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South Korea's Economic Reforms And U.S. Interests

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Summary

From the perspective of U.S. exporters and investors, gaining fair and effective access to South Korea's market is part of a broader problem of doing business in an economy that limits the role of market forces. Extensive government intervention and regulation of economic activity, non-transparent and often discriminatory bureaucratic actions, and a strong drive for autonomy all make South Korea one of the most difficult markets in the world to do business in. To the extent that the South Korean government implements economic reforms that expose more segments of its economy to market forces, the sources of U.S.-South Korean trade tensions are likely to dissipate.

Over time, South Korea appears likely to implement fundamental economic reforms in order to bolster its international competitiveness. But the recent, dramatic drop in President Kim Young Sam's popularity, combined with the politics of a presidential election in December 1997, have all but eliminated the possibility of new reform initiatives this year.

A loss of momentum for reform, in turn, has varied implications for U.S.-Korean economic relations. Some past reforms that have facilitated increases in U.S. exports (primarily of capital goods, and raw materials) and investment should not be affected. Coupled with falling South Korean competitiveness, the recent U.S. trade surplus with South Korea should persist. But little or no progress in liberalizing other sectors of Korea's economy that are of considerable interest to U.S. business (particularly consumer goods and finished manufactures that compete directly against Korean-made products) can be anticipated, and backsliding in other areas is also possible. As a result, 1997 may witness an increase in U.S.- South Korean trade tensions.

Background

In South Korea today, there are growing concerns among elites, as well as the public, that the country's economy is off-track. A slower economic growth rate (the economy grew at 6.7% in 1996 compared to the 8-9% growth rates in the previous few years), a large (\$22 billion) and growing current account deficit, a depressed stock market, and continuing out-sourcing of production to other Asian countries by the country's large conglomerates or *chaebol* are behind the fears that the country's competitiveness may be fading.

The slowdown in the economic growth rate is due to a combination of cyclical (temporary) and structural (deeply rooted) factors. A weakening of the Japanese yen and falling prices for some of Korea's major exports are the major cyclical factors. The weaker yen has made it more difficult for Korean exporters of cars and ships to compete against Japanese producers, and declining global demand for semiconductors, which account for 20% of Korean exports, has contributed to the widening of the trade deficit.¹

A number of structural weaknesses are increasingly recognized by Koreans as the source of the country's declining competitiveness. Rigid labor markets, an inefficient financial system, an overburdened infrastructure system, and a difficult environment for foreign direct investment have all contributed to the country's rising production costs and declining competitiveness.²

To curb rising business costs and attract the technology and foreign capital that are necessary to meet rising competitive pressures, many Korean economists and technocrats have long urged the government to initiate fundamental and comprehensive economic reforms. They have called upon the government to radically reduce its role in the economy, to curb monopolistic practices of the *chaebol*, to reform an out-dated labor-management system, and to open the economy further to foreign goods and services.³

President Kim's Reform Record

Korean reformers pinned considerable hopes on President Kim Young Sam when he assumed office in 1993. A leading opposition figure for over three decades and a critic of heavy government regulation of the economy, President Kim proposed a blueprint for a "New Korean Economy" based squarely on the principles of private sector autonomy, fair competition, and open markets. Despite the considerable powers of the Korean presidency and high initial popularity ratings, President Kim to date has enacted only a few significant, yet partial, reforms relating to tax avoidance (real name reform) and membership in the Organization for Economic Cooperation and Development (OECD).

¹ Burton, John. Slowdown in Seoul. Financial Times, January 9, 1997, p. 11.

² Burton, John. Structural Inefficiencies Persist. Financial Times Survey: South Korea, November 15, 1996, p. I-VI.

³ For a full discussion, see Ahearn, Raymond J. South Korea: Prospects for Greater Market Openness. Congressional Research Service, Report 96-299 F, March 26, 1996, 32 p.

More importantly, two recent events -- the bankruptcy of *Hanbo Iron and Steel* and a weak revision of Korea's labor law -- have contributed to President Kim's popularity dropping to around 15% and have undermined his credibility as a force for economic reform. In addition, the December 1997 presidential election is largely viewed as a major reason why President Kim is unlikely to adopt reformist positions on economic issues during the remainder of 1997. As the opposition parties (headed by perennial presidential candidates Kim Dae Jung and Kim Jong Pil), have adopted relatively populist and nationalistic positions on most economic issues, President Kim has become more cautious.

Real Name Reform

In part to loosen the traditional close and collusive ties between government and business, the Kim Administration in August 1993 implemented a real-name system for financial transactions. In the past, it had been possible to open accounts and conduct business under false names, directly and indirectly fostering institutionalized corruption, tax avoidance, and other illegal financial dealings. The reform was intended to reduce collusive aspects of government-business relations and allow funds once channeled into bribes to become available for more productive uses.

The real-name reform did reveal major political scandals in 1995 with the arrest, trial, and sentencing of two former Presidents on corruption charges. The Kim Administration, however, did not use the public outrage as a lever for reducing the tight economic regulations that give rise to illicit payments in the first place. Concerns that such reforms could harm some of Korea's largest *chaebol*, thereby undercutting the growth of the Korean economy, seemingly deterred the administration from heading in this direction.⁴

Real-name reform has been no more successful in freeing up capital for more productive uses. Before the law was passed, many small and medium size companies borrowed from wealthy individuals who held their money in "false name" accounts to avoid taxes. This was necessary because the banks, consistent with government guidance, mostly lent to the *chaebol*. But when real name reform was implemented, this important source of funding dried up as many people shifted their money from "false name" accounts to tax-free bonds.

OECD Membership

In late 1996, the South Korean national parliament approved Seoul's membership in the Organization for Economic Cooperation and Development (OECD), a grouping of advanced industrialized countries designed to coordinate economic policies and promote economic growth. Despite domestic political opposition, President Kim supported making Korea the 29th member of the OECD (and the second Asian member) largely on the grounds that admission to this club would confer on Korea advanced-country status and prestige.

⁴ Kristoff, Nicholas D. Korean Tycoons Dodge A Bullet. New York Times, December 8, 1995, p. A7; and Hoon, Shim Jae. What, We Worry: South Korea's Chaebol Remain Unscathed by Scandal. Far Eastern Economic Review, November 23, 1995, p. 79.

Overtime, membership in the OECD is expected to force Korea to open its financial markets and reduce their regulation of its economy. With regard to the banking system which now is heavily controlled and protected by government regulations, Korea will have to lift certain kinds of restrictions on capital flows, allow market forces to determine interest rates, and provide foreigners substantially more freedom to make portfolio and direct investments. However, according to the terms Korea negotiated for its accession, these reforms could take a number of years to implement.

Korea accepted only 65% of the various OECD financial liberalization obligations, as compared to the organization's average of 89%. Seoul promised to proceed with full liberalization once the gap between Korean and international interest rates falls by 2% from its current 6-7 percentage points, and inflation falls to 3% from its present 4.5% level. Some analysts believe that these economic preconditions are unlikely to be met until well after 2000.⁵

Hanbo Bankruptcy

Hanbo, Korea's 14th largest *chaebol*, filed for bankruptcy in January, 1997, amid allegations that Kim Administration officials exerted pressure on banks to provide loans to Hanbo in return for illegal political contributions. Besides the political corruption issue, the scandal exposed continuing government efforts to support ambitious, but risky, industrial projects that result in production overcapacity and heavily indebted companies.

Hanbo's attempt to build the world's fifth largest steel mill precipitated the crisis. Management greatly underestimated the cost of the mill from the beginning, and ended up amassing a debt that totalled 22 times its shareholder equity. So large was the debt, that even under best case projections of operating profits, few analysts thought that it could be retired. Why banks continued to lend Hanbo enormous sums of money for this project without a feasibility study or without demanding adequate collateral is a matter under investigation.⁶

The bankruptcy filing on March 18, 1997 by *Sammi Steel*, one of Korea's 30 largest *chaebol*, has heightened concerns that other industrial conglomerates could be near collapse. Unlike a number of past *chaebol* financial crises, however, the government has not rushed-in to bail-out creditors. As a result, *chaebol* management may become more cautious and hesitant to expand into non-core business areas in the future.

Labor Law Reform

President Kim did try to reform Korea's rigid labor laws in late December 1996, but rising public opposition, including several weeks of strikes and public protests, caused him to reverse course and support a watered-down version. This compromise legislation, which was supported by the opposition parties, was approved by the National Assembly in early March, 1997.

⁵ Burton, John. S. Korea Braces for Restructuring. Financial Times, October 14, 1996, p. 4.

⁶ Clifford, Mark L. Meltdown in Seoul. Business Week, February 10, 1997, p. 50-51.

President Kim's initial bill, which was passed by his ruling New Korea Party in a predawn, secret session on December 26, 1996, without the presence of opposition parties, gave employers greater rights to lay-off or terminate workers. At the same time, the bill failed to provide workers with greater freedom to organize, a commitment that the government had made to the OECD. The compromise version, by postponing management's right to lay off workers by two years and by maintaining government's capacity to severely restrict union activity, made neither side -- big business or organized labor -- happy. President Kim's retreat prompted one Korean government official to comment that he "appears to have lost courage in pushing economic reforms."⁷

Implications for U.S. Economic Interests

While fundamental economic reforms are likely to be implemented over time to bolster South Korea's declining international competitiveness, the recent, dramatic drop in President Kim's popularity and the impending presidential election make further reforms problematic this year. This development, in turn, has varied implications for U.S.-South Korean economic relations in the near-term. Some reforms that have facilitated significant increases in U.S. exports and investment should not be affected. However, little or no progress is likely in liberalizing some sectors of Korea's economy that are of considerable interest to U.S. business, and backsliding in other areas is also possible. As a result, 1997, on balance, may witness an increase in U.S.-South Korean trade tensions.⁸

Due to tariff and non-tariff barrier reforms implemented over the past 15 years, the Korean market has become more accessible to U.S. and other foreign exporters and investors. Many of the reforms have eliminated, reduced, or redressed some of Korea's most formidable barriers that had been erected at the border to keep the Korean market for Korean producers. In the process, U.S. exports to South Korea have recorded steady increases commensurate with the rapid rise of the Korean economy over the past ten years. In 1996, U.S. exports totalled \$26.5 billion, making Korea the fifth largest market for U.S. exports. The United States now exports more to Korea than it does to France and Italy combined and runs a trade surplus (in 1996) in excess of \$3 billion.

The bulk of U.S. exports consist of capital goods and raw materials that are used by Korean *chaebol* to modernize factories and build products such as cars, ships, and electronic goods for exports. In addition, Korea is the third largest export market for U.S. agricultural products, mostly bulk commodities such as feed grains, cotton, and wheat. As long as the Korean economy continues to grow at a healthy pace, the Korean market should continue to absorb growing volumes of these kinds of U.S. products.

The story on the investment side, however, is somewhat different. The total stock of U.S. foreign direct investment is less than \$5 billion, a relatively low level compared to U.S. investment position in other Asian countries. While U.S. foreign direct investment flows to Korea increased substantially in 1995 and 1996, due in part to a liberalizing

⁷ Burton, John. S. Korean Leader Gives Way On Job Reform. Financial Times, March 1, 1997, p. 6.

⁸ A number of U.S. political and security concerns, however, could militate against strong U.S. market opening pressures. See Sutter, Robert G. Korea: U.S.-South Korean Issues. Congressional Research Service, Issue Brief 96005 [continuously updated].

foreign investment regime, major sustained increases are unlikely to occur in the absence of basic reforms that address Korea's "high cost" environment. The same considerations that are deterring foreign companies to invest in Korea -- high costs for land, labor, and capital -- are also the same factors driving Korean *chaebol* to invest abroad.

The areas where little or no progress can be expected this year in opening Korea's market to U.S. exports are ones where U.S. products compete directly with Korean products or services and where market reforms have lagged other sectors or industries. On the product side, one would not expect, for example, additional reforms to be forthcoming that would accelerate U.S. sales of pharmaceuticals, automobiles, or telecommunications. These are all sectors that still provide Korean producers with considerable protection from foreign competition. And on the services side, one would not expect any accelerated movement on financial sector reform this year, an area where Korean banks, insurance companies, and securities firms are relatively inefficient and protected.

More ominous is Korea's current attempt to address its current account deficit by promoting a frugality campaign. Korean businesses and citizen's groups are currently sponsoring boycotts of foreign products in response to President Kim's call last year to end "luxurious consumption," and there are signs that the government may be indirectly hampering imports of consumer durables. This development has the potential for reversing gains the Korean government recently has made in shedding its image as a "one-way" free trader.⁹

Beyond 1997 and the December presidential election, a major unknown is whether the next Korean President will embrace reformist economic policies and push hard to dismantle the various instruments of state control over the economy. Procrastination is likely only to hurt the Korean economy and U.S.-South Korean economic ties.

⁹ Lee, Charles S. Buy Korean: Imports Get the Blame, Again. *Far Eastern Economic Review*, March 6, 1997, p. 58.

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