JAPANESE ECONOMIC CRISIS: TRANSMISSION MECHANISM ON KOREAN ECONOMY

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Background to crisis?

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With Japan's financial institutions moving to close their accounts in March, there have been some concerns that Japan may face another economic crisis. Since the Asian financial crisis, the account closing in March has been a time of anxiety as it is when banks recover their loans. Coinciding with this, the abolition of Japan's deposit guarantee law in April is expected to cause depositors to withdraw their deposits from financial institutions. In addition, with the continued slump in consumption and investment, recovery in the real economy is not foreseen, and the basic factors of economic crisis, such as lack of reforms and unresolved bad debt, still remain.

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The most immediate factor of instability is the abolition of the deposit guarantee law in April. This measure, originally scheduled for April 2001, was postponed a year due to worries that it would cause a chain reaction of financial institution bankruptcies. After the law is abolished on April 1st, only deposits under 10 million yen and their interest will be protected. Most of the funds currently deposited in financial institutions are not deposited for capital gains but for safe keeping, and if their security is not guaranteed, a large and sudden outflow may occur. In this case, some financial institutions may go bankrupt while others rush to recover their loans, which would increase financial anxiety and worsen the real economy's stagnation.

With the worsening slump in Japan's real economy, a shock from the financial sector may result in a crisis through the entire economy. In the third quarter of 2001, Japan's GDP fell by 0.5% year-over-year. Retail sales in particular fell by 14.9% in December, reflecting a contraction in consumption, which accounts for two-thirds of the country's GDP. Meanwhile, exports also fell by 14.9%, contributing to a cycle of low domestic and international demand leading to a decline in investment and increased unemployment.

Positive external factors

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Considering the overall situation, Japan is not expected to experience a financial collapse or an economic crisis in the short term. Although many concerns were raised about an economic crisis ahead of this year's accounts settlements, the financial system has still survived. Also, the abolition of the deposit guarantee law is not a sudden or unexpected event, and much of the funds in question have already been transferred. In addition, the Japanese government holds more than 15 trillion yen of public funds and has prepared various responses in the case of a bank run.

The abolition of the deposit guarantee law may actually help Japan's economy out of its recession by stimulating consumption and investment. Funds diverted from bank deposits may be invested in the securities, bond, or real estate markets, and part of the funds may be used for consumption. For such a positive effect to occur however, at least some of the current anxiety needs to be resolved, and some signs of recovery should be seen.

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Although Japan's recession continues, there are positive factors at the international level. The economic recovery of the US, a possible upturn in the world IT market, and strengthened price competitiveness due to the weak yen bode well for Japanese exports. Although there are few signs of a recovery in Japan's domestic economy, the second half may see expanded investment and employment thanks to increased exports.

Concerns for Korean economy

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Although Japan is Korea's second largest export market accounting for about 10% of total exports, the possibility of a crisis is not enough to have a serious impact on exports. Meanwhile, Japanese imports account for about 20% of Korea's total imports, and much of this consists of capital goods used in production. If Japanese companies slowdown their production activity, this will cause the investment and production of Korean firms to suffer.

The continuing fall of the Japanese yen is expected to impact Korea's real economy by worsening the price competitiveness of Korean products. Due to the possibility of a Japanese economic crisis, the yen's fall is expected to continue. The weakening yen may cause Korean electronics and telecom equipment (which are competing with Japanese goods) to lose price competitiveness and export share in the recovering international markets. Meanwhile, the weak yen, combined with reviving consumer sentiment in Korea, is expected to cause imports of Japanese household goods and electronics to rise significantly.

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Despite the worsening Japanese economy, it is unlikely that a rapid outflow of Japanese investment funds will shock the Korean economy, because Japan's share of foreign investment has decreased. From 1962 to 2001, Japan accounted for about 14.8% of Korea's total foreign direct investment, but in 2001, Japan's share fell to 5.8%. In addition, Japan accounted for only 1.1% (973 billion won) of foreign stock holdings in Korea as of December 2001. However, because a significant portion of British and American foreign direct investment and stock investment consist of Japanese investment funds, a further decline in the Japanese economy may result in a larger capital outflow than expected. The biggest concern for Korea is that the possibility of economic crisis in Japan may cause international investors and credit rating companies to become skeptical about Korea as well. VIP