objectives of serving as a repository of expertise on economic, banking, and financial issues relating to the Pacific Basin and of building ties with policymakers and economic officials there. The knowledge gained and the contacts developed are valuable in understanding trends affecting the Twelfth District, in carrying out responsibilities in banking supervision, and in ensuring that policymakers have the understanding of global economic developments necessary to conduct policy and promote the stability of financial markets. This Economic Letter *summarizes President Yellen's report to the Head Office Board of Directors on her trip to Seoul, Korea, and Tokyo, Japan, in November 2008.*

I am pleased to report this morning on the recent trip to Seoul and Tokyo organized by our Bank last month. It was very timely since, in recent months, both countries have borne more of the brunt of what has become a truly global financial crisis.

When the financial crisis affecting the U.S. and Europe first arose back in the summer of 2007, it was believed that Asian countries like Korea and Japan would be relatively insulated from the crisis both because their financial institutions were not heavily exposed to U.S. mortgage debt and related securitized products and because of continued intraregional growth in Asia. However, as the crisis has persisted, any sense of insulation has deteriorated. Slowing worldwide growth has curtailed intraregional and extraregional exports, a main driver of economic activity in both countries. In addition, stock market prices in both countries have declined, as expected profits have fallen and as the deleveraging of global financial markets has led to an equities selloff. The collapse of Lehman Brothers in mid-September, greater global risk-aversion, and the resulting disruption of global financial markets have severely impacted Korean and Japanese financial institutions and acted as a further drag on growth.

Korea

In Korea, foreign capital outflows have caused not only a steep decline in the stock market but also a sharp depreciation of the won—both are down roughly 40% in recent months.

I think it's important to emphasize that the current problems are by no means a reprise of the financial crisis a decade ago. Korean banks are much stronger now. Their aggregate nonperforming loan ratio is 0.8%, compared to 6.0% before the Asian financial crisis, and their Basel capital ratios are close to 11%, up from 7% in late 1997. Moreover, Korean banks and their corporate clients no longer suffer from currency mismatches as they did in 1997 when their foreign currency liabilities exceeded assets. Today, in contrast, Korean banks, including the Korean branches of foreign banks, have a significant book of foreign currency loans with duration mismatches, mainly to shipbuilding entities who anticipate earning foreign currency receipts in the future. Loan durations are for two to three years, but financing has been rolled over in the three- to six-month markets.

The situation for Korean banks worsened considerably after the Lehman failure. As dollar assets have left the country and global credit markets have frozen up, Korean banks have scrambled to find dollars to repay maturing dollar loans. The dollar liquidity strains have spilled over into the local currency markets, and banks have become more cautious about extending loans on concerns of worsening asset quality.

Since October, the Korean government has sought to support economic growth and restore confidence through monetary policy and fiscal policy

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measures. The Bank of Korea has cut its policy interest rate three times by a total of 125 basis points to 4% and noted that further cuts were possible (in fact, the rate was reduced to 3% shortly after my trip).

The Korean authorities also have taken several steps to inject liquidity into the domestic banking system in order to help Korean banks repay or roll over their short-term foreign debts, and they are developing plans to inject capital into the banking sector, should that be necessary. Steps already taken include $100 billion in guarantees on external borrowing by domestic banks, the injection of $30 billion in dollar foreign reserves into the banking sector to enhance dollar funding requirements, and a $30 billion foreign exchange swap with the Federal Reserve. This swap arrangement is particularly important, since Korea appears to prefer forgoing access to liquidity from the IMF (International Monetary Fund). I might add that the Fed swap arrangement was universally applauded as a key confidence-building step, and Korea already has begun to draw on it.

The Korean government also has announced fiscal stimulus plans, including both more public spending and tax cuts. There is a general belief in the efficacy of fiscal policy and support for even more stimulus than what has already been proposed. As I will discuss in a moment, this contrasts with the view in Japan. Interestingly, no one talked about inflation, which appears to be receding as a problem, given the fall in commodity prices.

Japan

Economic activity in Japan also has been slowing. Japan's exports to the U.S. have been falling for over a year, and exports to Europe began slowing earlier this year. In October, Japan's exports to the rest of Asia, including China, weakened for the first time in almost seven years. Japan's economy contracted for two consecutive quarters for the first time since 2001.

Japanese stock prices have fallen sharply, reaching their lowest level in 26 years at the end of October. However, unlike the Korean won, the yen has been appreciating during the crisis. This is largely due to the unwinding of the so-called carry trade, as investors who borrowed in cheap yen to invest in high-yield currencies are now reducing their positions abroad. The yen has also benefited from its safe haven appeal amidst a general flight to safety. The significant decline in new issues of corporate bonds and commercial paper in October provides further evidence of the weakening of Japan's financial markets.

As in Korea, Japan's banks, particularly the mega banks, are much stronger than they were in 1997. Until quite recently, they remained domestically focused and not overexposed to investment banking or structured finance. They built strong capital positions and sought overseas expansion opportunities. They are highly liquid, sitting on huge deposit bases.

As a result, despite some recent writedowns on loans to domestic construction and real estate firms, Japanese banks were expected to weather the U.S. subprime crisis and, in fact, be a source of capital for weaker financial entities.

These expectations were shattered following the mid-September Lehman collapse, as the resultant sharp and unexpected decline in the equities market caused severe losses in Japanese banks' equity holdings. Because those losses affected the banks' Tier 1 capital, many large Japanese banks have been seeking to raise new capital.

Policymakers in Japan have responded to these developments through a combination of monetary and fiscal policy measures. The Bank of Japan reduced its policy rate in November, albeit by only 20 basis points to 0.30%. Like the Fed, the Bank of Japan is concerned now about the effect that lowering the rate further would have on the functioning of financial markets, including money market funds. We did not sense that monetary authorities were inclined to pursue a policy of quantitative easing on the same scale as earlier in this decade. However, in early December, the central bank announced it would allow commercial banks unlimited access to funds, provided they have sufficient collateral; this parallels similar facilities established earlier by the Fed, the European Central Bank, and other central banks.

With interest rates close to zero, the burden of easing recessionary pressures in Japan has fallen on fiscal authorities. In response, the government has announced a series of fiscal stimulus packages, though their magnitude is relatively small. In fact, we did not encounter much support for fiscal policy among our contacts there; most believe that the planned fiscal stimulus will have a very limited impact on Japan's growth. In many views, Japan's long-run fiscal position leaves the government in poor shape to use fiscal policy as a countercyclical tool, since Japan's public debt-to-GDP ratio exceeds 170%.

Learning from Japan's "lost decade"

I'd like to wrap these remarks up with some reflections on what Japan's experience during its "lost decade of growth" which began in the early 1990s may have to tell us about handling the financial crisis and recession here in the U.S. Needless to say, this was a frequent topic of conversation, and, also needless to say, some issues were the subject of debate.

In terms of Japan's past conduct of monetary policy, a major lesson is that, when policy interest rates approach their lower bound and there is fear of deflation, it is important to make clear and strong commitments about the future stance of policy. The Bank of Japan did this by issuing statements that it would maintain its zero interest rate policy until inflation reappeared. The central bank also engaged in quantitative easing from 2001–2006, but it was unclear if that boosted economic activity much.

In terms of the massive fiscal stimulus of the 1990s, people generally seem to agree that it failed to raise real growth and succeeded only in raising public debt to excessive levels. One possible explanation is that spending went to activities that did not yield much "bang for the yen." Another explanation is that Japanese citizens may have believed in the government's long-term commitment to balance its budget; in that case, they would expect any current fiscal stimulus to be undone in the near future through higher taxes, prompting households to save rather than spend.

Regarding the current financial turmoil, our contacts suggested several approaches for resolving it, some of which, of course, we have already implemented. One is to provide a safety net for the financial system during a crisis by extending deposit insurance and to enhance interbank liquidity by guaranteeing debt. Another emphasizes the importance of the government's role in recapitalizing the banks, provided that there are conditions about reducing risky lending and that the government stands to gain from future bank profits.

Finally, analysts universally concluded that the government needs to help banks get toxic assets off their balance sheets. Otherwise, banks will remain focused on the potential for further deterioration of these loans at the expense of looking forward and making new loans. Thus, new capital will be hoarded to protect against potential new losses. Equally important is price discovery. In Japan, the government took severe haircuts in purchasing assets from banks (in 2000). This policy reduced uncertainty by establishing a floor price for future asset sales. Everyone we met with urged the U.S. to move forward with an asset disposition program, as originally envisioned for the Troubled Asset Relief Program (TARP).

In closing, let me say that I, for one, found it especially enlightening to get this first-hand view from Asia, as all three of our countries struggle through these difficult times.

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