Financial Restructuring in Japan
- a Korean Perspective -

Kun-Young Yun
Yonsei University

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I. Current Japanese Economy: an Overview

1. Number 2 in the world (2002)
   ◇ Second largest: GDP = $3,992 billion
   ◇ Second richest: Per capita GDP = $31,200
   ◇ Population: 128 million

2. Current Situation
   ◇ Not growing fast enough
     *Growth rates in the good old days:
       1960s: 10%
       1970s: 4.4%
       1980s: 4.1%
       1993-2002: 1.1%
   ◇ Unemployment rate: 2.2% (1992) → 5.4% (2002), and rising.
   ◇ Deflation in goods and asset prices

☞ The financial system is believed to be at the center of the problem
Figure 1. Economic Growth, Unemployment, and Interest Rate (%)

Figure A1. Velocity of Money: % Change in GDP/(M2+CD)

Figure A2. Propensity to Consume (%)

Figure A3. Exchange Rate (Yen/US dollar)

Figure A4. Balance of Payment and Foreign Exchange Reserves

Figure A5. Balance of Government Budget

*Note: Bond dependency = Gov't Bond Issues / Total expenditure
Figure A6. General Government Debt / GDP (%)

II. Current Issues on the Japanese Financial System
1. Bubbles in the Asset Markets

◇ Nikkei 225
  9,894 (1983)
  → 38,916 (1989)
  → 7,831 (April 2003)

◇ Land in 6 large urban areas
  1.00 (1982)
  → 3.47 (1990)
  → 1.02 (2001)

◇ Δ in GDP Deflator
  1993-2002: -0.7%
  less than 0 in 8 out of the last 10 years

2. Impacts of the Collapse on the Financial System

Table 1. Non Performing Loans of Japanese Deposit-taking Financial Institutions (End of March) (trillion yen)

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>1. Banks</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Loans (A)</td>
<td>553.1</td>
<td>506.6</td>
<td>496.2</td>
<td>494.1</td>
<td>473.2</td>
<td>453.6</td>
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<tr>
<td>NPLs (B)</td>
<td>19.5</td>
<td>29.6</td>
<td>30.4</td>
<td>32.5</td>
<td>42</td>
<td>39.2</td>
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<tr>
<td>NPLs-FRL1)</td>
<td>-</td>
<td>33.9</td>
<td>31.8</td>
<td>33.6</td>
<td>43.2</td>
<td>40.1</td>
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<tr>
<td>Losses from Disposal of NPLs (C)</td>
<td>13.3</td>
<td>13.6</td>
<td>6.9</td>
<td>6.1</td>
<td>9.7</td>
<td>-</td>
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<tr>
<td>Cumulative Losses since 19922)</td>
<td>45.1</td>
<td>58.8</td>
<td>65.7</td>
<td>71.8</td>
<td>81.5</td>
<td>83.4</td>
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<tr>
<td>B/A (%)</td>
<td>3.5</td>
<td>5.8</td>
<td>6.1</td>
<td>6.6</td>
<td>8.9</td>
<td>8.6</td>
</tr>
<tr>
<td>C/A (%)</td>
<td>2.4</td>
<td>2.7</td>
<td>1.4</td>
<td>1.2</td>
<td>2.0</td>
<td>-</td>
</tr>
<tr>
<td><strong>2. Banks + Cooperative Type Financial Institutions</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Total Loans (D)</td>
<td>688.5</td>
<td>642.2</td>
<td>629.2</td>
<td>626.4</td>
<td>606.4</td>
<td>-</td>
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<tr>
<td>NPLs (E)</td>
<td>25.0</td>
<td>38.7</td>
<td>41.4</td>
<td>43.4</td>
<td>53.0</td>
<td>-</td>
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<tr>
<td>NPLs-FRL</td>
<td>-</td>
<td>42.6</td>
<td>40.9</td>
<td>43.0</td>
<td>52.4</td>
<td>-</td>
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<tr>
<td>E/D (%)</td>
<td>3.6</td>
<td>6.0</td>
<td>6.6</td>
<td>6.9</td>
<td>8.7</td>
<td>-</td>
</tr>
</tbody>
</table>

Note: 1) NPL-FRL: Non-performing loans based on Financial eonstruction Law.
2) Cumulative losses from disposal of NPLs.
Source: Financial Services Agency, Japan.

☞ Banks are burdened by NPLs and pressured to meet capital adequacy requirements.
⇒ Bank lending and business Investment are shrinking.

*Emergency Countermeasures to Deflation*, Feb 27, 2002.
*Comprehensive Measures to Accelerate Reform*, Oct 30, 2002, and

☞ Why is the problem so persistent?
   The answer may be: Systemic nature of the problem requires a comprehensive, decisive, and bold policy.
☞ Any lessons to be drawn from the Korean experience?
III. Financial Restructuring in Korea

- GDP growth rate in 1998: -6.7% (the lowest in post-Korean war period)
- Unemployment rate surged to 8.8% in Feb 1999.

2. Resolution of Bad Institutions and Bad Loans

Table 2. Financial Restructuring in Korea

<table>
<thead>
<tr>
<th>Restructuring Status</th>
<th>Number of Companies (year-end 1997) (A)</th>
<th>License Revocation</th>
<th>Merger</th>
<th>Liquidation, Transfer to Bridge Bank, Suspension of Operations</th>
<th>Total (B)</th>
<th>Change (B/A)</th>
<th>Newly Opened</th>
<th>Current Total</th>
</tr>
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<tbody>
<tr>
<td>Banks</td>
<td>33</td>
<td>5</td>
<td>9</td>
<td>0</td>
<td>14</td>
<td>42.4</td>
<td>1</td>
<td>20</td>
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<tr>
<td>Merchant Banks</td>
<td>30</td>
<td>18</td>
<td>6</td>
<td>4</td>
<td>28</td>
<td>93.3</td>
<td>1</td>
<td>3</td>
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<tr>
<td>Securities Companies</td>
<td>36</td>
<td>5</td>
<td>1</td>
<td>1</td>
<td>7</td>
<td>19.4</td>
<td>16</td>
<td>45</td>
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<tr>
<td>Insurance Companies</td>
<td>50</td>
<td>7</td>
<td>6</td>
<td>2</td>
<td>15</td>
<td>30.0</td>
<td>9</td>
<td>44</td>
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<td>Investment Trust Companies</td>
<td>30</td>
<td>6</td>
<td>1</td>
<td>0</td>
<td>7</td>
<td>23.3</td>
<td>6</td>
<td>29</td>
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<tr>
<td>Mutual Savings Banks</td>
<td>231</td>
<td>71</td>
<td>26</td>
<td>25</td>
<td>122</td>
<td>52.8</td>
<td>12</td>
<td>121</td>
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<tr>
<td>Credit Unions</td>
<td>1666</td>
<td>2</td>
<td>102</td>
<td>303</td>
<td>407</td>
<td>24.4</td>
<td>9</td>
<td>1268</td>
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<tr>
<td>Lease Companies</td>
<td>25</td>
<td>9</td>
<td>1</td>
<td>0</td>
<td>10</td>
<td>40.0</td>
<td>3</td>
<td>18</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2101</td>
<td>123</td>
<td>152</td>
<td>335</td>
<td>610</td>
<td>29.0</td>
<td>57</td>
<td>1548</td>
</tr>
</tbody>
</table>

3. Public Funds and Public Burdens


<table>
<thead>
<tr>
<th></th>
<th>Equity Participation</th>
<th>Contributions</th>
<th>Deposit Insurance Claim</th>
<th>Asset Purchases</th>
<th>Purchases of NPLs</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bond Issues</td>
<td>42.2</td>
<td>15.2</td>
<td>20.0</td>
<td>4.2</td>
<td>20.5</td>
<td>102.1</td>
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<td>Recycled Funds</td>
<td>3.9</td>
<td>1.6</td>
<td>6.2</td>
<td>4.4</td>
<td>17.0</td>
<td>33.1</td>
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<tr>
<td>Public Funds¹</td>
<td>14.1</td>
<td>-</td>
<td>-</td>
<td>6.3</td>
<td>0.5</td>
<td>20.9</td>
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<tr>
<td>Others²</td>
<td>-</td>
<td>0.1</td>
<td>2.9</td>
<td>0.1</td>
<td>1.1</td>
<td>4.2</td>
</tr>
<tr>
<td>Total</td>
<td>60.2</td>
<td>16.9</td>
<td>29.1</td>
<td>15.0</td>
<td>39.1</td>
<td>160.3</td>
</tr>
</tbody>
</table>

¹ Include government budget, government fund, and foreign loans.
² Include loans from financial institutions, KAMCO's and KDIC's own funds.

Source: Public Fund Oversight Committee, 2003

<table>
<thead>
<tr>
<th>Category</th>
<th>Equity Participation</th>
<th>Contributions</th>
<th>Deposit Insurance Claim</th>
<th>Asset Purchases</th>
<th>Purchases of NPLs</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>33.9</td>
<td>13.7</td>
<td>-</td>
<td>14.0</td>
<td>24.6</td>
<td>86.2</td>
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<tr>
<td>Merchant Banks</td>
<td>2.7</td>
<td>0.2</td>
<td>17.2</td>
<td>-</td>
<td>1.6</td>
<td>21.7</td>
</tr>
<tr>
<td>Securities Companies and Investment Trust Companies</td>
<td>7.7</td>
<td>-</td>
<td>0.01</td>
<td>-</td>
<td>8.5</td>
<td>16.2</td>
</tr>
<tr>
<td>Insurance Companies</td>
<td>15.9</td>
<td>2.9</td>
<td>-</td>
<td>0.4</td>
<td>1.8</td>
<td>21.0</td>
</tr>
<tr>
<td>Credit Unions</td>
<td>-</td>
<td>-</td>
<td>4.6</td>
<td>-</td>
<td>-</td>
<td>4.6</td>
</tr>
<tr>
<td>Mutual Savings Banks</td>
<td>-</td>
<td>0.1</td>
<td>7.3</td>
<td>0.6</td>
<td>0.2</td>
<td>8.2</td>
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<tr>
<td>Overseas Financial Companies</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>2.4</td>
<td>2.4</td>
</tr>
<tr>
<td>Total</td>
<td>60.2</td>
<td>16.9</td>
<td>29.1</td>
<td>15.0</td>
<td>39.1</td>
<td>160.3</td>
</tr>
</tbody>
</table>

Source: Public Fund Oversight Committee, 2003
4. Fixing the Stable after the Cow Is Stolen

Financial Supervisory Commission (FSC) investigated 464 institutions:
- 4,879 people involved in inappropriate activities.
- 2,404 people contributed to the losses of financial institutions
  → 1,377 people were reported to the prosecutors’ office.

Korea Deposit Insurance Corporation (KDIC) investigated 418 institutions:
- 4,716 people have contributed to the losses of financial institutions.
  → Sued 5,166 people for 1,534 billion won and confiscated 1,373 billion won.
IV. Restructuring Japan’s Financial System: a Korean Perspective
1. Comprehensive Measures and Financial Revival

◇ Four strategic areas of structural reform:
   - Financial system
   - tax policy
   - regulation, and
   - government expenditures.

◇ Financial Restructuring:
   - Accelerate disposal of NPLs => resolution of the NPLs problem by 2004
     (reduction of NPLs/Loans ratio of major banks by half)

◇ Improve Financial Administration:
   - tightening asset assessment
   - enhancing capital adequacy, and
   - strengthening governance of major banks

◇ And revive corporate borrowers
   + ensure smooth flow of loans to SMEs.

☞ Lessons from Korea
   - A well functioning financial system is essential for stability and growth.
   - Stem the deterioration of financial system at the earliest possible date.
2. Would it work this time? Some Remarks.

- If the excessive NPLs in the financial institutions are the prime cause of deflation and economic slowdown, the cost of NPLs disposal and bank recapitalization is a small price to pay.

- Since the government purchases (through RCC) NPLs and new claims on the banks at market value, the expected net burden to taxpayers is zero.

- Injection of public funds for disposal of NPLs and bank recapitalization causes temporary, not permanent, increase in government debt.

- Disposal of NPLs, *per se*, does not “create” losses. Financial institutions merely realize the capital losses that accrued in the past.

- Temporary reduction of NPLs may not be sufficient to restore stability to the financial system.

- The large flow of loans that are downgraded from performing to non-performing must be dealt with.

- Improve profitability of the borrower corporations!

- Financial restructuring itself helps move resources from inefficient to efficient firms.

- Other factors affecting profitability of firms include tax policy, regulation, competition in the markets, R&D, education, etc.

- Provide adequate safety nets for the unemployed, and ensure stable flow of funds to SMEs!

- Act decisively, boldly, and quickly to clean-up NPLs and recapitalize the weakened banks.
V. Concluding Remark

◇ Overhauling the financial system may be the most urgent problem to be resolved.

- Must treat the fundamental sources of the problem.

- No More Stop-gap!!

- No More Piecemeal Approach!!

- Decisive and bold approach is recommended.

- Commit sufficient public funds for quick resolution of NPLs and recapitalization of the financial institutions.

- Otherwise, the economy may have to continue on the suboptimal path for a long time, and the restructuring process may be overtaken by other events demanding urgent government attention.