## LEADING KOREAN ECONOMIC INDICATORS

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<tbody>
<tr>
<td><strong>Growth Rate of GDP</strong></td>
<td>9.1</td>
<td>5.1</td>
<td>5.8</td>
<td>8.6</td>
<td>8.9</td>
<td>7.1</td>
<td>5.5</td>
<td>-5.4</td>
</tr>
<tr>
<td>(Annual Change at 1990</td>
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<tr>
<td>Constant Prices)</td>
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<tr>
<td><strong>GDP</strong></td>
<td>294.1</td>
<td>307.9</td>
<td>332.8</td>
<td>380.7</td>
<td>456.5</td>
<td>484.4</td>
<td>442.6</td>
<td>304.3</td>
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<tr>
<td>(Current US$ billions)</td>
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<tr>
<td><strong>GNP Per Capita</strong></td>
<td>6,757</td>
<td>6,958</td>
<td>7,484</td>
<td>8,467</td>
<td>10,037</td>
<td>10,543</td>
<td>9,511</td>
<td>6,750</td>
</tr>
<tr>
<td>(Current US$)</td>
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<td></td>
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<tr>
<td><strong>Current Account</strong></td>
<td>-8.3</td>
<td>-3.9</td>
<td>1.0</td>
<td>-3.9</td>
<td>-8.5</td>
<td>-23.0</td>
<td>-8.2</td>
<td>40.0</td>
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<tr>
<td>(US$ billion, BOP basis)</td>
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<tr>
<td><strong>Consumer Prices</strong></td>
<td>9.3</td>
<td>6.3</td>
<td>4.8</td>
<td>6.2</td>
<td>4.5</td>
<td>4.9</td>
<td>4.5</td>
<td>7.5</td>
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<tr>
<td>(Annual Change at 1990</td>
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<tr>
<td><strong>Unemployment Rate</strong></td>
<td>2.3</td>
<td>2.4</td>
<td>2.8</td>
<td>2.4</td>
<td>2.0</td>
<td>2.0</td>
<td>2.6</td>
<td>6.8</td>
</tr>
<tr>
<td><strong>Foreign Direct Investment</strong></td>
<td>1,395</td>
<td>895</td>
<td>1,044</td>
<td>1,317</td>
<td>1,941</td>
<td>3,203</td>
<td>6,971</td>
<td>8,852</td>
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<tr>
<td>(US$ Billion)</td>
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<tr>
<td><strong>Stock Price Index</strong></td>
<td>657.1</td>
<td>587.1</td>
<td>728.2</td>
<td>965.7</td>
<td>934.9</td>
<td>833.4</td>
<td>654.5</td>
<td>409.0</td>
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<tr>
<td>(Average)</td>
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<tr>
<td><strong>Exchange Rate</strong></td>
<td>733.8</td>
<td>780.8</td>
<td>802.7</td>
<td>803.6</td>
<td>771.0</td>
<td>804.8</td>
<td>951.1</td>
<td>1,398.7</td>
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<tr>
<td>(Average US$)</td>
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Source: Bank of Korea.
March 1999

Dear Reader:

This volume contains articles written by respected observers of Korea in the United States, Korea, and Japan which address the principal issues impacting Korea’s economy and its external economic relations in the wake of the financial crisis which struck Korea in the fall of 1997. After providing an overview of Korean political and economic developments in 1998 and the outlook for 1999 and beyond in Part I, Part II focuses on Korea’s response to the economic crisis at the sectoral level. Section III focuses on the business environment for foreign investors, Part IV focuses on Korea’s external economic relations, while the final section examines relations with North Korea.

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We at the Korea Economic Institute of America remain dedicated to objective, informative analysis and welcome your comments on this and our other publications. We seek to expand contacts with academic, business, and public affairs groups across the country, and would be pleased to entertain suggestions for joint programs.

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OVERVIEW

SOUTH KOREA IN 1998

by Peter M. Beck

Introduction

If 1997 was characterized by unprecedented political and economic change, 1998 was the year of challenge and response. After Korea teetered on the brink of financial meltdown at the end of 1997, President-elect Kim Dae-jung began to lead South Korea’s response to the economic crisis from the moment he was elected in December 1997. When financier George Soros visited Seoul in early January 1998, he met with President-elect Kim Dae-jung. He did not meet with then-President Kim Young-sam. Kim’s inauguration two months later represented the first peaceful transfer of power from the ruling party to the opposition in Korean history.

By the end of 1998, there were growing signs that the economy was finally starting to turn the corner. President Kim at times wielded a big stick in pressing banks and the chaebol to restructure. Revolutionary in the eyes of some, Kim’s reforms have not been without critics. Unfortunately, South Korea’s (hereafter Korea’s) political parties were not up to the challenge of addressing the economic crisis, favoring confrontation over compromise and cooperation. In spite of the political turmoil, Korea achieved economic stabilization and began to undertake a comprehensive restructuring drive. The results should begin to unfold in the coming months.

The foreign policy issues facing Korea were no less daunting. As always, chief among them was North Korea. The North failed to respond positively on a governmental level to Kim’s policy of engagement, but private exchanges flourished. Revelations in August about a possible underground nuclear project north of Pyongyang, and the North’s three-stage missile test two weeks later were vivid reminders of the ever present threat posed by North Korea. Kim had markedly better success with the rest of the world, where he is regarded as a strong advocate of democracy and economic reform. In sum, much was accomplished in 1998, but much remains to be done in the face of considerable uncertainty.

Korea Responds to the Economic Crisis

The first task confronting Kim Dae-jung upon winning the presidential election was stabilizing Korea’s foreign financial flows. As a result of a sudden loss of investor confidence, there was a massive outflow of funds by foreign lenders and investors in late 1997; Korea’s foreign exchange reserves fell dangerously low, and the won approached 2000 to the dollar at the end of 1997. Preventing national bankruptcy was paramount. Kim declared his commitment to upholding the conditions of Korea’s $58 billion stand-by agreement signed with the IMF in early December 1997, the most controversial of which was maintaining high interest rates. Koreans referred to the sudden economic downturn as the “IMF Crisis,” but there was a common understanding that Korea’s fundamental problems were home-grown. The turning point came in late January 1998, when one-quarter of Korea’s short-term foreign debts were rescheduled by creditor banks. Kim pledged to fully realize democracy and a market economy in Korea and undertook a bold program of financial and corporate restructuring.

Financial Sector Restructuring

Korea’s financial system proved inadequate for withstanding the harsh economic winds that blew through the country in the fall of 1997. Korea’s banks were essentially a tool of the government’s financial policy, allocating loans based on government directive rather than independent financial assessments. Consequently, their level of non-performing loans rose dramatically as large companies began to go bankrupt in 1997. According to the Korea Institute of Finance, Korea’s banks were holding an estimated $116 billion in bad loans as of June 1998.

In response, the government has undertaken a bold financial restructuring policy, forcing five banks to close, two to be nationalized and nine others to merge. Over 20 merchant banks were also either closed or had their business operations suspended. The merchant banks had been engaged in reckless lending practices. The government allocated a total of 64 trillion won (over $38 billion) to rescue the banking sector in 1998, and more may well be needed. The brightest news for the banking sector came on the last day of 1998 when GE Capital and Newbridge Capital announced the purchase of one of the nationalized banks, Korea First Bank. The sale represents not only an infusion of badly needed capital, but also the opportunity for Western banking practices to fully take hold in Korea.

Corporate Restructuring

The Kim Administration has stressed the importance of corporate restructuring, especially by the nation’s conglomerates (or chaebol), as one of the keys to Korea’s economic recovery. The largely family-run conglomerates had come to dominate the economy through the preferential treatment given by the government. Chaebol reform had been attempted by successive governments since the early 1980s, but had failed each time. It took the type of crisis which arrived in the fall of 1997 to give Kim Dae-jung the leverage necessary to press for sweeping change. Kim has pushed the chaebol to establish transparency and accountability as well as lower their dangerously high debt levels.

As the year progressed, the government began increasingly to pressure the top five chaebol to swap and merge subsidiaries, which became known as “big deals.” After much foot-dragging, the top five announced the first round of major business swaps at a meeting with Kim on December 7. Daewoo and Samsung pledged to swap their electronics and auto units, respectively, while LG and Hyundai agreed in principle to merge their semiconductor operations. Moreover, the top five chaebol promised to cut their total subsidiaries to less than half of the current 264, lower their debt equity ratios to 200%, submit consolidated financial statements audited by international accounting firms, and eliminate cross-debt guarantees by the year 2000.

However, the agreements between the top five were long on pledges and short on details. For example, it is unclear how many chaebol subsidiaries will be merged with others as opposed to shut down or sold off. The two “big deals” also got off to a rocky start, with at least two of the groups threatening to call the whole deal off, and labor unions threatening to strike. Many foreign observers have grown impatient with the pace of restructuring. However, several Korean analysts, including Park Yoon-shik of George Washington University, caution that restructuring takes time. In the case of Chrysler Motors, restructuring took over three years.

It is also important to distinguish between the top five chaebol


and the rest of the chaebol. Several of the mid-ranked groups have undertaken sweeping restructuring drives. For example, the Ssangyong Group (number six) and Hyosung (number 16) have slimmed down dramatically.

The chaebol are also coming under increased pressure from new and revitalized government agencies and civic groups. In the public sphere, the newly-created Financial Supervisory Commission (FSC) serves as an effective monitor and implementer of Korea’s restructuring policies. The Fair Trade Commission has also been increasingly active in enforcing the anti-monopoly law against the chaebol, assessing violators with substantial fines. Korea’s civil society has also became more active. The People’s Solidarity for Participatory Democracy, led by maverick Jang Ha-sung of Korea University, has filed class action suits against several chaebol on behalf of minority shareholders, charging the companies with mismanagement and abuse of power. A more activist government and civil society will help lead the chaebol to become more transparent, accountable, and profit-oriented.

**Promoting Foreign Direct Investment**

After shunning foreign direct investment (FDI) for decades to keep the economy in Korean hands, President Kim Dae-jung identified FDI as one of the keys to strengthening the financial and corporate sectors and helping Korea overcome its economic difficulties. In the process, he has changed the public’s perception from viewing FDI as a threat to a savior. FDI plunged in the wake of the crisis, but began to rebound in the second half of the year and exploded during the last two months. Preliminary figures released by the Ministry of Finance and Economy indicate that FDI rose to $8.8 billion in 1998 on a project basis, a rise of 27 percent over the previous year. Volvo, Wal-Mart, Fairchild Semiconductor, and Enron International are a few of the companies announcing investments exceeding $100 million during 1998.

Of the steps Kim has taken to improve the investment climate in Korea, the most important has been the passage of the Foreign Investment Promotion Act in September 1998. The act includes sweeping changes in the government’s approach to foreign investment at every stage of the process by streamlining investment procedures, making the approval process more transparent, and increasing the incentives offered to investors. The new law has sent a clear message to foreign investors that Korea is ready to do business. However, the FDI total for the year fell short of the government’s expectations. A number of obstacles to investment remain, including the lack of corporate transparency, and disparities in asset valuations. The sale of Korea First Bank on December 31 to Newbridge Capital should go a long way to erasing the perception among many foreign investors that Korea was not yet ready to part with its premier companies.

**Has the Recovery Begun?**

After posting in 1998 its worst economic growth figures in over 30 years (a contraction of over five percent), signs of a recovery began to emerge towards the end of the year. The exchange rate stabilized at 1200; interest rates fell below even pre-crisis levels into the single digits; and usable foreign exchange reserves approached $50 billion at the end of 1998 after falling to $9 billion in December 1997. Korea also ran a current account surplus of nearly $40 billion, largely due to falling imports. Korea also received short and long-term votes of confidence from investors. The stock market rebounded, rising 98% during the year in dollar terms, making the Kospi the highest flyer in the world last year. In the real economy, industrial output began to recover in the fourth quarter, led by semiconductors and autos. Industrial output grew encouragingly by 4.7% in December (year to year), the highest increase since the crisis began. Consequently, many analysts are forecasting positive growth for 1999, the Bank of Korea being one of the most optimistic with a forecast in January of 3.2%. The IMF has forecast growth to be in the 1–2% range. Credit rating agencies have also begun to raise Korea’s corporate and sovereign ratings; both climbed back to “investment grade” towards the end of the year.

Nevertheless, there are still several areas of concern. After taking a momentary dip, unemployment began to rise again toward the end of the year, approaching

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8%, a nearly four-fold increase from pre-crisis levels. Long the engine of growth, exports fell slightly in value terms for the first time since the 1950s. Korea was unable to take advantage of the devalued won, largely because its neighbors were also in recession. In order to stimulate the economy, the government also allowed the budget deficit to widen, currently holding at 5% of GDP and expected to rise higher. In addition to falling revenues, the 1999 budget allocation for restructuring was increased 116%. The social safety net has also expanded considerably, with expenditures for unemployment insurance rising 45%. This year will clearly be brighter than last year for Korea, but most analysts expect that it will take several more years for the economy to recover fully.7

The Politics of Confrontation

President Kim Dae-jung’s public approval ratings remained high during 1998, generally in the 60–70 percent range. Following the example of his American counterpart, Kim held a series of town hall-style forums to build public support for his initiatives. Despite predictions to the contrary, Kim’s ability to appeal to a broad spectrum of the electorate has resulted in broad support for his policies and little or no social unrest in the wake of the economic crisis. However, critics have accused Kim of having a heavy-handed leadership style. In spite of his popularity, like Clinton, Kim has not been able to translate his public support into success in the legislature.

Upon taking office, President Kim immediately got a taste of the political challenges he would face. In what must be one of the shortest political honeymoons ever, within hours of his inauguration, the opposition-controlled National Assembly blocked his appointment of Kim Jong-pil as prime minister.8 This set the tone for relations between the ruling coalition of the National Congress for New Politics (NCNP)-United Liberal Democrats (ULD) and the opposition Grand National Party (GNP). Kim came into office with his party occupying the second largest number of seats in the National Assembly. Even the alliance with Kim Jong-pil’s ULD fell well short of the GNP’s 163-seat majority in the 299-seat legislature. Although the ruling coalition was gradually able to craft a slim majority of 158 seats by attracting independents and peeling away members of the GNP, the National Assembly remained deadlocked throughout the year. An alleged fund-raising scandal involving GNP leader Lee Hoi-chang’s presidential campaign aides and the arrest of his brother and two associates on charges of plotting a border shootout with the North during the election campaign heightened the rancor between the parties and led the GNP to adopt a siege mentality. Over 350 bills were in legislative limbo during the year (including several vital reform bills), forcing the ruling coalition to resort to unilaterally passing the most pressing bills like the budget at the end of 1998.9

Although much scorn has been heaped on former President Kim Young-sam for his handling of the economic crisis, one of his lasting achievements was establishing the political neutrality of the military. Kim’s successor quickly learned that one of his central tasks will be establishing the political neutrality of the security apparatus. Shortly after taking office, the Agency for National Security Planning (NSP) came under intense scrutiny for its involvement in a smear campaign against Kim Dae-jung during the presidential election. The North Wind incident (“wind” signifies scandal as does “gate” in the United States), resulted in the arrest of several NSP officials, including the director of the NSP, Kwon Young-hae, who received a five-year prison sentence for masterminding the plot.10 A second incident was brought to light at the end of the year when the opposition Grand National Party broke into the office used by the NSP at the National Assembly.

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8. Kime Jong-pil was subsequently appointed “acting prime minister” by President Kim.


The fact that the incidents came to light and the responsible parties were punished should send a clear message to agents that political intervention does not pay. It was more than a little ironic to have former military government-turned opposition leaders claim that the agency was engaging in torture and illegal wire tapping. As a result, Kim Dae-jung launched an investigation to examine the opposition’s claims. Korea’s political leaders are still adjusting to roles they have never played before. Yonsei University political scientist Moon Chung-in refers to this as “transitional psychological trauma.”

One incident helped highlight the progress Korea has made under Kim Dae-jung. The conservative *Monthly Choson* accused presidential advisor and Korea University political scientist Choi Jang-jip of being pro-North Korean for writing that the Korean War had been a “historic” event. Conservatives argued that this was tantamount to praising the North’s attack on the South and demanded that Choi resign. When President Kim Young-sam had faced a similar situation with his Unification Minister (Han Wan-sang) in 1993, Han was forced to resign. This time, the court ordered the *Monthly Choson* to recall all copies of the issue mentioning Choi, and Kim retained Choi as his advisor. Claiming that his views had been taken out of context and his reputation damaged, Choi filed a suit but reached an out-of-court settlement with the magazine.

In the fall, Kim Dae-jung launched an anti-corruption drive targeting top officials and politicians as well as lower echelon bureaucrats. By the end of the year dozens of high-level officials and lawmakers as well as 10,000 working-level bureaucrats had been punished. The opposition claimed that it was being unfairly targeted for punishment. Since each of Korea’s previous presidents has attempted to clean up the government, only time will tell if Kim’s efforts are successful. To a large extent, success will depend on the extent to which the targets perceive the reforms to be fair and unbiased rather than tools of personal or political retribution.

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**Can South Korea Engage the North?**

In contrast to his predecessor, Kim Dae-jung adopted a consistent policy of engagement toward North Korea by separating political and economic issues. Kim has stuck by his “Sunshine Policy” in spite of provocative acts by the North, including three incursions. The North rebuffed the South’s overtures at the governmental level, but, thanks to Kim’s more flexible approach, private exchanges flourished, with Hyundai providing the source of most of the sunshine in 1998. After leading two colorful (not to mention smelly) cattle drives across the DMZ, Hyundai honorary chairman Chung Ju-yung inaugurated sightseeing trips to the famed Kumgang (Diamond) Mountain in November. Even more surprisingly, he was able to meet with the North’s reclusive Kim Jong-il, signaling that the North may be ready to have South Korea’s companies play a more active role in the economy. A group of the South’s leading musicians and performers went to Pyongyang in November for the first-ever joint concert. Even excluding the 10,000 tourists who visited Kumgang Mountain, 3,200 South Koreans visited the North in 1998, more than during the previous nine years combined.

North Korea remained one of the most opaque and obstinate countries in the world, but discernable change did take place, though the implications were often difficult to interpret. Kim Jong-il retained his titles of Chairman of the National Defense Commission and the Worker’s Party but he did not become the president of North Korea, the third and most important title held by his father. The position was conferred eternally on his Father, Kim Il-sung; in the amended constitution ratified in September.

The North also actively engaged international organizations. The most comprehensive nutritional survey to date was conducted by the United Nations Development Program in the fall of 1998. The survey confirmed that the hunger in North Korea is chronic and widespread. The impact of stunted mental and physical

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development in the country’s children will be felt for decades to come.\textsuperscript{13} Humanitarian assistance continued, but donor fatigue and frustration with the North was becoming apparent, as evidenced by the departure of \textit{Medecins sans Frontieres}. The challenge for policymakers is to find ways to provide humanitarian assistance while gaining Pyongyang’s compliance in halting its missile and nuclear programs. The South continues to urge the North to accept family exchanges, but even this modest but emotionally compelling proposal has been shunned.

The Four Party Talks fared little better than bilateral relations. About the only thing North Korea, South Korea, the United States and China could agree on was to continue talking. If submarine, frogman and speedboat incursions were not enough, the North further raised tensions on the peninsula and tried the patience of many policymakers in Washington and Tokyo as suspicions grew in August that the North was undertaking a clandestine nuclear program at Kumchang-ri, 100 miles north of Pyongyang. This was followed two weeks later by the North’s first three-stage missile test over Japan (the North called it an “artificial satellite launch” to play revolutionary tunes in outer space). Congress has threatened to cut off funding to the Korean Peninsula Energy Development Organization (KEDO) unless the Clinton Administration has reached agreement with North Korea on the means for satisfying U.S. concerns regarding the suspected underground site and unless the United States is making significant progress in negotiations with North Korea on reducing and eliminating the North Korean ballistic missile threat, including its ballistic missile exports.

Much to Seoul’s consternation, many analysts in Washington have concluded that a failure to do so could place the United States and North Korea on a collision course in 1999.\textsuperscript{14} President Clinton appointed former Defense Secretary William Perry to undertake a thorough review of U.S. policy toward North Korea at the end of 1998 precisely to avoid such an outcome. One proposal gaining popularity is a “package deal” with the North whereby the North is given a variety of “carrots” (such as the lifting of economic sanctions) in exchange for halting its nuclear and long range missile programs and establishing a dialogue with the South.

Managing Korea’s Foreign Relations

President Kim sought to place Korea’s foreign relations on a strong footing by visiting Korea’s most important partners, the United States in June, Japan in October, and China in November. Kim met with President Clinton in Washington in June and again in November in Seoul to coordinate policy toward North Korea and to discuss outstanding trade issues. With respect to North Korea, the roles of the two governments had completely reversed. Until Kim became president it was the United States which sought to engage the North and the South that was urging restraint. Now it was Kim urging the Clinton Administration to maintain a conciliatory posture toward the North as American nuclear and missile concerns escalated.

On trade, bilateral conflict with the United States over autos was averted, but a number of sectors remain unresolved, including steel, beef, pharmaceuticals and motion pictures.\textsuperscript{15} In light of Korea’s burgeoning trade surplus, action will have to be taken sooner rather than later. The two governments are currently negotiating an ambitious bilateral investment treaty, but there are growing signs that the talks have gotten bogged down.

During Kim’s visit to Japan in October, he received the strongest apology yet from the Japanese government for colonial era behavior and in exchange


\textsuperscript{15} For a review of outstanding trade issues between the United States and Korea, see \textit{Foreign Trade Barriers 1998}, United States Trade Representative (USTR), 1998, Washington, DC., pp.253–273.
decided to gradually open Korea’s market to Japanese culture. In China, Presidents Kim and Jiang Zemin agreed to 34 cooperative projects in order to deepen ties between the two countries.

The Outlook

After Korea veered toward the edge of economic catastrophe, President Kim Dae-jung has laid the foundation for Korea’s economic recovery. Kim can point to several important achievements during his first year in office, including stabilizing the economy, implementing economic restructuring in the face of strong resistance from vested interests, and attempting to engage North Korea. Yet, much remains to be done and many questions remain.

The first set of questions pertains to Korea’s economic recovery. The immediate question on the minds of most: “When will Korea’s economy resume positive growth?” is actually not the right question to ask. A more pertinent question is this: To what extent are the chaebol and banks committed to restructuring and lowering their debts and non-performing loans so that Korea is not so vulnerable to external economic shocks in the future? Most of the difficult questions, such as how to reduce chaebol overlapping businesses and excess capacity, remain. The old way of doing business will simply no longer work. A more probing question would be: How can Korea regain its international competitiveness? This will be one of the greatest challenges for Korea’s leaders. Successful restructuring will also largely depend on addressing the concerns of organized labor. Labor was not the volatile issue many feared it would be in 1998, but the chaebol have been constrained in their ability to lay off workers. The Tripartite Commission, composed of government, business and labor leaders, is an important first step.

Korea’s recovery is also conditioned by external economic conditions beyond Korea’s control. Korea’s economic health is directly tied to the health of the international economic system. A recession in the United States or China could deal a serious blow to Korea’s recovery. One of the biggest concerns is the potential for China to devalue the yuan. Moreover, a depreciation of the Japanese yen could have a similar impact as Korea and Japan compete head-to-head in key sectors.

Korean democracy remains strong and vibrant. However, there are still a number of domestic political uncertainties. When Kim Dae-jung and Kim Jong-pil joined forces on the eve of the 1997 presidential election, “DJP” (the nickname created by combining the initials of their first names) made a pact to convert Korea from a presidential to a parliamentary or hybrid system, such as France’s premier-presidential system, by the year 2000. Such a change is unlikely for several reasons. First, President Kim has commented on several occasions that Korea’s economic crisis makes a change in the form of government at present inappropriate. Moreover, public opinion polls show that Koreans still strongly support a presidential form of government, making the two-thirds vote required in the National Assembly and the national referendum required for constitutional changes unlikely. Nevertheless, Kim Jong-pil must ultimately decide whether to remain part of the ruling coalition or search for another coalition partner. This poses one of Kim Dae-jung’s greatest challenges in the National Assembly. The Grand National Party’s position appears even more precarious as several groups have threatened to break away. A major political realignment is a real possibility.

In addition, there are increasing calls to revise Korea’s electoral laws. One measure likely to pass before the National Assembly elections are held in April of 2000 is to trim the number of National Assembly seats from 299 to as few as 200. Given the seemingly unending deadlock and confrontation between the parties, the public is starting to conclude that less may actually be more. A secondary but almost equally important issue pertains to the size of electoral districts. At present, Korea has a mixed single member district (SMD) and proportional representation system. There are currently 253 SMDs and 46 national constituency seats. One proposal is to adopt a German-style system which would give greater weight to multi-member districts and proportional representation. Proponents argue that this would help ameliorate Korea’s chronic regionalism by allowing parties to win seats in each other’s strongholds. However, given that over 90% of voters in Kim Dae-jung’s home province voted for him and his party’s candidates, a second party would win few seats there. Moreover, such a system would actually lead to even greater fractionalization of Korean politics by making it easier for very small parties to win
seats, the most extreme case being Israel.\textsuperscript{16} The challenge for Korea’s politicians is not electoral engineering, rather it is building policy-based parties with nationwide constituencies which are capable of crafting legislation in a responsible manner.

Finally, Korea faces security challenges, with North Korea heading the list. The key for South Korea and the United States is to convince North Korea that the fruits of engagement outweigh the benefits of confrontation. This requires policy makers to strike the right balance between offering carrots and sticks. Close coordination between South Korea and the United States will be more important than ever.

The challenges facing Korea are great, but the Korean people’s ability to overcome them should never be underestimated. 1998 was a hopeful beginning.

\textit{Mr. Beck is the Director of Research and Academic Affairs at the Korea Economic Institute of America in Washington, DC.}

\textsuperscript{16} For a cogent analysis of the electoral reforms currently under consideration, see Kim, HeeMin, 1998. “Rational Actors, Institutional Choices and Democracy in Korea,” paper presented at the annual meeting of the American Political Science Association, Boston.
THE KOREAN ECONOMY IN 1998: RECENT TRENDS AND SHORT TERM OUTLOOK

by Dr. Sangdal Shim

Current Macroeconomic Trends

Since the onset of the financial crisis, the Korean government has resolved the liquidity problem and has taken important steps to cure structural weaknesses, enhance transparency, and fully liberalize the trade and investment regime. In the meantime, an institutional framework to promote economic restructuring has been established in both the financial and corporate sectors.

The Financial Sector

Until September 1997, the exchange rate was maintained at around 900 won to the dollar. However, with the sudden outflow of foreign capital, the value of the Korean currency fell by more than 50%, plummeting to about 1960 won to the dollar by the end of December. The Korean government actively sought to stabilize the foreign exchange market, and in July 1998 the exchange rate at one point reached 1200 won to the dollar. Nonetheless, as economic instabilities in Japan and Southeast Asia continued, the currency stabilized between 1350 and 1400 won to the dollar in September. It further rebounded to below 1250 by the end of the year as the result of a sustained current balance surplus and the rapid appreciation of the Japanese yen.

This exchange rate stability can be attributed to the expansion of foreign currency reserves and the progress of financial rehabilitation. Korea has improved its market conditions assisted by the inflow of funds from international financial organizations such as the IMF, the shift of the current account balance to a substantial surplus, the successful conclusion of the restructuring of $21.8 billion of short-term bank debt, and the issuance of $4 billion worth of global sovereign bonds, which were well received by the international capital market.

As inflows of foreign exchange have improved, foreign reserves have greatly increased. By the end of November 1998, usable foreign reserves (which had plunged to just $7.3 billion at the end of November 1997) reached $46.5 billion, surpassing the level of reserves preceding the financial crisis.

Figure 1: Exchange Rate Fluctuations (won/US dollar)

![Exchange Rate Fluctuations Graph]
Table 1: Foreign Currency Reserve Balances  
(US$ billions at the end of the period)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Foreign Currency Reserves</td>
<td>33.2</td>
<td>33.3</td>
<td>30.5</td>
</tr>
<tr>
<td>Usable Reserves</td>
<td>29.4</td>
<td>25.3</td>
<td>22.3</td>
</tr>
</tbody>
</table>

Market interest rates, which were maintained at a 13–14% pre-crisis level, were increased following the agreement made with the IMF to stabilize the foreign exchange market. In addition, the increased demand for funds by corporations at the end of 1997 pushed interest rates up to nearly 40% at one point.  

As the foreign exchange market stabilized, the IMF agreed to lower interest rates, and the Bank of Korea began to lower the RP (repurchase agreement) interest rate. Interest rates continued to fall as corporate demand for funds decreased due to reduced investments by the private sector. As of November 1998, the overnight call rate was at 7.2%, and the yield on 3-year corporate bonds had fallen to 9.6%, both of which were lower than their pre-crisis levels.

A credit crunch remains a problem, as financial institutions take an extremely conservative approach to lending in an effort to meet the Bank of International Settlements (BIS) capital adequacy ratio of 8%. As there is still uncertainty (i.e. default risk) among business companies, financial institutions also hesitate to extend loans to them. During the period between January to November of 1998, bank loans decreased by 12.9 trillion won, owing to a reduction of 14.4 trillion won in loans on trust accounts. Businesses faced with great difficulties in borrowing from banks are increasingly looking to alternative financing channels, such as discounted commercial papers (CPs) and/or issuance of corporate bonds.
Table 2: Foreign Exchange Rates and Interest Rates
(average won/US$, %)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Exchange Rate (won/$)</td>
<td>805</td>
<td>899</td>
</tr>
<tr>
<td>3rd Qtr</td>
<td>4th Qtr</td>
<td>Year Avg.</td>
</tr>
<tr>
<td>Call Rates (1 day)</td>
<td>12.5</td>
<td>12.3</td>
</tr>
<tr>
<td>Corporate Bond Yields (3 yrs)</td>
<td>11.9</td>
<td>12.1</td>
</tr>
</tbody>
</table>

Table 3: Bank Loans and Corporate Bonds Issued
(change in billion won)

<table>
<thead>
<tr>
<th>1998</th>
<th>1997</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Loans</td>
<td>5.2</td>
</tr>
<tr>
<td>deposit accounts</td>
<td>7.9</td>
</tr>
<tr>
<td>trust accounts</td>
<td>-2.7</td>
</tr>
<tr>
<td>Discounts of CPs</td>
<td>19.6</td>
</tr>
<tr>
<td>Corporate Bonds (net)</td>
<td>5.3</td>
</tr>
</tbody>
</table>

The Real Economy

The rate of growth of production decreased from a –7.8% in the first quarter to –11.6% in the second quarter (compared to the same period the previous year) as domestic demand remained very much depressed. Consumption and investment, as well as exports, have slowed since May 1998. This trend of declining production continued late into the year, but the rates have eased as production growth recorded –8.2% in the third quarter and –8.0% in November 1998.

The average operating ratios for the manufacturing sector continued to decline, reaching a historically low level of 62.9% in August. But as the automobile and semiconductor industries are expanding owing to good export conditions, operating ratios slightly increased to 70.0% in September, and 67.6% in October. Inventory growth, which has been decreasing continuously since February, recorded –13.7% in October.

The GDP growth rate was –6.8% in the third quarter of 1998, unchanged from the second quarter. Total consumption growth was –11.8% in the third quarter, which is a slowdown in the negative rate compared to –12.9% in the previous quarter as the shrinking of household spending eased. As machinery investment in the corporate sector is still extremely sluggish, fixed investment also continued to decline –28.3% in the third quarter. But the increasing export rate slowed from 14.4% in the second quarter to 8.9% in the third quarter.

Corporate bankruptcies continued to occur at a high rate until August due to decreased consumption and investment as well as the shortage of funds. Since the end of 1997, when the ratio of dishonored bills reached its peak due to a sudden wave of bankruptcies among corporations and financial institutions, it has been on a declining trend, recording 0.41% in the third quarter, and 0.25% in October. Although corporate bankruptcies are also on a downward trend, the number of small and medium-sized firm bankruptcies is still high, as they are less able to withstand the current credit crunch.

Aided by the sudden decrease in imports, the current balance is showing a large surplus, recording a $34.1 billion surplus in 1998 through October. However, as exports have decreased due to the depressed demand of the Southeast Asian markets since May, the trade balance surplus is on a declining trend.
Under the present circumstances, stagnating exports and decreasing imports are leading the Korean economy to a contracted equilibrium.

As the foreign exchange rate has stabilized and the international prices of raw materials have decreased, import prices, which have been surging significantly since the end of 1997 and the beginning of 1998, also stabilized. Stagnating domestic demand and decreasing nominal wages are contributing to the downward stabilization of consumer prices. Consumer price inflation decreased from 8.6% in the first half of 1998 to 7.0% in the third quarter, and 6.8% in November. The increasing number of bankrupt firms and layoffs pushed the rate of unemployment up from 2.6% in the third quarter of 1997 to 7.6% in July 1998, leaving an estimated 1.65 million people without jobs. As the unemployment compensation measures continue to strengthen the social safety net, the rate of unemployment decreased to 7.1% by October. Wages have also been declining due to the decreased rate of operations in the manufacturing sector and reduced overtime work. In the third quarter, wage growth in manufacturing was −10.1% compared to the same period of the previous year.

**Macroeconomic Forecast for 1999**

**Domestic Economic Trends**

**Business Conditions:** Industrial production is declining at a noticeably decelerating pace, although there remains a severe imbalance among sectors. In addi-
the coincident index has been rising since September 1998, indicating that the economy is near the bottom.

### Consumption and Investment:
Both consumption and equipment investment show signs of slight recovery, with reduced uncertainty and falling interest and Won/Dollar exchange rates. Quarterly growth rates of wholesale and retail trade indices (seasonally adjusted) and equipment investment have been rising since the third quarter. However, construction investment and related indicators continue to decline.

### Balance of Payments:
A large current account surplus is exhibited as export growth turns positive and the fall of import growth slows. Terms of trade are improving as declining import prices more than offset that of export prices.

### Prices:
As the exchange rate is further stabilized and domestic demand remains extremely low, prices are stabilized. Falling international prices of raw materials, including crude oil, also contribute to domestic price stabilization.

### Table 5: Gross Domestic Product
(Real, year-on-year basis, %)

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1st half</td>
<td>3rd Qtr</td>
</tr>
<tr>
<td>GDP</td>
<td>6.2</td>
<td>6.1</td>
</tr>
<tr>
<td>Consumption</td>
<td>4.7</td>
<td>5.1</td>
</tr>
<tr>
<td>Private</td>
<td>4.5</td>
<td>4.8</td>
</tr>
<tr>
<td>Government</td>
<td>6.0</td>
<td>7.2</td>
</tr>
<tr>
<td>Fixed Investment</td>
<td>0.3</td>
<td>-3.7</td>
</tr>
<tr>
<td>Machinery</td>
<td>-1.0</td>
<td>-12.7</td>
</tr>
<tr>
<td>Construction</td>
<td>1.3</td>
<td>3.8</td>
</tr>
<tr>
<td>Total Exports</td>
<td>20.4</td>
<td>33.2</td>
</tr>
<tr>
<td>Total Imports</td>
<td>7.7</td>
<td>4.7</td>
</tr>
</tbody>
</table>

### Table 6: Bills Dishonored and Corporate Bankruptcies
(% of bills dishonored, number of firms)

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3rd Qtr</td>
<td>4th Qtr</td>
</tr>
<tr>
<td>% of bills dishonored</td>
<td>0.25</td>
<td>0.80</td>
</tr>
<tr>
<td>No. of insolvent companies</td>
<td>3,834</td>
<td>6,101</td>
</tr>
</tbody>
</table>

### Table 7: Current Account Balance
(% change, US$ billions)

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3rd Qtr</td>
<td>4th Qtr</td>
</tr>
<tr>
<td>Current Account</td>
<td>-2.1</td>
<td>4.0</td>
</tr>
<tr>
<td>Goods Trade Balance</td>
<td>0.0</td>
<td>3.1</td>
</tr>
<tr>
<td>Exports (Customs)</td>
<td>34.1</td>
<td>36.7</td>
</tr>
<tr>
<td>(% change)</td>
<td>(11.1)</td>
<td>(3.6)</td>
</tr>
<tr>
<td>Imports (Customs)</td>
<td>35.7</td>
<td>34.5</td>
</tr>
<tr>
<td>(% change)</td>
<td>(-3.8)</td>
<td>(-14.8)</td>
</tr>
</tbody>
</table>
**Domestic Economic Outlook**

**Growth:** The GDP growth rate is expected to be around 2% in 1999, up from about –6% in 1988. Economic growth in 1999 is expected to be driven by the partial recovery of domestic demand rather than by exports.

**Consumption and Investment:** Private consumption as well as equipment investment will show modest recovery. However, the growth rate of construction investment will stay negative, reflecting extremely low orders during 1998.

**Balance of Payments:** The current account surplus will amount to $25 billion in 1998, although the growth rate of imports will exceed that of exports. The terms of trade are expected to improve as the appreciation of the won has differential impacts on import and export prices.

**Prices:** The CPI inflation rate is projected to be around 2% in 1999.

**Policy Prescriptions**

**Evaluation of the Current Economic Situation**

While the financial market has been stabilized to a considerable extent, and the real economy is showing some signs of recovery, the financial crisis is yet to be overcome. The problems associated with the weak financial structure of the corporate sector and the potential non-performing loans in the financial sector still remain far from being fully resolved.

Favorable macroeconomic conditions offer an opportunity to implement the required structural reform measures.

Expansionary macroeconomic policies should be accompanied by decisive actions of structural reform without undermining medium and long-term fiscal soundness.

**Policy Directions**

**Main Direction:** Economic policies should be focused on the acceleration of the reform process, flexible macro-policies, and fiscal reform.

**Structural Reform:** The establishment of transparent and firm loss-sharing principles among creditors and shareholders is imperative. Workout programs with debt-equity swaps should be applied only to solvent but illiquid firms, which is to be determined through fair and objective investigation of their financial structures.

**Table 8: Prices**
(year-on-year basis, %)

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3rd Qtr</td>
<td>4th Qtr</td>
</tr>
<tr>
<td>Consumer prices</td>
<td>4.0 5.1 4.5</td>
<td>8.9 8.2 7.0</td>
</tr>
<tr>
<td>Import prices</td>
<td>4.6 16.7 9.5</td>
<td>53.6 32.1 23.5</td>
</tr>
<tr>
<td>Producer prices</td>
<td>2.8 5.2 3.9</td>
<td>14.4 13.9 12.0</td>
</tr>
</tbody>
</table>

**Table 9: Labor**
(year-on-year basis, %)

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3rd Qtr</td>
<td>4th Qtr</td>
</tr>
<tr>
<td>Manufacturing Wages</td>
<td>5.4 -2.9 5.2</td>
<td>-2.7 -3.9 -10.1</td>
</tr>
<tr>
<td>Unemployment</td>
<td>2.2 2.6 2.6</td>
<td>5.7 6.9 7.4</td>
</tr>
</tbody>
</table>
Monetary Policy: In the presence of huge deflationary pressures, the macroeconomic stability of the economy should be preserved by maintaining low interest rates. The inflationary pressure from the demand side is not likely to be significant when the economy is experiencing deep recession and structural reform. However, the extent and pace of interest rate cuts should be carefully judged given changing situations, such as a subsiding credit crunch and lowered interest rates in the advanced countries. Moreover, it is necessary to let the market determine the exchange rate and not resort to direct intervention.

Fiscal Policy: Fiscal expenditures should be economized for use in structural reform, and the automatic-stabilizer role of the budget should be maintained. In addition, a medium-term fiscal plan should be established so as to preserve long-run fiscal soundness.

Unemployment Policy: The unemployment policy should be changed from a “negative” policy protecting the unemployed to a “positive” policy which will create new jobs. However, rapid expansion of the social safety net for poor households is required, since the pain of unemployment is estimated to be at its highest during the first half of 1999.

Table 10: Prospects for the Korean Economy in 1999
(YoY increase, %, US$ billions)

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1st Half</td>
</tr>
<tr>
<td>GDP</td>
<td>0.8</td>
</tr>
<tr>
<td>Consumption</td>
<td>1.8</td>
</tr>
<tr>
<td>Fixed Investment</td>
<td>-4.1</td>
</tr>
<tr>
<td>Exports</td>
<td>0.3</td>
</tr>
<tr>
<td>Imports</td>
<td>19.6</td>
</tr>
<tr>
<td><strong>US$ billions</strong></td>
<td></td>
</tr>
<tr>
<td>Current Account Balance</td>
<td>11.6</td>
</tr>
<tr>
<td>Goods Trade Balance</td>
<td>13.8</td>
</tr>
<tr>
<td><strong>Per Cent</strong></td>
<td></td>
</tr>
<tr>
<td>CPI (%)</td>
<td>0.9</td>
</tr>
</tbody>
</table>
Overview

A year after narrowly avoiding a general payment moratorium on its external obligations, Korea’s vastly improved external liquidity position has greatly reduced the near-term risk of a relapse into crisis. The conduct of macroeconomic policy has facilitated stabilization of domestic interest rates and the exchange rate. Moreover, long-term prospects for economic stability are boosted by tangible progress made in consolidation of the financial system. A dynamic could be set in motion in which market-based financial sector resource allocation complements government efforts to restructure an inefficient corporate sector and thereby hasten a sustainable recovery in the economy.

Recognizing that the foundation for a durable gain in both domestic and foreign investor confidence is being established, Moody’s on December 18, 1998, placed the rating for Korea’s foreign currency country ceiling on review for possible upgrade to investment grade status. The positive outlook was also prompted by improved prospects for a return to normal exit for the foreign interbank credit market—the epicenter of the financial upheaval in late 1997. To stem massive outflows in late 1997, the regulatory authorities of the G-7 countries orchestrated a de facto, involuntary rollover of short-term interbank credits which were subsequently refinanced into long-term credits. The nature of the rollover was viewed as a default in the Moody’s rating system. Yet such drastic action, together with an exceptional amount of emergency funds from the IMF and World Bank, enabled Korea to contain the crisis and prevent a wider payments disruption on its international bonds and other long-term credits.

The policy approach of the authorities to the crisis has been to deregulate, strengthen institutions, and liberalize, a strategy adopted by most, but not all, countries in East Asia in response to the crisis. Korea, however, has advanced furthest among those countries most severely affected by the crisis. Korea’s further opening of the capital account to foreign investors provided the opportunity to Moody’s to assign an initial rating, several notches up in the investment-grade scale, for government won-denominated bonds. This rating reflected Korea’s prior record of fiscal prudence which allows the government greater leeway not only to run large budget deficits to stimulate the economy and soften the effects of the harsh domestic adjustment, but also to restructure and recapitalize the financial system. The rating on won-denominated government bonds also reflects the opinion that fiscal implications of the foreseeable political situation with North Korea will be limited. Pyongyang’s hostility to a normalization of political relations with Seoul may preclude a large role for South Korean taxpayers in the stabilization of the North Korean economy.

The worst of the crisis seems to be over, but the economy is not out of the woods yet, even though economic activity has stabilized recently. The gain in momentum in structural reform will need to be sustained to safeguard against the great dangers arising from rising unemployment, prolonged recession and aggravated income inequality. Moreover, Korea’s balance of payments will need to remain resilient to possible future external shocks. At the darkest moments of the crisis in December 1997, Kim Dae Jung was elected president, the first time that an opposition party won political power. The Kim administration has proved capable of forging a new political and economic paradigm that dilutes the corrupting collusion between government and business while maintaining the support of the electorate. President Kim, however, will need to contain the inherent factionalism of Korean politics, which could derail structural reform and set back long-term recovery.

In summary, key factors that will influence the outlook for Korea’s ratings include:

- Maintenance of a strong external payments position resilient to possible external shocks;
• Favorable factors affecting external trade, particularly regarding Japan’s economy and the future yen exchange rate;

• Maintenance of appropriately accommodative economic policies, including the floating exchange rate regime, which lessens the burden on monetary policy and frees the authorities from depleting official foreign exchange reserves to support the exchange rate;

• Sustained progress in structural reform of the financial and corporate sectors, which enhances market-based resource allocation;

• Continued cohesion of the political consensus for economic adjustment and restructuring; and

• Stability in North-South economic and political relations.

Recent Developments and Outlook

The adjustment since late 1997 has been much more severe than anticipated by the authorities. As a result of strict targets contained in the IMF program, an extremely tight macroeconomic policy was maintained early in the adjustment program, leading to a doubling to 30 percent in corporate bond interest rates in the month of December 1997. Real GDP, instead of increasing 1-2% as forecast in the government’s original macroeconomic framework, probably contracted about 6% in 1998. The downturn was led by sharp contraction in corporate investment and consumer spending, as is seen in the 24% drop in domestic demand (Table 1). A surge in corporate bankruptcies increased the unemployment rate to 8% by the end of 1998 from 2.6% in 1997—an increase greater than expected by government and which has overwhelmed the social safety net for a labor force that had been sheltered from layoffs by law and practice.

Macroeconomic policies were relaxed once the severity of the adjustment became evident. The budget deficit target increased from 1.5% of GDP to 5% of GDP for 1998 and 1999, in part to strengthen the social safety net for unemployed workers, and interest rates declined progressively to an historical low in the single digit range by early 1999. This was accompanied by a recovery in the won per dollar exchange rate to under 1200 in January 1999 from 1700 a year earlier.

The silver lining of the wrenching adjustment last year was the shift in the current account into a surplus of at least $38 billion, an enormous shift in resources, equal to about 15 percent of GDP, achieved in just one year. The depreciation of the exchange rate, high interest rates, falling household incomes and declining corporate investment slashed imports in half in the first half of 1998. Although export volumes continued to grow, lower export prices depressed dollar export earnings until the last two months of 1998. The large current account surplus has allowed some debt reduction, but has more importantly boosted official foreign exchange reserves to a level that provides a more comfortable cushion against pressures that contributed to the 1997 crisis—namely, large short-term debt and an abrupt shift in creditor confidence.

The maintenance of less restrictive economic policies, a leveling off of unemployment and continued growth in exports are key elements behind the recovery in economic growth projected by the Ministry of Finance and Economy to 2.0% in 1999 and by the OECD to 4.0% by 2000. The Bank of Korea is even more optimistic, expecting that real GDP will grow 3.2% in 1999. Whether the economy can achieve such growth, albeit at rates far below historical trends, will depend on a number of key factors. Among those within the control of policy are the pace of a coordinated restructuring of the financial system and corporate sector. This is necessary to relieve the credit crunch, reduce excess industrial capacity, and increase international competitiveness. In addition, employment and household incomes will need to stabilize, as projected, to boost the largest single component of GDP, private consumption. There is a view that the worst is over in rising unemployment since small and medium-sized corporations have already gone through a thorough shake out, and any future downsizing of the workforce of the large chaebol will be small relative to the total labor force. This view fails to take into account the fact that many small and medium-sized corporations are structurally related to the large chaebol. Consequently, chaebol restructuring will result in job losses in the small and medium-sized enterprise sector as well.

Recovery will also depend on favorable external factors that are far from assured. There are some signs
that economic growth in the United States and Europe will slow in 1999 and 2000, limiting the potential demand for Korea’s exports. Continued economic weakness in Japan, economic and financial dislocation in Southeast Asia and slower growth in China, the markets for about half of Korea’s exports, would also dampen prospects for economic recovery in Korea. Moreover, the appreciation of the yen in late 1998 probably helped boost Korea’s exports during that period. The risk is that the competitiveness of Korean exports in large part depends on a strong yen, but that economic recovery in Japan will likely require a weak yen to boost Japan’s export competitiveness and complement the transitory and weak stimulus to growth provided by conventional Japanese policy measures. For these reasons, the export sector is seen as providing a diminishing source of Korea’s economic growth over the intermediate term. The implication is that Korea will need to rely increasingly on domestic demand for the recovery of its economy, and this will most likely require continued momentum in structural reform.

**Structural Reform**

The ongoing restructuring of the financial and corporate sectors has, however, led to a credit crunch. Banks’ capacity to lend has been reduced by the need to improve their capital-asset ratios while setting aside provisions for rising non-performing loans. Corporations’ demand for funds has also been diminished as the large chaebol have scaled back investment and started to downsize, while small companies have experienced historically high bankruptcy rates.

The underlying principles for the restructuring of the financial system consist of resolution of non-viable institutions based on capital adequacy standards and full support to other institutions that have a clear chance to return to normal operations. The consolidation is intended to create large banks by international standards, while eliminating excess banking capacity. Ultimately, these reforms hold promise of a fundamental change in banking philosophy to market-based credit decisions from policy lending and passive lending to dominant corporate interests. If successful, this could greatly enhance government efforts to strengthen the efficiency and competitiveness of the corporate sector.

The government is committed to spending at least 64 trillion won (about 15 percent of GDP) to purchase non-performing loans, recapitalize banks and make depositors whole. So far these efforts have included closures, mergers, and nationalizations. One of the two nationalized banks has been sold to foreign investors, and the other will likely follow before the end of 1999, as agreed with the IMF. This process has not resulted in any loss to creditors; however, shareholders of non-viable banks have largely been wiped out.

Corporate restructuring is an integral element of economic recovery, but so far it lags the progress made in

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**Table 1: Macroeconomic Performance and Outlook**

<table>
<thead>
<tr>
<th></th>
<th>1997 % change</th>
<th>1998e % change</th>
<th>1999f % change</th>
<th>2000f % change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic Demand</td>
<td>5.5</td>
<td>-6.0</td>
<td>2.0</td>
<td>4.0</td>
</tr>
<tr>
<td>Change in Net Exports (% of GDP)</td>
<td>-2.8</td>
<td>-23.8</td>
<td>-0.7</td>
<td>7.0</td>
</tr>
<tr>
<td></td>
<td>8.6</td>
<td>17.0</td>
<td>3.0</td>
<td>-3.0</td>
</tr>
<tr>
<td><strong>Inflation</strong></td>
<td>4.5</td>
<td>7.8</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td><strong>Unemployment</strong></td>
<td>2.6</td>
<td>7.0</td>
<td>7.5</td>
<td>8.3</td>
</tr>
<tr>
<td><strong>Budget Balance (% of GDP)</strong></td>
<td>-0.5</td>
<td>-5.0</td>
<td>-5.0</td>
<td>-1.5</td>
</tr>
<tr>
<td>Current Account ($ billions)</td>
<td>$8</td>
<td>$38</td>
<td>$20</td>
<td>$21</td>
</tr>
</tbody>
</table>

Notes:  
e = estimate; f = forecast  
the financial sector, because the chaebols political power and historical business strategies make them recalcitrant to the ambitious government reform efforts. The key objectives are to increase efficiency and reduce leverage. These weaknesses became evident in the 1990s with rising incremental capital-output ratios (more capital needed for each unit of output) and ballooning debt-equity ratios, which reached 500 percent for the largest chaebol (more than twice that in Japan, whose manufacturing firms were also becoming less efficient, and at least several times that of U.S., European and Taiwanese manufacturing firms). The consolidation process among the smaller chaebol is more advanced, while the top five chaebol have, in general, demonstrated more resistance to government directives to downsize, reduce debt-equity ratios, eliminate cross guarantees, and enhance corporate governance and disclosure within a three-year period.

External Position Profile

Adjustment in the composition of Korea’s external debt occurred through a 50 percent reduction in short-term obligations (Table 2). This was concentrated in short-term bank credits, which were both repaid and refinanced into long-term credits. Total external liabilities in 1998 rose somewhat as net lending by official creditors offset net repayments to private creditors. The IMF, World Bank and Asian Development Bank portion of the $58 billion bailout program for Korea is $35 billion, of which $21 billion was disbursed by the end of 1998. Official creditors have withheld their financing pledges, and the rapid rise in the current account surplus last year dampened the urgency for such funds. Japan, however, has agreed to make $5 billion available to Korea under Prime Minister Miyazawa’s initiative for six Asian countries in crisis.

Conventional debt ratios indicating the degree of solvency of a country by comparing debt to exports and GDP have not changed appreciably since the crisis. However, a more telling indicator has changed significantly for the better—official foreign exchange reserves versus debt payments due in one year (Table 2). This reveals liquidity pressures that could arise if creditors slash short-term credit lines and refuse to refinance maturing long-term credits. The rapid rise in Korea’s net, liquid official reserves and reduction in short-term debt improved this ratio significantly from pre-crisis levels to much closer to 1.0. An important factor that explains part of the reason why countries such as China and Taiwan avoided the full brunt of the Asian crisis was that their relatively large holdings of official reserves made them less vulnerable to speculative attacks on their currency and sudden shifts in creditor confidence.

Dr. Byrne is Vice President and Senior Analyst at Moody’s Investors Service in New York City.

Table 2: External Debt and Official Assets
(unit: $ billions)

<table>
<thead>
<tr>
<th></th>
<th>1996</th>
<th>1998e</th>
<th>1999f</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Debt</strong></td>
<td>158</td>
<td>168</td>
<td>150</td>
</tr>
<tr>
<td>Long-term</td>
<td>79</td>
<td>122</td>
<td>102</td>
</tr>
<tr>
<td>Short-term</td>
<td>100</td>
<td>49</td>
<td>48</td>
</tr>
<tr>
<td>(financial institutions)</td>
<td>(78)</td>
<td>(30)</td>
<td>(25)</td>
</tr>
<tr>
<td><strong>Official Net Foreign Exchange Reserves</strong></td>
<td>34</td>
<td>49</td>
<td>57</td>
</tr>
<tr>
<td>Ratio of reserves to short-term payments*</td>
<td>0.32</td>
<td>0.72</td>
<td>0.72</td>
</tr>
</tbody>
</table>

Notes:  
* e = estimate; f = forecast  
* Principal and short-term debt.  
Numbers may not sum to total owing to rounding.  
Source: Korean Ministry of Finance & Economy (MOFE).
KOREA’S RESPONSE TO THE CRISIS: KOREA’S STRUCTURAL ADJUSTMENTS

KOREA’S ECONOMIC REFORM MEASURES UNDER THE IMF PROGRAM

by Dongchul Cho

Causes of the Economic Crisis

This is probably the most severe economic crisis for the Republic of Korea since the Korean War. Major chaebol (industrial conglomerates) collapsed one after another. The amount of non-performing loans skyrocketed. The financial market melted down. Foreign currency reserves were depleted. The whole country was on the brink of bankruptcy. Even the IMF was not able to bail out Korea without the support of advanced countries. And then the economy sank. More than one million workers lost their jobs in just one year.

Something must have been wrong. Something big. Some say it was over-consumption, while others say it was over-investment. Some say it was the cost of high wages, while others say it was the cost of high interest rates. However, these were merely casual observations of macro variables rather than coherent diagnoses based on solid microeconomic analyses.

Now many economists seem to believe that the fundamental cause of the crisis was the lack of market discipline, particularly in the financial sector. The assumption prevailed in the financial market that the government would not allow chaebol to fail, and this expectation generated excess demand for credit by the chaebol and easy supply of credit by banks. This implicit government bailout policy effectively eliminated the threat of bankruptcy—the essence of the market economy—for the chaebol, and thus largely eliminated the pressures on businesses to enhance efficiency.

If this analysis is correct, all of the casual observations can be explained as the natural outcomes of the implicit bailout policies. The “over-investment” and excessive demand for credit generated the “high” interest rates (perhaps relative to capital productivity) by chaebol. The “over-consumption” was the result of “high” wages (perhaps relative to labor productivity) generously provided by the bankruptcy-risk-free chaebol.

However, such a Ponzi-like scheme is not sustainable. Firm profitability had been eroded even as the aggregate economy grew at a steady rate. The narrow profit margins and weak financial structures had made the chaebol very vulnerable to unanticipated shocks. The shock finally came from external sectors in the form of a collapse of export prices in 1996 and a currency crisis in 1997. Many chaebol went technically bankrupt, and the continued bailout efforts of the government caused non-performing loans to surge even higher. The financial market finally melted down, and the currency crisis followed. Thus, although the crisis in the last stage appeared in the form of a currency crisis, the fundamental cause was the distorted incentive structure (called “moral hazard”) in the financial market among the government, financial institutions, and chaebol.

Whether these arguments are correct may require further examination. At the very least, however, this hypothesis provides a consistent and coherent explanation of the observations on the Korean economy. What is important in understanding the current restructuring policies is not the hard empirical evidence that can be accepted by serious scholars in academia, but the perception of the IMF and the Korean government. Based on the above diagnosis of the fundamental causes of the crisis, the policy prescriptions inevitably point toward chaebol restructuring at the final stage.

Nevertheless, the foreign currency situation was too urgent to wait until the structural reforms were complete. The paralyzed financial system also required emergency measures in order to restore its capability even to a minimal level, and this had to be accompanied by labor market and government sector reforms. In short, reforms across the board were necessary.
However, this article will only sketch the basic spirit and sequence of the whole reform package and its interrelationships, leaving detailed explanations for each sector to the other articles. The issues of the IMF’s macro-policies, which have been hotly debated domestically and internationally, will be touched upon in the last section.

Structural Reform Policies

Principles of the Reform Package

The basic principle behind the reform package was equitable sharing of the economic losses. This was extremely important, not only for political reasons, but also for economic reasons. Only by enhancing the accountability of the agents who were responsible for the crisis could market discipline be reestablished and moral hazard minimized. For example, unequivocal government bailouts should be avoided, and the loss-sharing principle needs to be established. Shareholders took the losses first, creditors without collateral next, and then creditors with collateral last. Many government officials, bank managers and chaebol owners were removed. Some of them were even arrested. A million workers who had been employed by less competitive firms were laid off. Perhaps the only groups of people excluded from the economic penalization were bank depositors and foreign creditors. The Korean government protected both domestic and international creditors from potential bank runs at the Korean banks.

Another important principle behind the reform package was market liberalization, particularly for the foreign participants in the financial market. This policy change is reflected in the elimination of the exchange rate band as well as of many investment restrictions on foreign investors in the stock and real estate markets. The plan to sell the two major troubled banks (Seoul and Jael Banks) to foreigners is another example.

Interrelationship of the Sectoral Reforms

Even though the most important and urgent reforms were focused on the financial market, the reform package was comprehensive because all of the sectoral reforms were interrelated. The soaring non-performing loans of financial institutions were simply a reflection of the low profitability and vulnerable financial structures of the corporate sector.

In order to curb the increase in non-performing loans and the prolonged instability of the financial market, the profitability and financial structures of the corporate sector needed to be improved. Improving profitability required increasing labor market flexibility and relaxing macroeconomic policies. Improving the financial structure required more capital to recapitalize both the financial and corporate institutions. Since it was almost impossible to expect that the financially distressed private companies could raise their own capital in the market, most of the resources needed to be financed by the government. Government debt was rapidly increasing, and so public sector reform had to be instituted immediately to regain discipline over the government budget.

Sequence of the Reforms

Although the reform package was very comprehensive, the Korean government could not carry out everything at once. The sequence of reforms was important as well.

In the first phase, it was most urgent to restore foreign currency liquidity, and every policy was focused on this goal. Most importantly, a high interest rate policy was imposed, and the maturity of short-term foreign debt was extended to longer-term maturities. In order to provide clear signals to the market that the government was really serious about the economic reforms, financial market rehabilitation and labor market reorganization plans were enacted into law. Most of the institutional obstacles for foreign investors were lifted.

As foreign reserves accumulated, the interest rate policy was gradually relaxed, and then the rehabilitation program for the financial institutions was actively implemented. Of the 33 commercial banks, the Financial Supervisory Committee (FSC) ordered five to close and 11 to restructure. Out of the 377 non-bank financial institutions, 34 were closed, 21 were ordered to suspend operations, and 20 were ordered to restructure. In order to clear up the non-performing loans and recapitalize the banking sector, the government spent 64 trillion won (about $45.7 billion), approximately 15 percent of the annual GDP.
As a result of this financial market restructuring and the flexible monetary policy, the credit crunch began to ease, and the interest rate rapidly stabilized. Then the policy focus was moved to corporate sector restructuring. Many chaebol below the top five were already technically bankrupt, and the debt restructuring programs (“workouts”) between the creditor banks and the bankrupt chaebol were underway. The “too big to fail” myth had already shattered for the smaller chaebol. The problem was the top five. The financial market was still providing them with a nearly unlimited amount of credit. With the financial market continuing to operate in this way, the Korean economy could not complete its restructuring efforts.

The government started to press the top five chaebol. Early in 1988, the government and owners of the top five agreed upon several reform plans: providing consolidated balance sheets, including for all of their subsidiaries; eliminating cross-loan guarantees among subsidiaries; reducing the debt-equity ratio to under 200 percent within two years; and so forth. However, as the Korean financial market still provided the bulk of the credit to them, the government imposed an upper limit of credit on almost all financial intermediaries as well as on most financial instruments. Now, the top five chaebol are being pressed to restructure by the government, by foreign investors, and by many Korean journalists. This restructuring policy is still ongoing, and the final outcome should be evident in 1999.

### Macro Policy Adjustments

The Korean economy had maintained a fairly stable macro-economic environment. The rate of growth had been fluctuating around 6% to 8% for several years, while the inflation rate had been lowered from around 6% to 4% through continuous disinflation policies in the 1990s. The current account deficit, which widened to almost 5% of GDP in 1996, appeared to be a problem, but by the time the crisis was triggered in November 1997, Korea had managed to balance its current account. In addition, the soundness of the government budget had long been a great virtue in the Korean economy.

Nevertheless, such strong macro fundamentals were not enough to offset the severity of the foreign currency liquidity situation in the eyes of the IMF. Once the foreign exchange market goes into a panic state, capital drastically flows out of the country and the exchange rate skyrockets. At least until the current account fully adjusts to a new exchange rate level, the domestic financial market cannot avoid suffering from a liquidity shortage, and the domestic interest rate goes up in the market regardless. In order to ensure and expedite the restoration of foreign currency liquidity, the IMF imposed a policy of extremely high interest rates. The short-term inter-bank call rate was initially set at over 30 percent, and gradually adjusted downward as the foreign currency situation improved.

### Table 1: Macroeconomic Performance of the Korean Economy

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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP Growth Rate (%)</td>
<td>8.6</td>
<td>8.9</td>
<td>7.1</td>
<td>5.5</td>
<td>-5.9</td>
</tr>
<tr>
<td>Unemployment Rate (%)</td>
<td>2.4</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
<td>6.9</td>
</tr>
<tr>
<td>CPI Inflation (%)</td>
<td>6.2</td>
<td>4.5</td>
<td>4.9</td>
<td>4.5</td>
<td>7.5</td>
</tr>
<tr>
<td>Current Account (US$ billions)</td>
<td>-4.5</td>
<td>-8.9</td>
<td>-23.7</td>
<td>-8.1</td>
<td>40.2</td>
</tr>
<tr>
<td>Foreign Debt (US$ billions)</td>
<td>89</td>
<td>120.0</td>
<td>164.0</td>
<td>158.0</td>
<td>154.0</td>
</tr>
<tr>
<td>Won/Dollar Exchange rate</td>
<td>789</td>
<td>775</td>
<td>844</td>
<td>1,415</td>
<td>1,215</td>
</tr>
<tr>
<td>Appreciation rate (%)</td>
<td>2.4</td>
<td>1.8</td>
<td>-8.2</td>
<td>-40.3</td>
<td>16.5</td>
</tr>
<tr>
<td>Corporate Bond Yields (%)</td>
<td>12.9</td>
<td>13.8</td>
<td>11.9</td>
<td>13.4</td>
<td>9.0</td>
</tr>
<tr>
<td>Ratio of Ordinary Income to Equity (%)</td>
<td>10.5</td>
<td>14.0</td>
<td>3.7</td>
<td>-1.4</td>
<td>1.7</td>
</tr>
<tr>
<td>Ratio of Ordinary Income to Sales (%)</td>
<td>2.7</td>
<td>3.6</td>
<td>3.0</td>
<td>0.3</td>
<td>-0.4</td>
</tr>
</tbody>
</table>

Notes: Figures for 1998 are derived as follows: GDP, unemployment, CPI rates, and current account figures are KDI forecasts. The foreign debt (IMF basis) is as of the end of October 1998. The exchange rate and yield rate on corporate bonds are as of December 5, 1998. The ordinary income to equity ratio and ordinary income to sales ratios are for the first half of 1998.
This high interest rate policy clearly helped improve the foreign currency liquidity situation within a short period of time. Although it may not have been very successful in attracting more foreign capital, the high interest rate was effective in suppressing the potential outflow of domestic capital. In addition, the high interest rate sharply curbed domestic and import demand, leading to a large current account surplus. As a result, official foreign reserves increased from less than $10 billion to almost $50 billion within a year.

Of course, the cost of such an achievement was great. Private consumption declined more than ten percent, and facility investment collapsed to half the level of the previous year. The rate of unemployment soared from less than 2% to almost 8%, and real wages declined by more than 10%. Corporate managers feared bankruptcy, and workers suffered massive lay-offs. Comparing the call rate and the bankruptcy rate (Figure 2) is illustrative.

The tight monetary policy has been eased as the foreign exchange market stabilized and inflationary pressures were eliminated. In fact, the inter-bank call rate declined to around 7% within a year, which is far below the pre-crisis level. This change of policy can be most vividly noted in the series of agreements between the Korean government and the IMF:

- Money market rates will be allowed to rise sufficiently and will be maintained at that level or higher as needed to stabilize the market. (December 3, 1997)

- Raise call rates to 30%, or above if needed, to stabilize the exchange rate. (December 24, 1997)

- Call rates have been at around 30% since Dec. 26 and will be kept high until the foreign exchange situation improves. (January 1998)

- With the mitigation of the immediate foreign exchange crisis, call rates will be cautiously allowed to ease, in line with continued exchange rate stabilization. (February 1998)

- Interest rate policy will continue to be conducted in a flexible and symmetric manner. Subject to the objective of maintaining stability in the foreign exchange market, call interest rates will continue to be lowered, in line with market conditions. (May 1998)

- Interest rate policy will continue to be conducted in a flexible manner with upward and downward adjustments as necessary. (July 1998)

- Easy monetary stance will be maintained .... (November 1998)
Further details of the IMF program are listed in Table 2.

Both domestically and internationally, there have been hot debates regarding the IMF’s interest rate policy. Among economists, it may be agreed that the pattern of the IMF’s interest rate policy was inevitable: impose a high interest rate at the outbreak of the currency crisis and gradually ease the policy as the foreign exchange market stabilizes. A more debatable issue is perhaps the speed of adjustment rather than the pattern itself. An ex post look at the macro indicators may show that the speed of policy relaxation was too slow. While the current account surplus and the foreign reserves accumulated more rapidly, aggregate demand collapsed much more than the IMF initially anticipated, even causing deflationary pressures in spite of the huge exchange rate depreciation.

The following reasons can perhaps explain the slow adjustment of the IMF’s interest rate policy. First, the IMF seems to have underestimated the size of the deflationary impact that the high interest rate would bring about in the short run, given the fragile debt structure of Korean firms. Roughly speaking, the corporate sector’s debt is 1.8 times as high as the annual Korean GDP, which implies that a five percentage point increase in the interest rate squeezes the corporate sector’s cash flow by 9% of annual GDP! A profit squeeze of this magnitude can almost wipe out the entire corporate sector’s profit.

Second, the IMF seems to have overestimated the elasticity of inflation with respect to the exchange rate. Unlike many Latin American countries, Korea has never used the exchange rate as the nominal anchor to check hyperinflation. In other words, no economic agents in Korea have used a foreign currency as a unit of transaction, and thus the inflationary pressure of exchange rate depreciation is transmitted only through import prices. This elasticity is at most 0.15. The most impressive response in this regard was probably the decline in the nominal wage by approximately 5% (15% in manufacturing sectors), which implies purchasing power loss of more than 40% in U.S. dollar terms.

As for fiscal policy, the tight stance was criticized from the beginning. The Korean economy has maintained a very sound fiscal position, and the current account was expected to turn into a huge surplus. Not even the currency crisis provided a good justification for the tight fiscal policy for an economy like Korea. Faced with
such criticisms and the drastic collapse in domestic demand, the fiscal policy stance has been eased from a mild fiscal surplus or balance (December 1997)) to a deficit, and the size of the deficit has greatly widened from 0.8% of GDP (February 1998) to 5% of GDP (November 1998).

Dr. Cho is a Research Fellow at the Korea Development Institute (KDI) in Seoul.

Table 2: Updated Memorandum on the IMF Economic Program for Korea (May 7, 1998)

<table>
<thead>
<tr>
<th>Macroeconomic Policies</th>
<th>Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Macroeconomic Projections: real GDP growth of -1%, inflation in single digits</td>
<td></td>
</tr>
<tr>
<td>• Flexible exchange rate policy</td>
<td></td>
</tr>
<tr>
<td>• Reserve management policy: targeting to increase to US $41 billion by end-Dec. 1998</td>
<td></td>
</tr>
<tr>
<td>• BOK foreign exchange window, fiscal policy, social safety net</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial Sector Restructuring</th>
<th>Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Merchant Banks</td>
<td>• 6% capital adequacy ratio by June 30, 1998, otherwise, licence will be revoked.</td>
</tr>
<tr>
<td>• Under capitalized Commercial Banks</td>
<td>1) diagnostic reviews</td>
</tr>
<tr>
<td></td>
<td>2) check for any further deterioration in asset quality</td>
</tr>
<tr>
<td></td>
<td>3) strengthen supervisory rules &amp; procedures</td>
</tr>
<tr>
<td>• Other Commercial Banks</td>
<td>Below 8% BIS capital adequacy ratio</td>
</tr>
<tr>
<td></td>
<td>FSC’s diagnostic reviews</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Prudential Regulation and Supervision</th>
<th>Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Prudential regulations on short-term foreign borrowing &amp; foreign exchange exposure</td>
<td>• Stipulating banks have short-term assets (less than 3 months) of at least 70% of short-term borrowing &amp; fund at least 50% of long-term assets</td>
</tr>
<tr>
<td></td>
<td>• Banks publicly disclose statistics on foreign currency liquidity</td>
</tr>
<tr>
<td>• Consolidated supervision</td>
<td>• Completion of the unification of supervisory organization enhances consolidated supervision to encompass the full range of bank risks</td>
</tr>
</tbody>
</table>

| Capital Account Liberalization | |
|-------------------------------| |
| • Money market/Corporate borrowing, Equity market/FDI, and foreign exchange liberalization | |

| Trade Liberalization | |
|----------------------| |
| • Import liberalization | Rationalizing existing subsidy program |
| • Services | • Permitting foreigners to engage in security dealings, insurance, leasing, and other property-related business |

| Corporate Governance & Restructuring | |
|--------------------------------------| |
| • Transparency, accountability to shareholders, corporate restructuring, labor market flexibility | |
FINANCIAL SECTOR RESTRUCTURING IN KOREA

by Yoon-Shik Park

Introduction

The immediate cause of the so-called IMF crisis in Asia in general and Korea in particular was the abrupt withdrawal of foreign capital, especially short-term hot money flows. In a sense, therefore, the 1997–98 Asian financial crisis can be characterized as an international liquidity crisis as much as a fundamental economic crisis. In the absence of a strong and well-diversified financial system encompassing viable capital markets in Asia, international capital flows overwhelmingly took the form of short-term bank loans to Asian commercial banks, finance companies (as in Thailand) and merchant banks (as in Korea).

Since the beginning of the financial crisis, the Korean government has realized that the country’s financial sector is in need of fundamental reform and restructuring. The objective of the financial sector restructuring was to restore market confidence in the financial system in the immediate aftermath of the IMF crisis and also to develop the Korean financial sector into a strategic industry by enhancing its overall competitiveness over the long term. This is to be accomplished through conforming to international best practices, following transparent principles of accountability, and strengthening and deepening the institutional structure of the financial sector.

This article will discuss the various financial restructuring measures taken so far in three major and interrelated areas: 1) strengthening financial institutions; 2) modernizing the financial supervisory framework; and 3) promoting the development of financial markets.

Strengthening Financial Sector Institutions

In 1998, the Korean financial sector underwent the most comprehensive consolidation which affected the entire range of financial institutions. An unprecedented number of financial institutions have had their licenses revoked or operations suspended. In total, 96 banks and non-bank financial institutions were directly affected in the consolidation.

Table 1: Financial Institutions Suspended or Closed
(as of October 1998)

<table>
<thead>
<tr>
<th>Type of Institution</th>
<th>Total Number (end of 1997)</th>
<th>License Revoked</th>
<th>Suspended</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks</td>
<td>33</td>
<td>—</td>
<td>5</td>
</tr>
<tr>
<td>Merchant Banks</td>
<td>30</td>
<td>16</td>
<td>—</td>
</tr>
<tr>
<td>Securities Companies</td>
<td>34</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Insurance Companies</td>
<td>50</td>
<td>—</td>
<td>4</td>
</tr>
<tr>
<td>Investment Trust Companies</td>
<td>8</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Mutual Savings &amp; Finance</td>
<td>230</td>
<td>15</td>
<td>12</td>
</tr>
<tr>
<td>Credit Unions</td>
<td>1,666</td>
<td>17</td>
<td>29</td>
</tr>
<tr>
<td>Leasing Companies</td>
<td>26</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>2,077</strong></td>
<td><strong>41</strong></td>
<td><strong>55</strong></td>
</tr>
</tbody>
</table>

Source: Korean Ministry of Finance and Economy.

Commercial Banking Sector

As of the end of 1997, only 13 Korean banks satisfied the Bank for International Settlements (BIS) capital adequacy ratio of 8 percent. After reviewing the rehabilitation plans submitted by the 12 unsound banks, the Financial Supervisory Commission (FSC) concluded that five were no longer viable as independent banks, and in July 1998 they were forced into liquidation through purchase and assumptions (P&As). Their assets and liabilities were transferred to five acquiring banks, selected by the FSC on the basis of their relative financial soundness (BIS ratio of 10% or higher), long-term business strategy, and comparative business advantages. The five liquidated banks were Dong Hwa Bank, Dongnam Bank, Dae Dong Bank, Chung Chong Bank and Kyungki Bank, while the five acquiring banks were Shinhan Bank, Housing and Commercial Bank, Kookmin Bank, Hana Bank and Koram Bank.
In order to ensure the financial soundness of the acquiring banks, non-performing assets of the liquidated banks classified as substandard or lower were excluded in the transactions, while all the liabilities were transferred to the acquiring banks except for provisioning funds for severance and retirement payments by the liquidated banks. Any shortfalls in the net worth of the liquidated banks were covered by the Korea Deposit Insurance Corporation (KDIC). The Korea Asset Management Corporation (KAMCO) and KDIC were made responsible for the disposal of the non-performing loans (NPLs) of the liquidated banks, and the acquiring banks can exercise a put-back option within a set time period after P&A transactions by requesting KAMCO to purchase their acquired assets if any of them are later found to be non-performing.

Of the 12 banks originally found to be unsound, the seven remaining had their rehabilitation plans conditionally approved by the FSC, requiring them to fulfill necessary corrective actions. In response, the remaining viable banks, including the seven conditionally approved banks and 13 healthy banks, have embarked upon strong corrective actions imposed by the FSC, such as disposal of non-performing loans, new equity capital infusion, management reform, and mergers. Thirteen healthy banks have been treated somewhat in a different manner from the seven conditionally-passed banks in terms of schedule and resolutions. Since October 1998, mergers have been announced between the Commercial Bank of Korea and Hanil Bank, Kookmin Bank and Korea Long Term Credit Bank, Hana Bank and Boram Bank, and Kangwon Bank and Hyundai International Merchant Bank.

In addition, Korea First Bank and Seoul Bank are to be sold in an open auction to foreign investors. In early January 1999, an international investment consortium led by U.S.-based Newbridge Capital announced an agreement with the Korean government to buy 51% of the shares of Korea First Bank. The consortium, which also includes General Electric Capital Services Inc., a unit of General Electric Company, will invest the money directly into Korea First Bank to increase the bank’s equity capital rather than buying government-held shares. The government currently owns 94% of the bank. The deal, which is likely to become final after May 1999, includes an option for Newbridge to sell back to the government acquired assets that turn out to be non-performing. According to press reports the sale of the other government-owned bank, Seoul Bank, is rumored to be under final negotiation with Hongkong Shanghai Bank as of early January 1999.

Non-Bank Financial Institutions

The government has applied basically the same restructuring principles to the non-bank financial institutions (NBFIs). The FSC first made a thorough review of the financial soundness of NBFIs and their rehabilitation plans. Those whose rehabilitation plans showed negligible hope of eventual recovery were closed, merged or had their operations suspended.

Among the original 30 merchant banks in operation at the end of 1997, 16 have had their licenses revoked and are currently undergoing resolution procedures. The remaining 14 merchant banks are being monitored for the implementation of rehabilitation plans and the achievement of the 8% BIS minimum capital adequacy ratio. Among 34 securities companies, two had their licenses revoked, and four had their operations suspended.

The FSC decided subsequently to liquidate the four previously suspended insurance companies, and their assets and liabilities have been transferred to healthy companies. The remaining 16 insurance companies that are subject to management improvement measures are closely monitored for their progress. Two surety insurance companies decided to merge for the sake of financial rehabilitation. Among 26 leasing companies, the controlling shareholders of ten have decided to dissolve their companies, and they are currently either undergoing liquidation on their own accord or are in the process of transferring their assets and liabilities to a bridge leasing company. The remaining leasing companies have the implementation of their rehabilitation plans closely monitored by the FSC. Investment trust companies, mutual savings and finance companies and credit unions have also gone through a similar process of consolidation through mergers, liquidation, or other rehabilitation procedures.

Modernization of the Financial Supervisory Framework

Traditionally, the financial sector in Korea was closely regulated and monitored by the government. Licens-
ing of new institutions and development of new financial products or services were subject to the micro management of financial regulatory agencies. These agencies were dispersed among the Ministry of Finance and the Bank of Korea. Informal and close relationships between the regulators and the regulated financial institutions was also maintained through the practice of “parachute appointments” of retired ex-regulators into top executive positions. This practice, known as amakudari, or descent from heaven, in Japan, was especially pervasive and entrenched among Korean NBFI s and their trade associations.

Furthermore, the supervision of financial institutions was divided among the Ministry of Finance and Economy (MOFE) and the Bank of Korea (BOK). The Office of Bank Supervision of the BOK regulated and supervised commercial banks, while the MOFE exercised similar powers for NBFI s through agencies such as the Securities Supervisory Board (securities houses), the Insurance Supervisory Board (insurance companies), and the Non-bank Insurance Corporation (mutual savings and finance companies as well as merchant banks). The dichotomy of regulatory structure resulted in a lack of consistency in supervisory practices and inadequate coordination among regulatory bodies. While the BOK through its Office of Bank Supervision was responsible for commercial bank supervision in general, MOFE was responsible for supervising the trust business of commercial banks and for granting and revoking bank licenses.

After the passage of financial reform laws in December 1997, all financial regulatory and supervisory functions have now been unified under the Financial Supervisory Commission (FSC), which has taken over the entire supervisory role for both commercial banks and NBFI s. After one year of preparation, the four financial regulatory agencies were formally consolidated into the Financial Supervisory Service (FSS) under the direction of the FSC. The ultimate goal of the FSC is to bring Korean financial supervision levels up to international standards. In this endeavor, the FSC has set up new paradigms through the conversion of supervision practices from direct regulatory methods to indirect ones, from the positive system to the negative system, from the application of abstract and subjective principles to transparent and objective principles, from organizational supervision to functional supervision, etc. In this sense, the FSC tries to enhance its level of financial supervision to that of international best practices.

For example, the FSC has adopted the Prompt Corrective Action (PCA) system, defined as the step-by-step imposition of obligatory corrective measures on unsound financial institutions that fall below a certain level of capital adequacy. Authorized under the Act Concerning the Structural Improvement of the Financial Industry, the PCA system allows the FSC to adopt capital adequacy standards criteria for deciding whether financial institutions are sound. These standards are the BIS capital adequacy ratio for banks and merchant banking organizations, the operational net capital ratio for securities companies, and the payment capacity insufficiency ratio for insurance companies. A three-step corrective measure, composed of improvement recommendations, improvement measures and finally improvement orders, can be imposed on any unsound financial institutions according to the degree of its unsoundness.

To enhance the accounting transparency of financial institutions, the FSC has also adopted the mark-to-market accounting method, which values assets at their fair current market value instead of at their historical acquisition costs, amends the book value, and recognizes the gains or losses from the difference. Until now, financial institutions in Korea had not adopted mark-to-market accounting for securities, even though it is in common use internationally. In addition, accounting standards for public disclosure and accounting standards for supervision, which had been integrated until now, will be separated and administered separately. Furthermore, the FSC has increased regular public disclosure items to the level requested by the International Accounting Standards (IAS), to include, for example, off-balance sheet transactions such as derivatives, asset classification, and special disclosure items such as those related to financial mishaps or the losing of a large lawsuit. For the sake of internationalization, account titles, which have been only in Korean so far, will be written in both Korean and English. However, issues such as the corporate governance of financial institutions, loan concentration, and consumer protection provisions have not yet been taken care of.

The government has also strengthened loan classification standards and provisioning requirements to make them more conservative. In accordance with interna-
tional standards, loans in arrears for three months or longer are now classified as substandard and below, and loans in arrears between one and three months are classified as precautionary loans.

**Table 2: Changes in Loan Classification Standards**

<table>
<thead>
<tr>
<th>Period of Overdue Payment</th>
<th>Old</th>
<th>New</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 to 3 months</td>
<td>Normal</td>
<td>Precautionary</td>
</tr>
<tr>
<td>3 to 6 months</td>
<td>Precautionary</td>
<td>Substandard or Doubtful</td>
</tr>
<tr>
<td>Over 6 months</td>
<td>Substandard or Doubtful</td>
<td>Substandard or Doubtful</td>
</tr>
</tbody>
</table>

According to the new loan classification standard, the total amount of non-performing loans (NPLs) at both commercial banks and NBFIs is estimated at 219 trillion won out of total loans of 556 trillion won, whereas according to the old standard only 144 trillion won would have been considered non-performing. The government is planning to spend a total of 64 trillion won to facilitate financial restructuring, of which 32.5 trillion is to be used to finance the purchase of NPLs, and 31.5 trillion will be used for recapitalization and deposit payments. The government will facilitate the disposal of NPLs held by those financial institutions planning mergers or those whose rehabilitation plans have been approved by the FSC. Actual purchases are carried out by KAMCO for all bad loans that fall into the category of substandard or below, and whose interest payments are more than three months in arrears. Fiscal resources to address all these restructuring measures are to be mobilized largely by means of issuing public bonds. The Korea Asset Management Fund and the Korea Deposit Insurance Fund are the bond issuers, while the government will provide a guarantee on these bonds and will bear interest costs.

**Promotion of Financial Market Development**

In the aftermath of the Asian financial crisis, many experts have observed that robust financial markets in Asia would have encouraged international portfolio investors to invest in Asian capital market securities, which would have been a far more stable form of foreign capital flows than short-term bank loans. Furthermore, strong financial markets would have required Asian countries to enhance their financial and corporate transparency, because capital market financing necessitates more stringent financial disclosure than bank financing.

In the past, Korea has relied too much on foreign commercial banks as the primary financial intermediation channel for foreign capital, while neglecting to develop a strong Korean capital market. Over-reliance on commercial banks in general has led to more short-term debt financing, both domestic and foreign, than long-term capital market funding. The especially high ratio of short-term debt to long-term debt is one of the main causes of the unstable financial structure of many Korean firms. Promotion of equity and fixed income securities markets, including both bond and money markets, is an important new global trend. Many countries have finally realized the importance of financial markets to their economy to supplement traditional reliance on the banking system alone. The financial market not only provides an alternative source of long-term funds for companies compared to the generally short-term funding from commercial banks, but it also brings about many ancillary benefits such as greater financial transparency, deeper financial infrastructure, more effective monetary policy operations, more investment opportunities to savers, and promotion of many innovative financing techniques. It also promotes more stable and longer-term foreign capital inflows.

It is well recognized that the government can play an important role in promoting the development of an efficient and robust financial market. The positive role of the government can be broadly categorized into two areas. First, the government should be proactive in market deregulation, financial liberalization, discontinuing the practice of setting issuance terms, lifting the reserve requirements on repos, removal of various taxes such as stamp duties and transfer and withholding taxes, adoption of strong and modernized bankruptcy and foreclosure laws, introduction of modern

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accounting and auditing standards, and adoption of a free brokerage commissions system. Second, the government should also develop a strong and modern market supervisory framework in order to ensure competition and fair market practices by controlling the potential abuses of the market by powerful commercial and investment banks and other influential market participants.

The demand side of the capital market is also important. A healthy capital market can exist only when there is a well-developed body of investors. It would be critical to understand the identity of these investors, their incentives and requirements for capital market instruments, and the measures required to broaden the investor base. In this connection, it is important for Korea to promote the development of strong institutional investors such as pension funds, mutual funds and insurance companies. Furthermore, it is critical to understand the market best practices that have been developed in various advanced capital markets.

Mindful of these requirements in strengthening the Korean financial market, the government adopted many bold measures during 1998. These included elimination of the ceiling on foreign equity ownership and removing limitations on foreign investments in local bonds and short-term money market instruments. Aware of the importance of efficient and reliable credit rating services for a viable financial market, the government has opened the credit rating service market to foreign competition and is promoting joint ventures between foreign and domestic credit rating agencies. Korea has also developed an institutional framework for mutual funds as a way to deepen the rank of institutional investors in the capital market. Private investors, both domestic and foreign, are now allowed to easily establish mutual funds in Korea. A new law was also enacted to introduce asset-backed securities, which will be especially useful in disposing of non-performing loans.

Prospects

There has been a truly monumental change in the Korean financial sector during 1998. The government has pursued financial restructuring to an unprecedented degree in such a short period, which might not have been possible without the Korean financial crisis. In this endeavor, international organizations like the IMF and the World Bank have played a constructive role by prodding and advising the government in its dogged pursuit of economic and financial restructuring. While the task is by no means complete, a giant first step has been taken, and the Korean financial system could be healthier and more competitive in coming years because of the ongoing restructuring efforts in key areas of the financial sector.

Dr. Park is Professor of International Banking and Finance at George Washington University in Washington, D.C.
RESTORSTRUCTURING THE CHAEBOL IN KOREA

by Edward M. Graham

A major goal of the Kim Dae Jung administration in the Republic of Korea is, and has been for over one year, to achieve restructuring of the chaebol. The chaebol are the large, highly diversified groups of firms that dominate the industrial output of Korea. The top five—Hyundai, Samsung, Daewoo, LG, and SK—directly account for about 9% of GDP but indirectly (e.g., accounting for value added by suppliers not counted as part of the group) account for at least double this figure. The top thirty chaebol account for about 15% of Korean GDP. The concentration is more evident in the manufacturing sector, where the top five account for about 25% of manufacturing shipments and the top thirty for about 40% of these shipments. It is important to emphasize that these are groups of firms, tied together somewhat loosely by common ownership (typically concentrated in one or a few families) and financial interlinkages. At the end of 1997, the top thirty chaebol encompassed over 800 firms. During 1998, closures and divestitures reduced this number to about 700.1 Most of the firms that were closed or divested were small, but there were a few major exceptions.

The desired restructuring of these groups would involve reduction of the scope of their operations so that individual firms concentrate on “core” business operations and, simultaneously, a reduction of overall capacity in a number of sectors where it is unlikely that demand at any time in the foreseeable future will enable full capacity utilization. Also sought are restructuring of their balance sheets to reduce very high debt to equity ratios and, perhaps, reform of their governance. These restructurings collectively represent one component of a larger effort to correct weaknesses in the Korean economy that were revealed by the international liquidity crisis of late 1997 and the subsequent slide of Korea into deep recession. A second, closely related, component is restructuring and reform of the banking system.

Why is all this restructuring necessary? A major underlying reason is that many of the chaebols business activities suffer from low rates of both labor and capital productivity, when compared to comparable activities of the most competitive foreign firms. This low productivity is one legacy of more than twenty years of effort, beginning in the 1960s, to drive the transformation of Korea from a largely agriculturally based economy to an advanced industrial economy. Although this drive was, by many measures, highly successful—e.g., per capita GDP grew almost fifteen-fold in twenty years, from $670 in 1976 to over $10000 in 1996—it is now clear that it came at a price. In particular, the nonproductive activities of the chaebol have led to low rates of profitability that reflect poor usage of scarce capital and human resources.

Much of this problem derives from past government policy. From the 1960s through the late 1980s, industrialization was driven not by market forces but rather by an industrial policy under which elite government agencies decided how resources would be allocated. To achieve desired rates of capital formation as well as to control the activities into which new capital investment was directed, Korea’s very high domestic savings were intermediated through banks into low-interest loans granted to those firms able to carry out the government’s plans. The most favored enterprises under this scheme evolved into today’s chaebol.2 The largest of these groups, during the period of active government intervention, became intense rivals of one an-

1. In fact, there were over 130 closures and divestitures, but about 30 new firms were created within the top thirty groups.

2. Most of the chaebol have grown from family-owned enterprises established prior to the 1960s and, in some cases, prior to World War II. However, the present structure of these groups took form only after Korea began its rapid industrialization. See Amsden 1989.
other, with each trying to outdo the others to achieve local dominance in favored business activities. This intergroup rivalry, coupled with industrial policy, led the chaebol over time to become highly diversified, but with each group often pursuing the same business activities as its rivals. Thus, each of the largest seven chaebol participates in at least 25 industries in the industrial sector (defined at the 3-digit Korean Standard Industrial Code level) and even the smallest of the top thirty groups participates in more than 10 such industries. Accordingly, one characteristic of the Korean economy has been that no major industrial sector is dominated by one firm, but rather that multiple sectors are jointly dominated by the same groups of firms. This characteristic is unique to the Korean economy, or at least so among the economies of the world’s industrialized nations.

Bank loans to these groups of firms were implicitly guaranteed by the government as well as granted under preferential terms. Thus, investment undertakings by the chaebol were, in effect, both heavily subsidized by the government and were risk-free in the sense that failure of an undertaking did not put at risk owners’ equity. It therefore is no surprise that the expansion of the chaebol largely has been financed by bank loans rather than by equity or long term debt held by non-bank institutions. (With respect to the latter, although the chaebol have issued substantial amounts of bonds, most of these in fact were sold to, and are still held by, the banks.) Within the chaebol themselves, there developed a system of cross-guarantees whereby loans received by one constituent firm of a group would often be guaranteed by other firms within the same group, thus creating what amounted to a system of internal subsidies within the group.

Under this system, Korean banks became little more than conduits for subsidized credit allocated under state direction, with little credit analysis performed by the banks themselves. Thus, when in the early 1990s the Korean government ended formal industrial policy and moved toward a less dirigiste, more market oriented system of resource allocation, the banks remained largely captives of the chaebol. No longer bound by government directive, Korea’s banks became free to make loans on their own authority. But, lacking the managerial competencies to act as truly independent lenders, the banks continued to favor their largest traditional customers, the chaebol. Therefore, during the 1990s, an increasing percentage of total bank loans (including long term debt instruments held by banks) were to the chaebol, and the debt to equity ratio of these groups rose. The percentages accounted for by the top five indeed even continued to rise even following the onset of the Asian crisis in 1997 and the subsequent election and first year of administration of President Kim Dae Jung. Overall then, the ending of industrial policy did not lead to less, but rather more, dominance of the Korean economy by the chaebol and, especially, by the largest of these groups.

The major manifestation of the low productivity of the chaebol, combined with very high leverage, has been low profitability (resulting in low interest cover, discussed below). Table 1 presents some pertinent data on the four largest chaebol and, for comparative purposes, similar data for nine internationally prominent non-Korean firms of varying national origins. These data must be read with considerable caution, because legal and accounting standards vary greatly among the home nations of the firms and, hence, the data are not prepared on a consistent basis. Although the chaebol are groups of firms and not single legal unities, data

3. Hyundai participates in 31 such industries, Samsung in 31, LG in 28, Daewoo in 26, and SK in 26. In addition, each of these top 5 groups holds financial subsidiaries. Data are from the Korea Fair Trade Commission, as cited in Yoo Seong-min 1998.

4. However, not all chaebol participate in all major sectors. For example, until recently Samsung was not in autos, but this sector rather was dominated by Hyundai, Daewoo, and the now-defunct Kia.

5. However, it should be noted that the most recent data indicate that the increase in debt in 1997 is in fact attributable to just two groups, Hyundai and Daewoo. By contrast, Samsung, LG, and SK in net reduced their debt during 1997 (The Korea Herald, 19 December 1998, page 12). The increase in the debt of the former two, nonetheless, in net greatly exceeded the reductions by the latter three groups.
Table 1: Financial Indicators for Leading Chaebol Group, with Comparison to Major International Firms

<table>
<thead>
<tr>
<th>Companies</th>
<th>Market value of equity* (billions of US$)</th>
<th>Total sales (billions of US$)</th>
<th>Net income (billions of US$)</th>
<th>Margin on sales (percent)</th>
<th>P/E</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Korean Chaebol</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hyundai group</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hyundai Electronics</td>
<td>2.32</td>
<td>6.20</td>
<td>-0.60</td>
<td>-9.66</td>
<td>—c</td>
</tr>
<tr>
<td>Hyundai Engineering and Construction</td>
<td>1.46</td>
<td>9.63</td>
<td>-0.07</td>
<td>-0.68</td>
<td>—c</td>
</tr>
<tr>
<td>Hyundai Motor</td>
<td>1.35</td>
<td>12.42</td>
<td>-0.24</td>
<td>8.68</td>
<td>—c</td>
</tr>
<tr>
<td>Hyundai Securities</td>
<td>1.30</td>
<td>0.11</td>
<td>0.01</td>
<td>11.80</td>
<td>104.16</td>
</tr>
<tr>
<td>Samsung group</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td>Samsung Electronics</td>
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<td>23.84</td>
<td>-0.64</td>
<td>-2.69</td>
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<td>Samsung Display Devices</td>
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<td>3.34</td>
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<td>-0.09</td>
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<tr>
<td>LG Electronics</td>
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<td>-4.09</td>
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<td>-14.34</td>
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<td>General Electric</td>
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<td>9.03</td>
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<td>4.49</td>
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<td>55.84</td>
<td>1.97</td>
<td>3.54</td>
<td>15.11</td>
</tr>
</tbody>
</table>

Note: Total sales and net income are fiscal year base for following period. GE, IBM, Daimler Benz: 12/31/1997; Toyota, Hitachi, Sony: 3/31/98; Microsoft: 6/30/98; Siemens: 9/30/98. All Korean companies other than Hyundai Securities, Samsung Securities, and Daewoo Securities: 12/31/1997; Korean security companies: 3/31/98. Exchange rates used in calculation are $1=121yen, 1.73mark, 0.61pound and 951won (1997 average).


b. Data are for 1997. Estimated by The Korea Center for Free Enterprise.

c. Negative sign.

d. Pre-Chrysler merger.

KOREA'S RESPONSE TO THE CRISIS: KOREA'S STRUCTURAL ADJUSTMENTS

7. Samsung Electronics in fact was rated in 1998 by *Forbes* magazine as the best managed of the world's consumer electronics firms, ahead even of Japan’s SONY. In 1997 Samsung Electronics recorded a net loss, but this seems to have been driven by an unexpected drop in world prices of semiconductors rather than by any major difficulty internal to the firm.

6. At a meeting attended by this author in Seoul in July 1998, it was claimed that the chairmen of the boards of the largest chaebol do not themselves know the full and true nature of certain key operating and financial data of their groups.

The low market value of the four large Korean groups reflects in part the heavy reliance of these groups on debt to finance expansion and the consequent claims on them by banks and other holders of debt. The high indebtedness of these groups is manifest in the low interest rate coverage ratios (earnings before tax plus capital consumption allowances divided by interest payments). Estimates of this ratio for the seven largest chaebol, as published by Goldman Sachs in late spring 1998, are indicated in Table 2. Financial analysts consider a ratio over 3.0 to be healthy and one below 2.0 to be unhealthy, with the range 2-3 considered problematic. As can be seen, only Samsung makes it into the healthy range while both Hyundai and Daewoo are in the unhealthy range. Because these latter two firms are exactly those that have increased debt since Goldman Sachs published its report, one can surmise that their coverage ratios have deteriorated. The smaller Korean chaebol all exhibit coverage ratios in the unhealthy range.

**Table 2: Estimated Cover Ratio for Top Seven Chaebol in 1998**

<table>
<thead>
<tr>
<th>Companies</th>
<th>Cover ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hyundai group</td>
<td>1.6</td>
</tr>
<tr>
<td>Samsung group</td>
<td>3.0</td>
</tr>
<tr>
<td>LG group</td>
<td>2.3</td>
</tr>
<tr>
<td>Daewoo group</td>
<td>1.4</td>
</tr>
<tr>
<td>SK group</td>
<td>2.6</td>
</tr>
<tr>
<td>Ssangyong group</td>
<td>1.0</td>
</tr>
<tr>
<td>Hanjin group</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Source: Goldman Sachs

It is against this backdrop that the Kim Dae Jung administration has sought restructuring of the chaebol. The year 1998 in this regard can probably be regarded best as one marked by discord and false starts with respect to this restructuring, but one that has ended with apparent agreement on some basic issues over which earlier lack of agreement blocked any promise of change. The major agreement is that the largest chaebol...
chaebol will in fact carry out the desire of the administration to concentrate on core businesses and to try to divest themselves of operations not material to these businesses. This is in fact a rather ill-defined goal, and it probably should remain so. The record of non-Korean firms that have attempted to be highly diversified industrial “conglomerates” tends in fact to be rather dismal (but with some notable exceptions), and it is not clear that Korean firms would fare any better in the long run. However, it is also clear that firms that too narrowly define their core businesses often do poorly, whereas firms that build upon core competencies to extend these to new lines of business often do quite well. (Indeed, one reason why Microsoft is today the defendant in an antitrust case being pursued by the U.S. Government is that the firm might have extended its core competence in computer operating systems into new lines of business such as internet software a little too successfully!)

At any rate, efforts to “de-conglomeratize” the large chaebol and to reduce surplus capacity had a checkered record during 1998. During the spring of the year, the Federation of Korean Industries (FKI—umbrella group of the chaebol) agreed with the government to pursue what came to be known as the “big deals,” whereby the chaebol would agree among themselves to swap assets to achieve focus on core businesses. However, during the summer, negotiations among the heads of the groups yielded little in the way of results that have been actually realized. The two truly big deals that were proposed—one involving the combination of LG and Hyundai’s semiconductor businesses to form what would be the world’s largest manufacturer of memory semiconductor chips, and the other involving a swap of Samsung’s automotive operations for electronics operations of Daewoo—have yet to be consummated.

The problem with the LG-Hyundai deal has been that, because the worldwide glut of semiconductor memory products that appeared in 1997 has ended, LG’s Semiconductor operations have become profitable. Accordingly, LG became increasingly reluctant to lose control of these. Also, the deal has been affected by labor unrest at LG Semiconductor, where the workers have feared for job loss were the deal to be completed. However, at the time of this writing, a break-through did seem imminent, following the resolution of a strike at LG Semiconductor and an announcement that terms of payment, a bone of contention between the two parties, was close to being settled.

The latter deal has been affected by Samsung’s reluctance to exit the auto business, a move that most analysts believe would be in the group’s best interests but, according to the financial press inside and outside Korea, has been resisted by the group chairman. However, as of the time of this writing, after a number of delays, this deal also appears to be on track.

The summer of 1998 also demonstrated difficulties in reduction of surplus capacity when a bitter labor strike against Hyundai Motors ended with an agreement between the firm and the striking unions that no workers would be laid off except via attrition. The strike and settlement underscored a very important dilemma. An important goal of restructuring—perhaps, in the long run, the most important goal—is to increase the productivity of labor in Korean industry. Without such an increase, neither the competitiveness of Korean firms nor, ultimately, the real wages of Korean workers can be improved. But this almost inevitably will require labor shedding from existing operations and redeployment of the displaced workers in activities where the marginal productivities of the workers are higher than at present. Alas, however, given the depressed state of the economy during most of 1998, for firms to shed labor could only add to the already very high pool of unemployed workers, an outcome acceptable to no one.

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8. One thinks of the largely failed efforts by such firms as Litton Industries, Textron, and IT&T in the United States to pursue a strategy of becoming conglomerates during the 1960s, as well as that of Daimler Benz during the late 1980s and early 1990s. However, one of the most successful international firms, General Electric, arguably has pursued such a strategy, but following very defined economic criteria (and, importantly, ones that are quantifiable) for what types of business it will pursue and aggressively divesting itself of operations that don’t meet the criteria or fail to perform according to expectation.
In spite of all of this, however, the Korean government has reported some success in its efforts to deal with problems affecting the second tier of chaebol. A “Corporate Restructuring Agreement” has been signed by 200 financial institutions whereby these institutions have created creditors’ councils to work out financial restructuring agreements. Once a creditors’ council has convened, an effective standstill on claims on debtor groups goes into effect. If an agreed-upon work out program cannot be achieved, the case can be resolved via arbitration. As of the time of this writing, 43 affiliates of 16 second-tier chaebol had completed workout programs.

Certain reforms that the government put into place during 1998 doubtlessly will change business practices in Korea so as to bring about long run benefits. Prime among these is the banning of intra-group debt guarantees that have, as noted, contributed to misallocation of resources. New guarantees of this sort already are banned and, in addition, the government is requiring that all such guarantees be erased by sometime next year. As has already been mentioned, the sorting out of these guarantees has hampered efforts to date at restructuring. Thus, an end to the practice should, among other things, ultimately lead to improved conditions for merger and acquisition activity in Korea. During the last quarter of 1998, the top five chaebol in fact reduced cross debt guarantees among their subsidiaries by almost $US 13 billion. In response to a request by the government’s Financial Supervisory Service, the top five have agreed to erase all such guarantees by the end of March, 2000.

In addition to the ending of intra-group debt guarantees, the Korean government has significantly strengthened prudential regulation of financial institutions and application of competition policy, and these moves will also have favorable long run effects on the restructuring of industry.9

Another dimension on which some success could be claimed has been in the area of acquisition of Korean firms by foreign investors, including firms that used to be members of the top five chaebol groups. Foreign direct investment into Korea in 1998 is estimated by the Bank of Korea to be in excess of $5 billion, a record for Korea, and much of this is accounted for by acquisitions. These acquisitions have not yet altered the fundamental nature of the large chaebol. However, more deals are in likely to be in the offing.

The overall conclusion is that, with respect to industrial restructuring in Korea, some progress has been made, but there is a very long way to go. Beyond excessive debt and overcapacity, the problems of the chaebol do differ from firm to firm. Samsung is profitable and relatively little indebted but, as suggested above, suffers from what many analysts believe was an unwise decision in the past to try to enter the already crowded market for cars in Korea. The automotive sector is running at barely 50% of capacity utilization, and most analysts believe that when Samsung does write off its large investment in entry into this sector and exit entirely, the group will be in quite good shape.10 Compounding this, in early 1999, surging demand for large memory devices has bolstered Samsung Electronics’ profits and contributed to the group’s claim that it will be able to reduce its debt to equity ratio to 200% by the end of the first half of 1999, down from 253% at the end of 1998. Heavily indebted Daewoo during 1998 continued with ambitious plans to expand outside of Korea, including in the overcrowded car market in India, and has taken over the Ssanyong Motor Company. Hyundai has taken over the bankrupt Kia group, also a car manufacturer, adding to Hyundai’s considerable debt and to its surplus automobile capacity. Hyundai has also announced ambitious plans for expansion into North Korea. Hyundai is kept afloat by its profitable shipbuilding subsidiary. And, in spite of the overall lack of profitability and huge debt of their groups, top executives at both Hyundai and Daewoo were as recently as December 1998 talking of still further expansion. Hyundai in early 1999 announced that it would split into five firms, but that family control would be maintained over

9. It is said with some credibility that the Korean Fair Trade Commission, created in the early 1980s but never highly effective, has emerged as one of the most powerful of Korean governmental agencies during the current administration.

each of these. Exactly how these firms could continue to expand but meet debt reduction goals by March, 2000 was unclear. Daewoo has announced that it would divest itself of a large number of its subsidiaries in order to concentrate on core businesses and to raise equity and Hyundai has announced that it will seek capital injections from abroad but analysts seem to be divided on whether these moves will be sufficient to meet debt reduction requirements.

Where does it all go from here? It is hard to say. The agreement in late December of the top management of the largest chaebol to focus more tightly on their core businesses is a promising turn of events. Another promising turn is the possibility that Korea’s recession is ending and that growth, even if modest by historical standards, will return to the Korean economy. 1999 thus is likely to be a watershed year for Korea.

Dr. Graham is a Senior Fellow at the Institute for International Economics (IIE) in Washington, D.C. He gratefully acknowledges the research assistance of Hiroko Ishii.
LABOR MARKET REFORM

by Donggyun Shin

The Korean Labor Market before 1998

Due to phenomenal economic growth for 30 years and the resulting rapid growth of demand for labor, Korea experienced an unprecedented labor shortage as it approached 1997. The unemployment level remained around 2% in the 1990s. Analysts argued that the unemployment rate was too low below the “non-accelerating wage rate of unemployment” (NAWRU). For the 1990–97 period, the average annual nominal wage increase was approximately 13 percent. Real wages almost doubled from 1987 to 1997. The demand for labor absorbed foreign workers from various countries in Southeast Asia. As of 1996, more than 200 thousand foreign workers actively participated in the Korean labor market, mainly in low wage sectors.

Meanwhile, wage increases far outran productivity increases, which discouraged a large number of industries from investing. Until the mid-1980s, Korea enjoyed cheap labor costs compared with competing countries such as Taiwan, Hong Kong and Singapore. However, the rapid rise in wages after 1987 increased unit labor costs, and cheap labor was no longer an advantage for Korea in international competition. Since the political democratization of 1987, trade unions, utilizing relatively advantageous collective bargaining contracts, were often successful in wage negotiations with employers. Nominal wages doubled within just four years. In order to compete in the international market, companies had to increase productivity through other methods such as upgrading skills, increasing factory efficiency, and moving to higher value-added products. The Korean economy reached a point which demanded a paradigm shift in development—a transition from an input-driven economy to a technology-driven one. For a successful transition and in order to enhance the competitiveness of the Korean economy, it became necessary to restructure the labor market and obtain harmonious and flexible industrial relations. Various policy prescriptions were suggested by specialists to restructure the labor market, but they mostly failed because of government inaction.

The Financial Crisis and Labor Market Restructuring

The financial crisis of late 1997 accelerated the restructuring process. Achieving labor market flexibility is at the center of this effort. Jobs are no longer to be protected. The goal of labor market policies is to protect employment instead. From the aspect of employment adjustment, the yearly job turnover rate is now 35%, which is very close to the 40% in the United States, which is known as having the highest labor market flexibility. From September 1997 until September 1998, the number of permanent workers decreased by 100 thousand. The percentage of wage workers among the total of those working dropped from 62.1% in June 1997 to 60.4% in June 1998. The average job tenure of Korean workers is 5.3 years, while that of U.S. workers is 6.7 years. The official unemployment rate as of September 1998 reached 7.3 percent, with the number of unemployed exceeding 1.5 million. Recent statistics show that more than nine of every ten unemployed persons are displaced workers, which implies that the recent structural adjustment of the labor market was both fast and dramatic.

Most of the unemployed came from the construction, trade, and manufacturing sectors. By occupation, most were from non-professional jobs such as technical personnel and simple laborers (53.6%) and services and sales positions (22.1%). For the period from January to August 1998, the monthly average of workers newly employed or reemployed was 840 thousand, and the monthly average of those separated was 766 thousand. The proportion of permanent workers among total workers keeps decreasing, while the proportion of temporary and daily workers is continuously increasing. These recent statistics reveal that the Korean labor market is experiencing very strong labor mobility.
on wage cuts. The Korea Development Institute predicted that real wages would drop by 12% in 1998 and by 13% in 1999. This indicates that procyclical nominal and real wage movements are very strong in Korea. With respect to the institutional aspects of the labor market, the unionization rate has been decreasing since the late 1980s and is now only a little over 13% (which is lower than the 16% of the United States). Furthermore, most collective bargaining in Korea takes place at the enterprise level, as in Japan and the United States.

Measures Concerned with Labor Market Flexibility

The question of whether a rise in the unemployment rate is cyclical or structural is not easily answered, as dramatic cyclical changes induce structural adjustments. Nor is it simple to compare the degree of labor market flexibility among nations. However, the above statistics show that most labor market variables have responded very quickly and procyclically with the recent recession, which implies that the Korean labor market is not that rigid. Moreover, Korea did something to extend labor market flexibility in the adjustment process. Newly introduced measures include a flexible work hour system, dismissal for managerial reasons, and the dispatched worker system.

Enhancing the competitiveness of companies required introduction of a flexible employment system and flexible work hour system. In early 1997, Korea revised its 43-year old labor laws according to democratic and tripartite procedures. Under the new labor laws, working hours can be extended up to 48 hours for a certain week on a biweekly basis under the Rules of Employment, and 56 hours for a certain week with a 12 hour a day limit on a monthly basis under written agreement. Further, a selective work-hour system allows workers to choose the beginning and ending time of work. For tasks performed mostly outside the workplace, or performed at the workers’ own discretion, labor and management may count the total number of hours worked as specified in a written agreement.

The new law also introduces employment adjustment for managerial reasons, while providing protection for workers by requiring, *inter alia*, urgent managerial reasons, prior efforts to avoid dismissal, and advance consultation with the trade union or other workers’ representatives. However, there was a two-year grace period for employment adjustment for managerial reasons under the new labor law. On January 15, 1998, as part of the International Monetary Fund’s financial bailout package, the Korean government formed a labor-management-government committee to discuss ways to resolve the nation’s economic crisis. On February 14, 1998, the National Assembly passed the new layoff legislation, which became effective February 20, 1998. As a result, the two-year grace period was abolished, and employers can dismiss employees for managerial reasons as long as, with a few extra conditions, they give a sixty-day-notice to the employees’ representative or the union which represents the majority of the employees. In addition to the flexible work hour system and dismissal for managerial reasons, a dispatched worker system has been institutionalized to meet the need of flexible employment patterns. After labor-management consultation, dispatched workers are available for jobs requiring specific skills, experience, etc.

Combating High Unemployment

Extending labor market flexibility, which aims at enhancing firms’ competitiveness, comes at the cost of a sharp increase in the unemployment rate. More than 1.5 million workers were unemployed as of October 1998. The Korean government is addressing drastic measures to lessen the social impact of high employment. First priority is given to projects with job creating potential, such as public works projects, major state-owned corporations, and regional economic projects. The resources for these projects are reflected in the supplementary budget. Second, to support employment security and to enhance the social safety net, the employment insurance program has been expanded into all workplaces, and livelihood protection schemes have been strengthened for the low income unemployed.

1. “Dispatched workers” are temporary employees who are on the payroll of temporary employment agencies, but are assigned to another employer for jobs requiring specific skills or experience.
Third, vocational training and job placement services will be fully implemented to enhance the employability of the unemployed. Various policy measures have also been introduced to cope with economically disadvantaged groups such as the long-term unemployed and unemployed female heads of household. According to a report from the Ministry of Labor, as a result of implementing the unemployment policy for four months up to the end of July 1998, 2,661.2 billion won out of 7,011.4 billion won which was scheduled to be spent for nine months (April – December) had been used and had benefitted 1.15 million workers through job retention, unemployment benefits, vocational training, and public works projects.

**Industrial Relations Reform**

When it comes to the development of Korea’s industrial relations, the year 1987 is considered a turning point. The “Declaration of Democratization” was proclaimed on June 29, 1987. The pre-Declaration period is classified as the period of “employer-dominating industrial relations,” whereas the post-1987 period, marked by massive industrial disputes, is seen as the “period of confrontation and conflict” in which a power equilibrium between employers and employees was strenuously sought. Before 1987, the number of labor disputes averaged 200 a year; in 1987, however, the number totaled 3,749.

Labor disputes in 1987 were characterized by their illegitimacy. In other words, worker demands were not reflected in a proper manner. Neither labor nor management was properly trained or mentally prepared for healthy negotiations and dispute settlements. As they went through massive labor disputes, the capacity of trade unions to organize was strengthened. The number of unionized workers increased from 948 thousand in June 1987 to 1,270 thousand at the end of the same year, and to 1,930 thousand by 1989. In the process, worker rights were promoted to some extent, and labor and management began to perceive each other as equals.

It was not until 1989 that the government began to take strong action against illegal labor disputes. As a result of the government’s measures, many trade union leaders were brought before the law. After 1990, labor disputes in Korea stabilized in terms of numbers. The number of labor disputes peaked in 1987 at 3,749 cases and dropped remarkably in 1989 (1,616) and 1992 (234). By 1995 there were only 88, and in 1996 only 85. The number of unionized workers dropped gradually from 1,930 thousand in 1989 to 1,610 thousand in 1995. However, this did not necessarily mean that industrial relations also stabilized in general. It only meant that the time of turbulence during the post-1987 period had stabilized comparatively since 1990, but labor and management had not quite shed their age-old confrontation and conflicts. Evidence shows that the total number of work days lost due to labor disputes increased from 392,581 in 1995 to 892,987 in 1996.

The problem was that confrontational labor relations were still pervasive. Labor-management negotiation practices depended heavily on the logic of power, and the distrust between the two parties was still widespread. Trade unions know that they cannot achieve much from the traditional confrontations and violent struggles, but they have not come up with a better process. Moreover, managers also maintained a reserved attitude toward labor relations, thinking that it would be all right as long as there were no labor disputes at the workplace. In a public opinion poll jointly conducted by the Presidential Commission on Industrial Relations Reform and the National Economy and Education Institute in May 1996, 90.5% out of the total 1,541 respondents replied that “labor relations should be improved,” which implied that labor relations in Korea were still plagued with confrontation and conflict.

Recognizing that an economy with inefficient labor-management relations cannot survive in the age of borderless competition, the government, labor and management came to agree that a new system for harmonious industrial relations was required to allow Korea’s economy to sustain development. The Korean Labor Laws, which had not been significantly changed for 43 years since their first enactment in 1953, were evaluated as unsuitable for the 21st century and the coming era of globalization and information. Therefore, these laws were under revision in early 1997. Especially, The Act concerning the Promotion of Worker Participation and Cooperation, promulgated in March 1997, demanded that enterprises with 30 or more workers organize a labor-management council composed of equal numbers of worker and management representatives and hold quarterly meetings. The labor-management council discusses, *inter alia*, im-
provement of productivity and workers’ welfare, prevention of labor disputes, and working environment issues. Under the new law, the labor-management council has been given enhanced powers. For example, the councils now have greater authority to introduce and manage education and training plans and welfare facilities at the work place. The Central Labor-Management-Government Council is the supreme tripartite body of labor, management, and public interest groups at the national level that deliberates on labor policies related to industrial, economic and social policies and other matters regarding measures to promote industrial peace.

As industrial relations change from confrontation and conflict to participation and cooperation, labor and management are trying to seek solutions through dialogue and negotiation. Nevertheless, it is desirable to have a dispute resolution system. In principle, whenever disputes occur out of disagreement on working conditions, the Trade Union and Labor Relations Adjustment Act prescribes that labor and management should make efforts to resolve the dispute autonomously. The new law also introduces a narrower scope and stricter conditions for compulsory arbitration. Only essential public services such as water, electricity, gas, oil, telecommunications, railroads, hospitals, inner-city bus services, and banking services are subject to compulsory arbitration. Compulsory arbitration can be conducted by the Labor Relations Commission if the Special Mediation Committee, composed of three public interest representatives, recommends arbitration.

Conclusions

The fundamental solution to the unemployment problem lies in the creation of jobs as soon as possible through the enhanced competitiveness resulting from successful structural reform. It is generally recognized that high unemployment is inevitable in the restructuring process. Various labor and social welfare programs have been introduced, therefore, to lessen the pain of high unemployment, though they are far from sufficient. One of the major tasks for the near future is to make wages functionally more flexible, that is, to strengthen the linkage between wages and productivity. As described above, real and even nominal wages are cyclically very flexible in the Korean labor market. However, individual wages do not appear to reflect productivity differentials, which creates functional wage rigidity. That explains why the Korean labor market has gradually lost international competitiveness even during the period of rapid economic growth. Rationalization of the wage system should be achieved through promoting an ability and performance-based wage and annual salary system. Functional wage flexibility should be the primary policy variable in order to achieve a healthy and competitive labor market.

Dr. Shin is a research fellow at the Korea Labor Institute (KLI) in Seoul.
GOVERNMENT REFORM IN KOREA

by Jin Park

Introduction

Korea is now enduring a serious economic crisis. More disturbing is that the underlying cause of this phenomenon is not just a short-term cash flow problem. It is rather a more fundamental problem of lost competitiveness. According to a recent report by McKinsey & Co., Korea’s industrial productivity rate is at barely half the level of the United States.

What happened to the last three decades of miracle growth that was the envy of the world? None of the participants in the economy—government, business, workers, or consumers—are free of responsibility. However, the people of Korea have long been praised for their industrious work ethics and achievements. Korean companies’ potential and past contributions in the industrialization process should be duly acknowledged, although they have now become targets of criticism for their irresponsible expansion.

One factor which must be deeply addressed, however, is the role of the government, which must change to meet today’s challenges. Government reorganization is a growing trend in the world as demands for improved service are on the rise everywhere. Korea is not an exception, because almost every observer both at home and abroad feels that the Korean government played an important role in the decline of the economy. This article seeks to suggest a line of policy adjustments that the government will need to undertake to bring about a better future. We need to reinvent the Korean government for at least four reasons:

• First, Korea simply cannot survive in today’s international environment with the system that it has today. The producer-oriented bureaucratic administration cannot deliver required public services efficiently. It will be sure to fail to attract the highly-skilled labor and highly-productive firms that are needed to remain competitive in this open international market with high factor mobility;

• Second, if reforms take place, they can result in an enormous reduction of the government budget. There are more than 700 government-affiliated agencies, and many of them are inefficient. The savings realized through reform could be reallocated to support corporate restructuring and to provide unemployment benefits;

• Third, reinventing the Korean government will serve as a catalyst for other reforms to follow. Before the government asks the public to bear the inevitable pain and suffering of reform measures, it must set an example by taking necessary painful steps of its own;

• Fourth, foreign investors are looking at Korea’s economic reform measures as an important signal for their investment decisions. Therefore, government reforms are an essential task for a Korea in crisis.

What Korea needs today is major reform, not just gradual improvement of the old order. This will not be an easy process. In The Prince, Machiavelli noted that there is nothing more difficult, more perilous, more uncertain, than to take the lead in the introduction of a new order of things. Severe opposition is expected to arise. However, in the present economic crisis a strong reform leadership can create a positive public consensus. Therefore, this moment must be seized.

What kind of vision should Korea follow when it begins to implement reform? It is the entrepreneurial model that I would propose. An entrepreneurial government sees itself as essentially a unique form of business run by the taxes paid by the public. Therefore, the entrepreneurial government’s ultimate objective is to create added value for the customers (taxpayers). An entrepreneurial government is small in size and efficient in service. It has genuine regard for the public as its customers and places the highest value on serving them. During the past decade, governments of the United Kingdom, New Zealand, and the United States have all restructured under the concept of a government enterprise in service to the public.
Government's Response to the Crisis

The basic directions to reinvent the Korean government are three-fold: 1) to restructure the organization of the public sector; 2) to reorganize personnel management; and 3) to reform fiscal procedures.

Public Sector Restructuring

To restructure the public sector, the division of public and private functions has been reassessed. Those with commercial characteristics will be privatized or contracted out to the private sector. At the same time, various government bodies and agencies need to be eliminated or merged. The Planning and Budget Commission (PBC) has outlined a series of restructuring plans for many government-affiliated organizations such as government-funded institutions and state-owned enterprises (SOEs).

The state-owned enterprises have made their share of contributions to the development of Korea, yet in part precisely because of these contributions the economic environment has changed drastically. The dangers of private monopolies have been drastically reduced, and the financial as well as the managerial abilities of the private sector have been greatly enhanced. Thus, the need for privatization has emerged as the past need for public corporations has vanished and the inefficiencies of these bureaucracies has become highlighted. Based on this perception, three principles have been applied to the reform of the state owned enterprises.

First, all state-owned enterprises were reviewed for privatization, and the following eleven will be privatized: Korea Telecom Corp.; Korean Tobacco and Ginseng Corp.; Pohang Iron and Steel Co., Ltd.; Korea Electric Power Corp.; Korea Heavy Industries and Construction Co., Ltd.; Korea Gas Corp.; Korea General Chemical Corp. (sold); Korea Technology Banking Corp.; National Textbook Co., Ltd. (sold); Daehan Oil Pipeline Corp.; and Korea District Heating Corp.

In formulating an action plan for each state-owned enterprise, the Planning and Budget Commission (PBC) has worked closely with the Ministry of Finance and Economy and the relevant line ministries. The PBC has also consulted with the managements and labor unions of the enterprises involved. In formulating specific privatization plans, the PBC has benefited from the advice of the World Bank’s technical assistance team as well as from various consulting firms and research institutions (such as the Korea Development Institute) with expertise in privatization.

The method of privatization is through sales of assets, partial sales of assets, and stock sales. Foreign investments will be encouraged. Concerns over concentration of economic power and the state of the stock market have received less attention than previously.

Second, state-owned enterprises that perform overlapping functions or have completed their objectives will be resolutely eliminated or merged. These plans are based on careful analyses of corporations’ functions, and no plans have been made without due regard to the utility of the functions being performed.

Third, even in cases where the government retains ownership, drastic structural adjustment and management reform is taking place. Reforms will be implemented with the goal of eliminating all sources of inefficiency. Top managers will be subject to contractual employment and will be given incentives in the form of stock options or other measures. However, managers will be given full authority over personnel and financial matters.

Privatization will increase government revenues, and private sector participation in infrastructure projects will also reduce the financial burden of the government. To this end, we have revised the terms of private sector participation in infrastructure projects in a manner that will be more attractive to private investors. These new practices include application of the BOT (Build-Operate-Transfer) method and increasing the rate of return on investment to a level acceptable to foreign investors. The Inchon New International Airport, which will open on January 1, 2001, will be privatized in such a manner.

The Planning and Budget Commission has also launched consulting projects on each government ministry. The output of these projects will be an important reference point for the government reorganization scheduled during the first half of 1999.
**Reorganization of Government Personnel Management**

As the second direction of reform, the government is reorganizing personnel management. In order to fulfill its role, the government must be exposed to the highest degree of accountability. Responsibilities must be clearly codified, and performance must be strictly reviewed. For this end, the following steps have been or will be taken.

First, each and every individual government employee must clearly understand his or her responsibilities. The importance of the “customer first” concept cannot be over emphasized. In the cases of New Zealand and the United Kingdom, all ministers and directors of government agencies before the start of each fiscal year prepare contracts that include goals and review standards. The Planning and Budget Commission of Korea has already partially implemented this practice, prompting every member’s full understanding of his duties and performance expectations.

Second, a result-driven personnel management system that systematically reflects performance reviews is needed. Until now, the government service simply focused on whether an action has been taken and how much money and labor was disbursed rather than the quality of service provided. After the study currently being carried out by the PBC, focus will be put on whether the service rendered was to the satisfaction of the customers.

Third, in carrying out their duties, full authority will be conferred on government employees, allowing each individual to make his or her own assessment and analysis. Through comprehensive delegation of decision-making power throughout the public sector, we believe increased efficiency can be achieved.

Fourth, personnel management must be merit-based. The existing practice that assigns more weight to seniority as opposed to merit will be changed. Furthermore, recruiting from outside the civil service system is necessary to enhance the quality of those in service to the government. The Planning and Budget Commission is setting an example in this regard by recruiting 14 non-civil servants for the government reform effort.

**Fiscal Reform**

Fiscal reform is the third direction in reinventing government. The problems associated with fiscal management in Korea can be summarized as follows. First, there has been overly rigid control. The effectiveness of fiscal management should be measured by output instead of input. To this end, budget entries will be reorganized to focus on results.

Second, the current fiscal system lacks transparency due to its complexity. The Planning and Budget Commission endeavors to simplify and clarify the present system through adoption of double entry accounting procedures which will be tried out in 1999.

Third, since the budget is administered on a yearly basis, it lacks flexibility and a long-term perspective. The Commission has established the Mid-Term Fiscal Planning Division to address this problem. This mid-term fiscal planning is designed to prevent inefficient fiscal expenditures.

**Prospects for Success**

All these three directions of reform have been attempted before, but the judgment on the success of those attempts is less than encouraging. What was the reason for those past failures, and will it be different now?

First, one can point to the one-time nature of those reforms. The current administration will seek to embrace a systematic transformation. To this end, the PBC will assign reform targets to each government ministry and agency. Those reform targets are now being reviewed twice each month in order to accurately assess implementation progress.

Second, clear objectives and detailed strategies and programs to implement the reforms are needed. Such objectives and strategies were not clearly stated in previous reform efforts.

Third, a core group that champions the reforms and can push forward with resoluteness and consistency must be established. This condition is important in order to deal effectively with the resistance of entrenched interest groups.
Establishing goals and strategies as well as establishing a group that can consistently carry out the reform measures is the responsibility of the Planning and Budget Commission. Its members will not hesitate to put forth maximum effort to bring about the hoped for outcome. For that reason, the Commission was placed under the direct supervision of the president, with authority to compile and coordinate the opinions of the entire public sector.

However, as Machiavelli noted, the innovator has for enemies all those who have done well under the old conditions, and lukewarm defenders in those who may do well under the new. Therefore, reform requires the support of the public, without which its success is less than certain. It is not too much to say that people’s support may well determine the outcome of our effort. At the same time, the media must play a role in steering the nation through the sea of conflict and distress that may be ahead.

In conclusion, the Korean government’s resoluteness, coupled with support from the people, will without a doubt bring about a reinvented government in Korea. The reason behind this firm belief is that generations of Korean people have been disciplined by the hard and bitter road to development, and they have shown the will to win over this economic crisis.

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NEW BUSINESS ENVIRONMENT FOR FOREIGN INVESTORS

THE POLICY ENVIRONMENT FOR FOREIGN DIRECT INVESTMENT

by June-Dong Kim

Introduction

Even though the Korean government has made efforts to liberalize foreign direct investment (FDI) since the mid-1980s, its basic position towards FDI was passive. In other words, the government allowed foreign direct investment into liberalized business categories and activities but was not interested in removing the myriad impediments or promoting foreign direct investment to the extent of other Asian countries.

At the end of 1997, Korea went through a currency crisis when the won lost over 50% of its value against the U.S. dollar. Loss of foreign reserves and refusals by foreign lenders to roll over Korean bank debts brought Korea to the brink of default in late December 1997. To overcome the crisis in a short period and with less pain, the Korean government has undertaken active promotion of foreign direct investment to replace the passive liberalization heretofore.

Improving the Foreign Investment Environment

On September 2, 1998, the National Assembly passed the Foreign Investment Promotion Act, which went into effect on November 17. The new law symbolizes the government’s effort to drastically change its policies on foreign direct investment from passive liberalization to active promotion. The Foreign Investment Promotion Act aims to create an investor-oriented support system providing one-stop service and support. It also seeks to make investment incentives competitive with those of other Asian countries. The basic framework of the Foreign Investment Promotion Act is to:

• Streamline foreign investment procedures;
• Strengthen investment incentives;
• Establish a “one-stop” service system; and
• Introduce an ombudsman system for foreign investors.

Streamlining Foreign Investment Procedures

The quasi-notification system, in which notifications by foreign investors were subject to acceptance, will be replaced with a genuine notification system in which foreign investors simply have to notify foreign exchange banks or the Korea Trade and Investment Promotion Agency (KOTRA) of their investment. Only in the case of mergers or acquisitions of defense-related firms is prior approval required.

For the sake of investor convenience, the requirement to designate a resident agent for notification or registration has been abolished, and the number of documents to file for an investment has been reduced from 83 to 37.

Strengthening Investment Incentives

The government has strengthened investment incentives by augmenting tax exemption and tax reduction rules. Corporate and income taxes will be exempted or reduced for FDI in target industries (such as the high-tech industry) for 10 years—full exemption for the first seven years and a 50% tax reduction for the remaining three years. Various local taxes will also be exempted or reduced for 8 to 15 years at the discretion of local governments. National and public real properties will be rented to foreign invested firms for up to 50 years. The new law also allows rental cost exemptions and reductions for FDI.

A Foreign Investment Zone (FIZ) will be developed to accommodate large-scale FDI. The location of the zone
will be determined at the request of foreign investors. Various support measures, including infrastructure and tax support, will be provided to foreign firms in the FIZ.

Since local governments face budget constraints, the national government will support local government FDI promotion activities by providing funds for the creation of FIZs, funds to purchase land to be rented to FIZs and to reduce rental fees, and budgetary support for such subsidies as job training. In order to induce active promotion on the part of local governments, the size of financing or budgetary support by the national government will be determined on the basis of assessment of local government efforts to promote foreign direct investment.

While strengthening investment incentives is needed to compete for inward FDI, it raises a degree of discrimination against domestic investors since the incentives stipulated in the Foreign Investment Promotion Act are applied exclusively to foreign investors. It also has the danger of triggering a negative-sum-game competition among countries in the region based on comparative incentives.

**Improving Administrative Services**

To improve administrative services to foreign investors, the government designated the Korea Trade and Investment Promotion Agency (KOTRA) as a one-stop service agency. The Investment Promotion Center at KOTRA is in charge of all matters related to guidance and administrative support to foreign investors. The Center also takes full charge of investor relations in order to promote FDI into Korea.

To expedite the provision of one-stop service through a quasi-governmental organization (KOTRA), the government introduced the Comprehensive Processing System for applications and an automatic approval system. Under the Comprehensive Processing System, approval of the principal application of a package of applications implies supplementary approvals of the remaining applications. The automatic approval system means that an approval shall be regarded as automatically granted if there is no response to an application related to FDI within the time period stipulated by law. Foreign investment promotion officers will also be appointed in local governments to implement and monitor the Comprehensive Processing System.

Recognition of the role of post-establishment service in promoting FDI has led the government to set up an ombudsman at KOTRA for foreign investors. The ombudsman will address grievances and difficulties of both new and existing investors. In order to solve matters requested by the ombudsman and coordinate promotion activities of various institutions, the function of the Foreign Investment Committee has been strengthened. Composed of ministers of the related institutions, the Foreign Investment Committee makes decisions on: basic policy and FDI law; the criteria for tax incentives (e.g. scope of businesses eligible for tax benefits); support for local government; and designation and support of FIZs.

**Liberalization of Sectoral Restrictions**

In August 1998, 22 business categories (including real estate, land development, waterworks, and investment companies and investment trusts) were fully opened to foreign direct investment. Manufacturing of tobacco products was partially opened, so that 25% of the total shares of the Korea Tobacco and Ginseng Corporation will be sold to foreign investment upon its privatization. Foreign investments into privately owned electric power generating firms and the trust industry were also fully opened. Furthermore, existing ceilings on foreign equity ratios were raised in five business categories (including electric power generation, newspaper publishing, and telecommunications) in January 1999.

There are now only 31 business categories in which foreign investment remains restricted, and these remaining sectoral restrictions are mainly due to national security, cultural protection, and the protection of farmers and fishermen.

**Liberalization of Cross-Border Mergers and Acquisitions**

Since friendly mergers and acquisitions (M&As) — with the consent of board of directors of the targeted company — were allowed in February 1997, the Korean government has implemented the following measures to further liberalize cross-border M&As:
Ceilings on foreign equity ownership in the stock market were completely eliminated as of May 25, 1998;

Hostile takeovers were fully liberalized as of May 25, 1998; seeking the permission of the target Board of Directors to exceed 33% of company is no longer required; and

The mandatory tender offer rule was abolished on February 16, 1998. Formerly, if any person wished to purchase 25% or more of a publicly traded company’s shares, such person was required to make a tender offer to purchase more than 50% of the company’s shares.

Liberalization of Foreign Land Ownership

The Korean people are intensely attached to the land, and therefore opening up the real estate market had been last on the agenda of the government’s liberalization plans in the past. However, the need to inject foreign capital as well as to avoid a sharp downturn of the real estate market persuaded the government to fully liberalize foreign land ownership through amending the Foreigner’s Land Acquisition Act in July 1998.

Under the amendment, foreign companies and foreign individuals may freely acquire land without any limitations on use or size. Previously, if a foreign company acquired “non-business” real estate as a result of acquisition of a Korean company, it was required to sell it within five years. With removal of this restriction, foreign companies which merge with or acquire Korean companies are now allowed to hold any real estate owned by the Korean company, regardless of its purpose.

The opening up of the real estate sector is regarded by foreign investors as one of the most drastic changes that the Korean government has enacted since the onset of the economic crisis. That foreigners can engage in real estate transactions is symbolic of the will of the Korean government to truly welcome foreign investment and to open its market.

Privatization

Since the early 1990s, the Korean government has tried to implement privatization plans for some of the state-owned enterprises (SOEs) in order to improve management accountability and efficiency. These efforts failed, however, due to opposition from interest groups such as the enterprises themselves and their related ministries. However, the urgency to increase revenue and to inject stable capital as well as to enhance efficiency has led the government to develop comprehensive programs for the privatization of state-owned enterprises. On July 3, 1998, the Planning and Budget Commission announced its first phase privatization program for 11 enterprises, including Korea Electric Power Corporation (KEPCO), Pohang Iron & Steel Company (POSCO), Korea Heavy Industry Construction Corporation, and Korea Telecom (KT). In formulating privatization plans for these state-owned enterprises, the following issues were duly considered: the adequacy of the existing regulatory framework; the level of competition in the market; the adequacy of the existing corporate governance structure; the company’s financial condition and performance record; labor issues; and finding an optimal privatization technique.

Out of these 11 state-run corporations subject to the first phase privatization plan, five companies and their 21 subsidiaries were selected to be privatized immediately. They are POSCO, Korea Heavy Industry & Construction Corp., Korea General Chemistry Corp., Korea Technology Banking Corp., and National Textbook Corp. The six remaining SOEs will be privatized on a gradual basis by 2002.

The second phase privatization program was announced on August 4, 1998. It focused on restructuring 19 state-owned enterprises, including the 6 SOEs to be gradually privatized under the first phase privatization plan.

Private-sector Participation in Infrastructure Projects

Whereas privatization of state-run corporations will lead to increased revenue for the government, private sector participation in infrastructure (PPI) projects will reduce the government’s financial burden and enable it to better support the structural adjustment programs. In order to make PPI projects more attractive to the private sector and to incorporate, to the extent possible, the “best practices” utilized by other countries, the following changes are being proposed:
• Add BOT (Build-Operate-Transfer), BLT (Build-Lease-Transfer) and ROT (Rehabilitate-Operate-Transfer) methods to the existing BTO (Build-Transfer-Operate) methods;
• Introduce various incentives (such as tax breaks and other forms of government support);
• Increase the rate of return on investment to an internationally acceptable level;
• Use outside consultants and advisors in feasibility studies;
• Increase transparency in the formulation and application of rules and regulations; and
• Establish and operate “one-stop” centers to help deal with red tape.

Enhancing Transparency

The lack of transparency is recognized as one of the most critical factors which led foreign creditors to lose confidence in the Korean economy in the current crisis. To enhance regulatory transparency, the government is embarking on wide-range regulatory reform. Besides streamlining investment procedures, the Committee for Regulatory Reform under the Prime Minister is currently reviewing about 10,000 regulations and aims to eliminate at least half of them.

To enhance transparency in the corporate sector, corporations have been required as of 1999 to produce consolidated financial statements that are in line with international standards. Penalties for any improper acts in the course of auditing have also been increased in order to enhance the accountability of external auditors and accounting personnel. In addition, the government has required disclosure of off-balance sheet liabilities such as affiliate payment guarantees, and has strengthened regulations concerning inadequate disclosure.

In tandem with these steps, the government has implemented measures such as compulsory appointment of outside directors and strengthening of voting rights of minority shareholders in order to improve corporate governance structures.

Conclusion: More Effort Needed

During 1998, the Korean government implemented drastic policy measures to promote foreign direct investment. In particular, the government enacted the Foreign Investment Promotion Act to improve the support system for foreign investors and liberalized M&A regulations to the point where Korea’s takeover laws are among the most straightforward in Asia. The liberalization of foreign land ownership is also symbolic of the will of the government to truly welcome foreign investment and to open up the market.

Although the government is making some progress in removing cross-border barriers, Korea’s markets and industries are still bogged down with internal regulations that are as complicated as they are vague. Besides the cumbersome regulations on market access for imported goods, lack of transparency in such areas as taxation, advertising and banking deters foreign investment. Furthermore, legal weaknesses are also a serious impediment. One of the common complaints by foreign businessmen is that real estate owners often demand side contracts to reduce their tax burden.

A key barrier to deals related to M&As in Korea is valuation. Agreement on valuations in Korea is difficult because Korean sellers often appear to be fixed on one price which is derived from a mix of book values, personal contribution to a business and other unmeasurable factors. This differs markedly from Western concepts of company valuation, which center on cash flow, discount rates and calculated forecasts. The other issues to be resolved for facilitation of M&A activity besides transparency and valuation are lack of conformity in financial data, related party transactions, cross-guarantees, tax issues, haircut on bank borrowings, labor issues (layoffs, severance accrual), and use of advisers.

There is also a substantial trust deficit or perception gap between Korean and foreign firms. According to a recent survey, more than half of non-Korean negotiators had difficulty trusting their Korean counterparts, and only 20% of non-Koreans felt that treating the foreigners as partners was of value to Koreans. This can, in part, be attributed to a lack of understanding by the
Western party of the Korean social system and of how this system is reflected in organizational structure. Such understanding takes time and experience to accumulate.

Even though some large foreign investors have made significant investments through acquisitions of Korean companies, the current stage of inbound investment is dominated by existing foreign invested enterprises with strategic motivations to expand their presence in both domestic and regional markets. The recent surge of investments through M&As can also be attributed to the weakened Korean won and to the urgency of the Korean companies to restructure. However, investments by new investors or institutional investors depend on how the reforms in the financial and corporate sectors are implemented. Only if uncertainties concerning the reform process and the recovery of the Korean economy are erased will new investors attempt to explore Korea’s potential.

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A great deal has been written about the difficulties of doing business in Korea. The *Hermit Kingdom* has been slow to open its borders to trade and investment, and the barriers that existed caused many to ask why any foreign company would bother doing business here at all. The fact is that, while Korea has been a difficult place in which to do business as a foreign company—although perhaps not to the degree sometimes portrayed in the Western press—significant changes have been made. Korean government leaders, the press and the public have had a fundamental change in attitude with respect to the conduct of business by both domestic and foreign companies and the acceptability of foreign participation in the Korean market. One should be optimistic on the future of international business in Korea. It is not “business as usual,” and old assumptions and patterns are being transformed, creating new opportunities. The purpose of this article is to examine the situation as it was before the economic crisis as well as the historic changes of late.


The modern economic model of Korea was born in 1961 when General Park Chung Hee seized power in a relatively quiet coup. Although three of the top four Korean industrial conglomerates (*chaebol*) today (Samsung, LG and Hyundai) were started by men whose business careers began during the Japanese colonial period, the Japanese-built infrastructure was designed more to strip Korea of its raw materials than to raise the country to a higher level of industrialization. Even had this not been the case, the Korean War devastated the peninsula to such a degree that, in 1963, almost ten years after the war, national GNP amounted to less than $4 billion. In the same year, of a total of 403,944 manufacturing companies, only 22% employed more than 500 employees.

**Government Driven**

The Park regime ushered in an era of intense industrial activity. Park was committed to raising Korea to the status of an internationally recognized economic power. His economic policy was one of trade-driven, strategic industrialization. The government identified key industries and then encouraged firms to concentrate their efforts in these areas. Naturally, the existing manufacturing firms benefitted enormously and through a mixture of tax incentives, preferential financing, rent-seeking and licensing they quickly came to dominate the Korean economy and continue to do so today.

**Chaebol Dominance**

By the 1970s, the *chaebol* controlled such a large percentage of Korea’s manufacturing capability that the collapse of one of them would have a disastrous effect on the economy as a whole. *Chaebol* experiencing difficulties were bailed out by the government through emergency loans, debt conversion agreements, and the encouragement of collusive practices between business groups. By the 1980s, the top ten conglomerates accounted for 62.4% of Korea’s $81 billion GNP. The top four alone (Samsung, Hyundai, Daewoo and Lucky Goldstar) accounted for 38.7%. At the same time, the average debt to equity ratio in manufacturing had risen from 93% in 1963 to 360% in 1983. By 1997, the average for the top 30 conglomerates exceeded 500%.

During the same period, foreign direct investment in Korea was minimal and tightly regulated. In 1985, for example, potential foreign investors in manufacturing had to submit 312 different documents in 62 different procedures taking an average of 1005 work days to complete. The Japanese process, by comparison, took only 492 days and 46 procedures, while the United States took only 175 days to approve 9 different procedures.
Unrest and Chaebol Expansion

The 1980s brought a good deal of political unrest. Park Chung Hee’s increasingly repressive regime came to a dramatic end when he was assassinated in 1979. Between 1979 and 1992, power changed hands four times, with Chun Doo Hwan and his replacement, Roh Tae Woo, being the two notable leaders of the 1980s. Constant tension in the political arena was matched by increasing labor unrest. The wealth and expansion of the chaebol did not go unnoticed by workers on the factory floor. Labor protests led to wage increases (averaging 10%) that continued into the 1990s and outpaced even Korea’s astonishing economic growth rate (around 8%).

Both Chun and Roh continued to promote policies favorable to the chaebol. The Roh government, for example, bailed out the bankrupt Daewoo Shipping and Heavy Machinery Company in 1989. Foreign investment in 1988 was still severely restricted, with 56 industries closed to foreign investment and 162 restricted. However, the Kim Young Sam administration which took office in 1993 embarked on a program of globalization that would open up the Korean market to a degree previously unknown. The focus was still more on Korean expansion overseas than on foreign investment into Korea. Between 1992 and 1996, on average, for every dollar that came into the country through direct foreign investment, $2 was spent on Korean investment overseas. The Kim administration, however, campaigned hard to secure membership in the OECD which, when it was granted in 1996, forced the market to open further still.

Although President Kim Young Sam led a very public initiative to “tame” the chaebol, including imposing criminal sentences on many of the top entrepreneurs in the country on charges of corruption, the huge conglomerates continued to grow apace. Hyundai moved aggressively into the U.S. car market, while Daewoo attempted to dominate the Eastern European market. Highly publicized attempted buyouts of Thomson (Daewoo) and Fokker (Samsung) were held up as evidence that the chaebol had almost unlimited access to credit. The “Korean model” of industrialization was still being hailed by many analysts as proof that government driven economies could compete with and even outdo the more established Western economies. 


![Figure 1: Chaebol Sales as a Percentage of GDP](image-url)

**Figure 1: Chaebol Sales as a Percentage of GDP**

replace Italy, Canada or Britain as a G7 nation within a decade.

**Warning Signals**

The first sign that something was wrong came in 1995, when the price of semiconductors fell from $56 to $9 in the space of a few weeks. At the time, almost 20% of Korea’s exports by value were in semiconductors, and the effects of the mountains of debt on which the chaebol were built quickly became apparent. Korean companies had low productivity compared to the more streamlined, market regulated Western firms. Also, servicing their debt burdens made it difficult for Korean firms to remain competitive. The response was to open more lines of credit to tide over the crisis. The Hanbo and Kia failures put a severe strain on the financial system and were poignant reminders of the flaw of the Korean economic model. The Asian financial crisis added further pressure, as more and more companies went bankrupt, the currency collapsed, interest rates soared and, in November 1997, Korea appealed to the IMF for assistance.

**Facing the Crisis: 1997 and Beyond**

Many people have speculated on the cause of the Asian economic collapse, and there is no single answer that explains why it happened. In Korea, the collusive triangle of government, banks and chaebol was certainly at the root of the problem. Credit allocation was largely irrational and based more on personal relationships than on viable investment strategies. Highly leveraged, over-diversified companies found themselves unable to downsize due to legal restrictions on layoffs. The fact that the financial market was highly protected and money was loaned on the basis of political connections meant that banks and other financial institutions lacked efficient risk analysis techniques. The government’s dependence upon the chaebol to keep the economy afloat served only to reinforce this collusion. By contrast, Korea had—and still has—an underdeveloped small-to-medium-sized business sector. Most of the small firms that do exist act as suppliers to the chaebol. As the value of the currency fell, chaebol and banks found it increasingly difficult to manage their debt burdens. Operations were restricted, leading to bankruptcies among suppliers. This in turn affected investor confidence in the market and the run on the currency intensified.

There is a common perception that the entrance of the IMF onto the Korean stage sparked the opening of the market. However, sweeping reforms were already underway. In 1993, when Kim Young Sam assumed power, the Korean stock market was closed to foreign investors. Kim relaxed the restrictions, allowing a 10% foreign investment ceiling per issue and a 3% limitation on individual holdings per issue. In accordance with OECD requirements, the stock market was opened further in 1996, raising the foreign investment ceiling to 18% per issue and the individual ceiling to 4%. At the same time, a schedule was put into place to allow for incremental opening over time. In 1998, the ceiling on foreign investments in the stock market was lifted altogether. Likewise, the telecommunications industry, closed to foreign investment in 1988, was opened up in 1996 to allow 33% foreign ownership in wireless services—although wire-based services remained closed. In 1998 the restriction on wire-based services was lifted to allow for 33% foreign ownership, and 20% foreign ownership of Korea Telecom was also sanctioned. Assuming passage in the National Assembly—which is challenging—incremental reforms over the next three years will increase foreign investment limits to 49% in wire-based services and foreign ownership of Korea Telecom to 33%. These reform schedules were put in place some time before the current crisis; the current government has merely speeded up the pace of reform. By 1996, only 74 industries in Korea were closed to foreign investment, with another 32 restricted. In 1998 only a handful of industries still have overt, government-controlled barriers.

The 1998 Index of Economic Freedom ranks Korea 24th out of a total 154 countries. By comparison, Norway ranks 27th, France and Italy 35th, the Philippines 44th, Israel 53rd and Greece 66th. In particular, France has a poorer showing than Korea in terms of taxation, government intervention, foreign investment and banking. Very few people, if asked, would consider investment in France to be less viable than investment in Korea. The fact remains that the Korean market was becoming increasingly favorable to foreign investment long before the IMF stepped in. Total foreign investment between 1961 and 1992 amounted to a little over $10 billion. Kim Young Sam’s presidency alone saw almost $15 billion of direct foreign investment in the country. Without this early drive toward market liber-
lization, it is doubtful whether Korea could have weathered the Asian crisis as well as it has. Despite its difficulties, the country today is poised to lead the region out of recession as the environment for international business improves still further.

**Meeting the Challenge: Finance**

What has happened since the crisis is encouraging. The government has performed a rigorous self-analysis—and with the help of the IMF and others—and has realized that only fundamental change will cure the system. The policies of the Kim Dae Jung administration should be applauded. Not every policy step has been or will be the perfect choice, but in a time of grave need the government has stepped up to push through serious reform. There is a new sense of frankness, openness and honesty in Korea.

To revitalize the financial sector, a package of financial reform bills was passed in late December 1997. Included were provisions to enhance the independence of the Bank of Korea as well as to establish a “neutral and independent financial policy making body,” the Financial Supervisory Commission (FSC). One of the first actions by the FSC was a requirement for domestic banks to meet the 8% Bank of International Settlements (BIS) capital adequacy ratio. Banks that did not meet this standard by June 1998 were either merged with stronger banks or put on probationary status. Five banks were closed. In the case of Seoul Bank and Korea First Bank, both are being sold in an open bidding process to be decided in 1999. Although financial reform started with the commercial banks, it has also moved on to other financial institutions. The government has closed 14 insolvent merchant banks—out of a total of 30—and an investment trust and two brokerages have also had their licenses revoked. Weak insurance companies were also merged with stronger competitors.

Non-performing loans, however, continue to hamper the recovery of the banking system. The credit crunch, which has eased very recently, has put the squeeze on small and medium-sized businesses, leading to further bankruptcies—and more non-performing loans. Two organizations playing an integral role in the banking sector reform are the Korea Asset Management Corporation (KAMC) and the Korea Deposit Insurance Corporation (KDIC). KAMC is in the process of purchasing up to $35 billion of non-performing loans, which will then be liquidated. KDIC is injecting new capital of up to $11 billion to recapitalize financial institutions. The government estimates that the taxpayers’ burden will be less than $3 billion in 1998 and

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**Figure 2: Foreign Direct Investment into Korea**

(US$ millions)

![Bar chart showing foreign direct investment into Korea from 1988 to 1993](chart.png)

Source: Korean Ministry of Finance and Economy.
about $6 billion in 1999. Given the experience of other countries' banking crises, however, it is possible that taxpayers will end up with a more substantial portion of this burden.

Table 1: Corporate Financial Assets & Debts (June 1998)  (US$ billions)

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<thead>
<tr>
<th>Category</th>
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<tr>
<td>Loans by financial institutions</td>
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<td><strong>Net (Assets-Debts)</strong></td>
<td></td>
<td><strong>-313.9</strong></td>
</tr>
</tbody>
</table>

Source: Ministry of Finance and Economy.
Note: Data converted from won at the rate of 1,400 won/dollar, the average for June 1998.

Improving Transparency

One of the greatest problems, made apparent in the early days of the crisis, was a lack of comparable financial information for international investors and regulatory bodies. As Korea incorporates itself into the global financial system, this will be an important part of the process. Improving accounting standards and enforcement and, more generally, transparency, will be a driving force in both financial and corporate sector reform. The government has acknowledged this need and has made important steps to improve transparency. In 1999, for example, consolidated financial statements will be mandatory. Cross debt guarantees, once a common aspect of chaebol borrowing, were prohibited from April 1998, and existing guarantees must be phased out by 2000. This means that chaebol affiliates will have to acquire credit on their own merits, and it will also force banks to implement more sophisticated credit analysis techniques. Improving transparency in the business environment will pay significant dividends in the future by providing better financial information to both domestic and international investors. In addition, the government has made dramatic improvement in opening itself for inquires, and the flow of information is open and honest, which has resulted in a significant increase in the government’s credibility.

Corporate Sector Reform

There is a significant gap in expectations between the government and the chaebol on the scope of corporate sector reform. Differences of this sort are common in many economies. It is interesting to note that the government’s call for the chaebol to divest assets, focus on core competencies, and implement profit-oriented strategies mirrors reports from the likes of McKinsey, Booz Allen Hamilton and others.

Although a few major transactions have taken place in 1998, most of the chaebol, with a few notable exceptions, have not yet been successful in shedding unprofitable or non-core businesses. There are a number of reasons for this. For one, dealing with mountains of corporate debt is a monumental task.

Change in organizations as massive as the chaebol will be time consuming. It is also important to remember Korea’s development—outlined earlier in this paper. The chaebol owners were those who made “Korea, Inc.” Changing old habits and strategies that were for many years successful will be difficult. Implementation of a market driven system, including a supervisory role rather than an authoritative role for the government, presents challenges as well.

Distinct from government-directed chaebol reform, successful implementation of financial sector reform will be the most significant force driving chaebol reform. As the government’s efforts to supervise the banks take hold, the chaebol will have to learn to operate in a totally different lending environment. The trend is towards project-specific lending, where economic merits and risk analysis become the chief guidelines. “Brand name lending” must become a thing of the past. Enforcement of international accounting standards, severing of cross payment guarantees, and active foreign participation will all help in this direction. However, there is another factor making corporate reform difficult, and that is the over-investment and over-capacity seen in almost every Korean industrial sector.

Walking the Labor Tight Rope

Tackling over-capacity ultimately means shutting down factories and laying off workers. Widespread blue-collar layoffs have yet to take place. Nevertheless, the hundreds of unemployed lined up outside Seoul Sta-
tion represent the harshest realities of the economic crisis. Unemployment at the end of 1998 is over 7%, or 1.6-1.7 million—although factoring in the underemployed would probably push this figure up a percentage point or more. For Korea, a country whose economic rise has been marked largely by periods of almost zero unemployment, this is a significant problem. The government has implemented an unemployment insurance system and other programs to serve as a social safety net, but these efforts cannot solve the entire problem.

Change in the labor market has been and will be challenging. Finding common ground for reform has been the demanding goal of the Tripartite Commission formed in 1998 between labor, government and business. Again, one should consider Korea’s development. The late 1980s witnessed a dramatic increase in labor protests. As companies largely gave in to labor’s demands, wages rose quickly, eroding Korea’s international export competitiveness. Labor unrest is still a significant worry to the Korean government and large employers. For those of us who have experienced the labor tensions of the 1980s and early 1990s, perhaps one of the greatest successes of the Kim Dae Jung administration has been the control and avoidance of social unrest.

There have been significant strikes and other protests, but markedly less compared to years past. A good example was the Hyundai Motor strike in the summer of 1998. The international press made this event out to be a government failure. On the contrary, for Korea this was a dramatic change, as an understanding of past labor militancy and the events in question show. Sandwiched between striking workers and riot police were the wives and children of workers. Given Korea’s past history of labor violence—and a not so distant past it is—this situation could have erupted into bloodshed, providing the media with yet another example of labor militancy and government overreaction. It did not turn out that way. Instead, the union and Hyundai peacefully agreed to some layoffs, less than Hyundai desired, but layoffs nonetheless. For the union to accept any layoffs was a major step forward, as a year ago the jobs-for-life social contract was still very much entrenched part of the Korean economic system. The labor market needs further liberalization in order for Korean companies to regain competitiveness, but to ask that a decades old social standard be changed overnight is simply untenable. However, as a consequence of the poor job market, employers are finding workers increasingly willing to accept wage freezes or even reductions in 1998. And some employers are using more creative means, such as early retirement plans, to curb labor costs.

The Doors Open Wider

Due primarily to President Kim Dae Jung’s leadership, the government has expedited the market liberalization started by the previous administration. This has in many ways set Korea apart from other economies in the region. The stock market is now 100% open to foreign investment—except in a few state-controlled firms. Likewise, the real estate market is completely open to foreign investment. Few may realize that Hong Kong, Japan and now Korea are the only places in Asia in which property can be held without restriction by foreigners. Anyone familiar with Korea’s tumultuous history of invasion and repulsion should know that this is a major turn of events. Put simply, attracting foreign investment is now a policy priority. The government has expanded the Korea Investment Service Center (KISC) to aid potential investors and streamline the process. Many provinces and even cities now operate a similar type of one-stop office for foreign investors.

The relationship between the government and the American Chamber of Commerce in Korea (AMCHAM) is also indicative of this sea change. Dialogue between the Chamber and government ministries has never been more open and forthright. Many of the Chamber’s industry and professional committees are working with senior and working level officials to improve on current regulations and policies. Granted, there is still some resistance to change in the more conservative ranks of the bureaucracy; nevertheless, this partnership is creating greater opportunities for foreign participation in the market.

Challenges Remain

Public relations or, more exactly, investor relations, remain an important challenge for the Kim Dae Jung administration. Decades of policies that discouraged foreign investment have produced a tarnished image of Korea in the ranks of global corporate decision-makers. Overcoming this image will take more than market liberalization; it encompasses selling market
liberalization to the outside world. Another challenge is supporting neglected small and-medium-sized businesses, as many believe these companies will be the engines of growth for the next century. Developing the service sector—already a more significant employer than the over-publicized Korean manufacturing sector—is also important. Reforming the banks, improving supervision, and liberalizing finance will eventually allow capital, both foreign and domestic, to support these two important areas.

More generally, greater participation by foreign-invested companies in all sectors of the Korean economy will lead to a more equitable and competitive market—in the end benefiting the Korean consumer. Korea is on its way toward leading Asia out of the crisis; continued reform and sound strategy will bring that goal to fruition.

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I. Introduction

Korea’s currency crisis in late 1997 quickly escalated into financial and corporate crises, with continued loss of confidence on the part of foreign investors, lenders, and credit raters. Short of foreign exchange and seeking a more stable source of external finance, Korea has scavenged for foreign direct investment (FDI). But who would invest in such an uncertain economy, long hostile to FDI, in the first place? This sent Koreans into a guilt trip of mega proportions—“we have been treating our foreign investors very badly.” In the words of Richard Samuleson of SBC Warbourg, at times Koreans acted as if they were giving foreigners a privilege by letting them do business in Korea; whereas multinationals can go wherever they like, to other places eagerly seeking foreign investment with all kinds of liberalization measures and incentives.

So, during 1998 the government has done a great deal to liberalize the foreign investment regime and to implement more effective FDI incentive schemes. In tandem with this change in policy, many projects were instituted to find out exactly what foreign investors did not like about the Korean business environment, what factors were giving them the greatest difficulties, and what kind of recommendations they would make to the government.

The case studies presented in this article are a result of one such effort. Strangely, as I went around conducting interviews, I felt as though I was asking a bunch of happy children what they wanted for Christmas to make them extra-happy. Quite unexpectedly, there were very few explicit complaints of any significance. True, almost all restrictive regulations limiting foreign investor operations have disappeared or are fast disappearing. Optimistic news abounded in 1998 of how conditions have improved and how foreign investment was now streaming in. Yet, there are many who caution against too much optimism. Some transactions, such as the planned sale of Hanwha Energy to AES of the United States, did not go through, and foreign investors among themselves are reported to whisper that “there is still much more to be done before Korea can say it has regained investor confidence.” It is rumoured that some foreign investors are actually packing to go home. Have those foreign investors I have interviewed merely been being polite? Or have they given up? Or have I overlooked warnings and suggestions that could have been more forcefully made? The main objective of this article is to consider this conflicting evidence and seek to resolve the apparent confusion.

I have selected three firms for discussion. They were selected mainly because of their availability but also because they provide an assortment of opinions; they are in different sectors with different forms and duration of investment; and they include both a firm which was successful in investing in Korea and another which decided against it. In accordance with the preferences of some of the interviewees, the names of the interviewees and the firms will not be mentioned. One of them is a chemicals firm, one a multinational bank, and one a construction equipment manufacturer. I will call them firm C, M, and E respectively.

II. Case Studies

The Chemicals Firm C

*Company Profile:* Firm C was established in 1942 as a joint venture with Corning Glass. The firm, headquartered in Michigan, expanded internationally during the 1960s to construct a global production network. It entered the Korean market during the 1970s and struck up a joint venture with LG in 1982. After 10 years, it bought out LG and established what is now Firm C.

This firm mainly produces silicon-based chemical products (mostly polymers) used in sealants, rubber, emulsions, and electronics. Raw material is mainly imported, from the United States and Wales, the only two places in the world where the firm produces basic materials. Firm C exports around 30% of its total Korean pro-
duktion. Its main competitors within Korea are Shinitsu, Daeyoung Chemical (a joint venture between Daeyoung and GE), Toshiba, and Korean Chemical.

**Decision Not to Invest in Korea in 1998:** Every 20 years, Firm C carries out large scale investment projects, and in 1998 it decided to establish a basic materials plant in the Asian region. It considered China, Malaysia and Korea and finally settled on Malaysia. The reasons given for this decision follow:

1) In Malaysia, Firm C was received as a customer; the bureaucrats and relevant ministerial officers were accessible and friendly. This has made the information gathering process about investment location and identifying counterparts with whom negotiations had to take place much easier than in Korea.

2) Further, it was possible to get a plant site near a harbour which was already well developed and had low cost power supply.

On the other hand, in Korea, the relevant bureaucrats were not cooperative until the very end of the site selection process. Further, high level officials with decision making authority were not accessible. Given this background, negotiation to make the investment took well over a year. The decisive issue was over an investment site—Saemangeum, offered by Korea. Firm C was reluctant to take this because it would take two years for this site to be fully developed (a sea filling project is currently being undertaken). No other site was considered in Korea. Coupled with uncertainties due to the currency crisis, Firm C decided against investing in Korea. Other considerations such as rent, land rent conditions and tax incentives, which did not vary very much among candidate sites in Malaysia, China and Korea, were not important factors in this decision.

**Views on Investment Barriers and Business Environment in Korea:** Firm C’s main difficulties in operating in Korea are high transportation and power costs. Other factors such as taxes or industrial relations presented no more problems than any other competitor country would have. Firm C was especially satisfied with its peaceful industrial relations; it regarded the Korean work force to be highly skilled and commended their “work ethic, dedication and willingness to learn.” Further, it perceived little problem with respect to protection of intellectual property rights, despite the fact that it relies much on patents to protect its technology.

Since most of Firm C’s major customers are industrial firms who base their purchasing decision on price and quality, Firm C has experienced little hostile reaction from the general public against foreign goods. In addition, it had good relations with domestic Korean firms with which it had to deal, and because it chose to stay away from politics was able to maintain good relations with bureaucrats as well. The current slack in demand is a difficulty, but it believes that this is only temporary and it expects the market to grow as macro conditions improve.

The only identifiable regulatory impediments concerned complex customs clearance procedures and import restrictions. This resulted in high import taxes on production facilities and machinery which were not produced within Korea but imported from Japan. Further, it was not happy with the high level of taxes it had to pay on imported raw materials which were subsequently processed and re-exported. Even so, these matters have improved with computerization, and no complaints have been reported in six months with regard to these matters.

With respect to investment incentives, Firm C would benefit more from tax exemptions than discounts on rent. Nevertheless, future investment plans of Firm C are modest (US$3–5 million) so that tax exemptions will not be much of an incentive. Generally, investment incentives were not its main concern as much as “cost control and the potential for market growth.”

The interviewee recommended that two things be done to attract foreign investment: 1) approach potential investors like customers, with a friendly, accessible and open attitude (this has not been the case in the past); 2) continually bench mark other Asian areas and world class countries who are competing for the capital of multinational companies. A one-time change will not suffice.

**The Multinational Bank, M.**

**Company Profile:** The bank M first opened in Korea in 1897. It closed during the 1920s and then reopened in 1982, in Pusan. The bank opened a Seoul branch.
two years later and subsequently expanded through acquiring other banks—Marine Midland Bank in 1986 and Midland Bank in 1988—as a result of mergers between the parent firm and these banks. The bank is continuing on its expansion path; it recently opened two more branches in Seoul and has a plan to open a new main office with a floor for retail banking.

The bank originally dealt primarily with trade financing. It also has a strong holding on corporate financing, both in local and foreign currencies. With the gradual opening up of the Korean financial market to foreigners, it expanded into other business such as custodial services for foreign investors in the Korean stock market (its share of this market is about 60%), treasury business in the local bond market, and foreign exchange. It also serves Korean firms operating overseas, for which reason it has many Korean staff in managerial positions in overseas branches.

Views on Investment Barriers and Business Environment in Korea: The interviewee accepted that any nation would have a “national interest,” resulting in a set of regulations or restrictions with respect to foreign operations, and that the kind of restrictions he found were “not surprising”; the bank has adjusted to them. Further, he was satisfied with the speed of deregulation because he felt that it would be destabilizing if it moved any faster.

The only significant regulation remaining is the rule that foreign bank branches have to set the amount of foreign exchange they can deal with and loans they can make based on the capital of the Korean branch rather than that of its parent. This naturally limits the possibility for expansion of foreign bank operations in Korea. Apart from any official regulations, the interviewee found various demands from the government for extensive reporting burdensome and annoying. It was further pointed out that one might expect greater regulatory hindrance in other sectors involved in importing consumer products. For example, when Marks and Spencer imported its goods, it had to change labels on every kind of clothing. Channel, because it is mainly a cosmetics firm, had to go through health inspection even when importing clothes.

What the interviewee found more disconcerting than any one governmental regulation was general public hostility towards foreign investors in Korea. However, foreign investors now feel more welcome than before, as attitudes have changed greatly after the currency crisis. It was argued that Korean suspicion of foreign banks—that they are here to make a quick profit and leave—is misplaced; Bank M, for example, did not remit any profits at least for the three years the interviewee has been in office in Seoul, reinvesting all the profits into its Korean operations. Another problem is labour inflexibility. It is understandable why it is made difficult to fire people (there is no social security), but obviously, it does deter efforts to improve efficiency. That is, a greater social safety-net must be established before firms can become truly efficiency maximizing.

One reason why the financial sector does not attract foreign investment is because it is not profitable enough. For example, commissions for bond underwriting in Korea are too low. The margin is about 20 basis points for medium sized bonds, and as low as 5–10 basis points for large industrial firms (chaebol), whereas in other OECD countries the average would be around 40 basis points when dealing with this level of risk. The low commission is not due to any cap on the fee by regulation, but because Korean securities firms have engaged in the kind of competition which disregarded a level of profitability sufficient to sustain the market. In effect, Korean securities firms had not engaged in accurate risk evaluations in accepting too low a profit margin. This has prevented them from returning a fair share of dividends to their shareholders, who so far have not demanded it. The shareholder culture, demanding a fair level of profit for the level of risk taken, has not taken root. This is a major problem, along with policy lending and the practice of evaluating branch managers on growth of assets rather than on profits. It was suggested that if the Korean authorities want to increase the size and liquidity of the bond market by attracting foreign capital, the government needs to make the market at least profitable enough for it to be sustained.

Another example is the swap facility. The bank was allowed to bring in dollars to exchange into won by the Bank of Korea to lend to Korean corporations. However, the profit margin in this business was extremely thin, with the Bank of Korea charging almost the same rate of interest as its lending rates. In 1997, however, because the government wanted to encourage an inflow of dollars, it allowed a greater profit margin (of about 2.5%), although this margin is tend-
ing to come down again. In general, the bank has seen good business in 1998.

However, whether it will continue to do well depends on the successful restructuring of the “top 5” chaebol, because the exposure of foreign banks (including Bank M) to corporate debt in Korea is very high. Therefore, foreign banks are very concerned about the chaebol restructuring process, of which there is much left to do. Foreign banks such as Bank M want to see the chaebol become more specialised than diversified, and are concerned with the recent spree of expansion by some chaebol. The interviewee found the idea that chaebol be allowed into the banking business before a shareholder value culture was instituted “frightening,” because it was obvious that they would want to finance themselves. While it was encouraging that the government’s pressure is giving the restructuring process momentum, the litmus test will come in the Spring of 1999 when debt extension on commercial loans of $3.4–$3.8 billion expires. These loans will not be re-extended unless creditors are happy with the kind of restructuring they see.

**Firm E, the Construction Equipment Manufacturer**

*Company Profile:* In July 1998, Firm E’s mother company, headquartered in Belgium, acquired the construction equipment department of Samsung Heavy Industry for $572 million. The mother company of Firm E is a well known Swedish multinational which has production facilities in more than 20 countries around the world and recently has been expanding aggressively into emerging markets. The recent contract includes transfer of Samsung’s technology and marketing and procurement networks. Further, Firm E will pay royalty to Samsung for continuing to use its brand name for three years. The acquired firm had been losing money for some time, and Firm E is expected to inject capital to restructure the firm. According to announcements made through the public media, Firm E intends to input $200 million in the excavator business in 1999, including the establishment of an R&D center for product development. A close cooperative relationship with Samsung is foreseen, with about 13% of Samsung Heavy Industry’s shares remaining in the new firm. There were no layoffs or pay cuts at the time of the acquisition.

*Motive for Investing in Korea:* Firm E’s main motivation for investing in Korea is to upgrade its excavator business. While Firm E is a significant producer of construction equipment (loaders, excavators, haulers, wheel loaders, graders), it holds only 1% of world market share for excavators, which constitute about 40% of the construction equipment market. Samsung’s high quality products and high market share, both in Korea (world’s fourth largest in the excavator market) and in Southeast Asia, were top considerations when making the acquisition decision. The Southeast Asian market is dominated by Caterpillar and Japanese firms, but Korean manufacturers, including Samsung, have a substantial 20% of the market. In Southeast Asia, there were no established plants that Firm E could acquire, and it would have been too expensive and time-consuming to make green field investments in this area. Firm E has been planning to establish production facilities in the Asian region for the past few years and considered this to be a good opportunity. Firm E’s strategic interests coincided well with Samsung’s need for foreign capital. Despite the fall of demand for construction equipment by 70-80% in 1998, Firm E sees long term demand in the Korean market to grow.

Another motive in investing in Korea is to lower production costs. For the first few years, Firm E will therefore be producing Samsung’s products and continuing to use its label on license before an indigenous Firm E model to be sold under its own brand name can be developed.

*Views on Investment Barriers and Business Environment in Korea:* There was no significant investment barrier to pin-point, and on the whole the bureaucrats involved responded promptly and were helpful. In fact, the Ministry of Industry and Energy has shown continued interest in the firm and has kept up close contact, soliciting requests for help. This has been more encouraging for the firm than any tax breaks or other benefits it received from the government at the time of acquisition.

Some of the difficulties at the time of negotiation arose from the lack of accurate accounting information on assets, and there were differences of opinion with respect to asset valuation. Nevertheless, negotiations were undertaken by professional law and accounting firms so that no serious friction occurred between Firm E and Samsung.
At the level of operations, Firm E has found no particular difficulty, as Samsung’s production facility, along with suppliers, procurement and marketing were transferred as going concerns. The changes will be more internal, as the firm moves on to “Firm E culture” from “Samsung culture.” Firm E has shown considerable respect for Korean culture and its system of business and seems to understand it before making any changes or imposing Firm E’s standards. Therefore, the process of restructuring (and downsizing due to drastic fall in demand) will progress gradually, especially as the firm tries to soothe a sense of insecurity and hurt pride of former employees of an “acquired” firm, since many still feel betrayed by Samsung.

However, in a memo provided to the Korean Trade Association (KOTRA) as an answer to the question “What are your suggestions to the Korean policy makers to create a better business environment...?,” Firm E responded that, first of all, there should be a rebuilding of confidence through speeding up reform in the financial and corporate sectors. Further, management must become transparent, adopting “global standards of fiscal systems to evaluate company value precisely.” Most of all, to attract foreign investment, the hostile views and suspicion of the Korean public against foreign investors and their products must be changed. In addition, Korean people need to accept that foreign investors, apart from bringing in capital, can make contributions to the Korean economy, for which they should be able to earn a fair share of return.

The most significant contribution Firm E can make is not in the area of product technology, but in managerial techniques, organization, and quality control. Its Korean employees are already beginning to feel the difference and are eager to learn. So far, Firm E presents one of the most successful cases of foreign acquisition of a Korean firm.

### III. Conclusions

The firms interviewed had diverse backgrounds. Yet some common themes emerge. Foreign investors were not concerned with any one particular government regulation or restrictions—these are understandable and something they can adjust to, or, in the case of an acquisition, something their Korean partners could take care of. Neither did they particularly wish for extensive investment incentives. When they invest, they invest because of the market potential and other strategic reasons more than anything else. The usual negative factors cited in Korea’s business environment, such as high costs of operation, inadequate infrastructure, labour unrest, and lack of intellectual property rights protection at the operational level, seem to cause no serious problems. In most cases, foreign investors had a positive outlook on the Korean economy in the long run, and were willing to suffer a few years of downturn.

The foreign investors were most concerned about two specific factors: a hostile public view of the products of the foreign investor, and the slow pace of reform in the financial and corporate sectors. The first factor made them feel generally unwelcome and also hurt their ability to increase market share. The second factor is important because in the short run foreign banks have large exposure to Korean corporations, and because the difference in corporate culture and industrial structure makes it difficult to do business in Korea. Foreign investors want shareholder values to be respected, and economic valuation to be based on profitability, future cash flow and rational analysis of risk. Perhaps the greatest principle to be recognised is that foreign investors want to do business for a profit, and they do see opportunities in Korea. Doing business in Korea should be no privilege to either side. Rather, it results from coincidence of economic interests. This is no better demonstrated than by the contrasting experiences of Firm C and Firm E. In the former case, investment did not materialize due to the one-sided effort of Korea to induce investment into an area which would only be developed in two years, whereas in the latter case, the strategic interests of Firm E coincided with Samsung’s needs.

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1. This perhaps reflects the sample bias. Those firms in such sectors as computer games or general import business would have faced greater problems.
FOREIGN DIRECT INVESTMENT IN KOREA: TRENDS AND PROSPECTS

by In-Soo Kang

Introduction

Foreign direct investment (FDI) has become one of the most important issues in the world economy. As the information society develops, national borders do not have as much meaning as before, and activities of multinational enterprises become transnational. FDI increased rapidly in the 1990s with the development of information technologies and the need for international production networks in a global economy. As these driving forces continue to work, global FDI flows will be even more vital in the next century.

FDI into Korea has followed a similar pattern and has rapidly increased after the substantial economic liberalization measures of the mid-1980s. After a brief slowdown in the late 1980s, FDI inflows into Korea returned to their normal trend in 1993 when they reached one billion dollars. They continued to increase until 1997, peaking at $6.97 billion. The recent trend indicates foreign investors’ positive perception of the business environment in Korea. However, the Korean currency crisis in late 1997 has weakened favorable assessment of investment opportunities. As a result of the crisis, the Korean economy is undergoing serious structural adjustments in both the financial and real sectors. The new Korean administration has taken every measure to regain the confidence of foreign investors, however, and a Foreign Investment Promotion Act was enacted in September 1998 in order to facilitate investment procedures and induce foreign direct investment. After the January 1998 agreement by international creditors to switch short-term debts to government guaranteed mid to long-term loans, the foreign exchange holdings of the Korean government have steadily increased, reaching $45.3 billion in October 1988. Even though the crisis is not yet over, macroeconomic indicators (especially exchange rates, current account balance and interest rates) have stabilized, and the labor market has gained flexibility due to a serious compromise among labor, business, and government.

Investment Trends and Patterns in Korea

The adoption of a negative list system for foreign investment accelerated FDI inflow in the mid-1980s. However, sharp increases in labor costs and the appreciation of the Korean won resulted in a downturn in 1988. There were ups and downs of FDI inflow until 1993. Then FDI inflows began to rebound from the slump and grew sharply thereafter. As shown in Table 1, FDI into Korea showed a sustained trend in the 1990s. Inflows increased from $3.2 billion in 1996 to $6.97 billion in 1997. In 1998 FDI reached 8.85 billion despite the currency crisis. The trend of monthly FDI inflow in 1998 was quite promising despite a sudden decrease in August, which may have been due to seasonal effects and instability in international financial markets. Although the monthly FDI inflow was only 130 million dollars in January 1998 right after the start of the financial crisis, it increased steadily until July, when it reached $1.24 billion for that month. After a sharp decrease in August, FDI bounced back to the previous year’s level and reached $1.94 billion for December. Due to the enforcement of the Foreign Investment Promotion Act and stabilization of the stock market, FDI inflows are expected to increase more rapidly in 1999.

The ups and downs of FDI inflows are not just cyclical. The increase in FDI reflects the changes in the industrial structure of the Korean economy. Until 1992, FDI in Korea was led by investment in the manufacturing sector as shown in Table 1. However, FDI inflows in manufacturing stagnated as the relative contribution of manufacturing to GDP and employment began to decrease. In contrast, foreign direct investment in the service sector rapidly increased from 27.6% in 1992 to 49.5% in 1993 and 66.3% in 1997. FDI in the manufacturing sector increased to 64.8% of the total in 1998, implying not a weakening of the services sector but instead the improvement of the economic environment for manufacturing after the financial crisis.
Table 1: FDI Flows into Korea
(units: US$ million; per cent)

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</tbody>
</table>


The distribution of investment within the manufacturing sector closely corresponds to the progress of industrial restructuring. While investment in labor-intensive industries rapidly decreased, investment in capital-intensive industries significantly increased. Also, investment in the services sector, which is both capital-intensive and knowledge-intensive, has increased rapidly from 1993. As reported in Table 1, the average size of investment projects also increased. The average size of an investment increased from $3.31 million in 1996 to $6.61 million in 1997, and remained at $6.33 million in 1998. Active investment in the services sector reflects the global trend to softening of economies. For Korea, the share of the services industry amounted to 63.8% of GDP and 65.8% of total employment in 1996. The recent upsurge of FDI in services has been helped by the liberalization measures implemented by the government in retailing and financial services.

Turning to the origins of FDI, there were substantial changes in investing countries over time. The United States and Japan were the major investors in Korea until the late 1980s (Table 2), accounting for more than 69% of total FDI inflows in 1990. However, Japan’s share of total FDI inflows drastically decreased from 29.4% in 1990 to 3.8% in 1997. It increased again from January 1998 and remained at the 8.5% level for the year. The U.S. share of total FDI inflows also decreased, from 39.6% in 1990 to 27.4% in 1996, but increased to 45.7% in 1997 and decreased again to 31.2% in 1998. The United States has proportionately invested in the heavy and chemical industries and in the service sector. However, Japanese investment in manufacturing has continued to decrease since the late 1980s, while its investment in the services sector remains inactive. Investment from Asian economies such as Hong Kong and Malaysia has increased, mainly due to the many investment funds that emerged with development of offshore financial markets in this region. Meanwhile the share of European Union (EU) countries increased considerably in the 1990s. In 1997, investment from EU countries accounted for 33% of total FDI inflows, second only to the United States. In 1998, the EU became the largest investing region (especially, the Netherlands, Germany and France) and its share in total FDI inflows reached 46.4% as of October. Transnational corporations based in the EU increased their investment in Korea in view of the growing East Asian market.

With respect to the foreign ownership of investment, the ratio of 100% owned FDI peaked in 1992, amounting to 56.5% of the total and 37.8% of all cases. This was possible due to deregulation of the local equity participation requirement. The 100% owned ratio fell...
### Table 2: FDI Inflows by Country of Origin
[Unit: US$ million]

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
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<td>America</td>
<td>335</td>
<td>312</td>
<td>434</td>
<td>344</td>
<td>323</td>
<td>666</td>
<td>925</td>
<td>3,418</td>
<td>1,843</td>
</tr>
<tr>
<td>USA</td>
<td>317</td>
<td>296</td>
<td>379</td>
<td>341</td>
<td>310</td>
<td>645</td>
<td>876</td>
<td>3,190</td>
<td>1,654</td>
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<tr>
<td>Canada</td>
<td>8</td>
<td>4</td>
<td>10</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>183</td>
<td>62</td>
<td></td>
</tr>
<tr>
<td>Asia</td>
<td>257</td>
<td>249</td>
<td>170</td>
<td>392</td>
<td>569</td>
<td>791</td>
<td>1,218</td>
<td>1,137</td>
<td>893</td>
</tr>
<tr>
<td>Japan</td>
<td>236</td>
<td>226</td>
<td>155</td>
<td>286</td>
<td>428</td>
<td>418</td>
<td>255</td>
<td>266</td>
<td>443</td>
</tr>
<tr>
<td>HK</td>
<td>3</td>
<td>10</td>
<td>10</td>
<td>75</td>
<td>43</td>
<td>58</td>
<td>229</td>
<td>85</td>
<td>10</td>
</tr>
<tr>
<td>Singapore</td>
<td>14</td>
<td>11</td>
<td>2</td>
<td>10</td>
<td>20</td>
<td>65</td>
<td>47</td>
<td>45</td>
<td>205</td>
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<tr>
<td>Malaysia</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>5</td>
<td>218</td>
<td>673</td>
<td>722</td>
<td>215</td>
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<tr>
<td>Europe</td>
<td>207</td>
<td>824</td>
<td>282</td>
<td>307</td>
<td>409</td>
<td>475</td>
<td>1,058</td>
<td>2,409</td>
<td>1,876</td>
</tr>
<tr>
<td>Germany</td>
<td>62</td>
<td>68</td>
<td>120</td>
<td>36</td>
<td>60</td>
<td>45</td>
<td>95</td>
<td>398</td>
<td>583</td>
</tr>
<tr>
<td>UK</td>
<td>45</td>
<td>19</td>
<td>24</td>
<td>71</td>
<td>25</td>
<td>87</td>
<td>79</td>
<td>259</td>
<td>54</td>
</tr>
<tr>
<td>France</td>
<td>22</td>
<td>29</td>
<td>29</td>
<td>40</td>
<td>56</td>
<td>35</td>
<td>90</td>
<td>411</td>
<td>226</td>
</tr>
<tr>
<td>Netherlands</td>
<td>36</td>
<td>599</td>
<td>44</td>
<td>131</td>
<td>67</td>
<td>170</td>
<td>205</td>
<td>831</td>
<td>628</td>
</tr>
<tr>
<td>Ireland</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>1</td>
<td>164</td>
<td>73</td>
<td>410</td>
<td>357</td>
<td>58</td>
</tr>
<tr>
<td>Sweden</td>
<td>9</td>
<td>9</td>
<td>10</td>
<td>3</td>
<td>—</td>
<td>13</td>
<td>10</td>
<td>14</td>
<td>187</td>
</tr>
<tr>
<td>Switzerland</td>
<td>19</td>
<td>74</td>
<td>37</td>
<td>7</td>
<td>11</td>
<td>10</td>
<td>162</td>
<td>103</td>
<td>61</td>
</tr>
<tr>
<td>Middle East</td>
<td>—</td>
<td>3</td>
<td>4</td>
<td>—</td>
<td>11</td>
<td>2</td>
<td>1</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>Total</td>
<td>803</td>
<td>1,396</td>
<td>894</td>
<td>1,044</td>
<td>1,317</td>
<td>1,941</td>
<td>3,203</td>
<td>6,971</td>
<td>4,638</td>
</tr>
</tbody>
</table>

Note: 1998 data for first nine months (thru September) only.

Korea’s System for Inward Foreign Direct Investment

The new Foreign Investment Promotion Act, which has been in force from November 17, 1998, has changed the essence of the FDI system from regulation and control to promotion and support. It consists of five main parts:

1. It offers greater tax exemption for foreign investors. Not only have the number of industries which are regarded as high-tech (and thus tax exempt) increased from 265 to 446, but the duration of the tax exemption period has almost doubled. Foreign investors can be informed about tax exemptions even before investment, and they can gain tax exemptions after they change their main field of investment;

2. New investment areas will be developed for foreign investors. For large foreign investments, the Korean government will guarantee infrastruc-
ture and social facilities if the investors want to develop some regions or areas. Foreign investors in those regions will enjoy not only tax exemption, but also free rent for factories and offices;

3. Investment procedures will become significantly simplified. Foreign investors only need to notify a Korean bank or the Korea Trade-Investment Promotion Agency (KOTRA). The amount of paperwork for FDI notification and establishment of new factories is being reduced by half. Automatic approval systems for FDI procedures will be adopted in many areas to facilitate the investment process;

4. The role of KOTRA (http://www.kotra.or.kr) becomes more important. The Korea Investment Service Center (KISC) has been newly set up within KOTRA to provide one-stop service to foreign investors. KISC now provides pre-investment consulting services as well as follow-on services after investment. Since KISC is not a private organization, it maintains strong relationships with both the central government and regional government offices; and

5. Finally, a committee on FDI has been set up to review FDI policies and systems as well as to improve the business environment for foreign investors. The conflicts between the central government and local governments are resolved and important issues regarding foreign investment are promptly discussed in this committee.

Structural Problems

The recent increase in FDI inflows does not necessarily imply that Korea’s business environment for foreign investment is satisfactory. Korea has its own disadvantages in attracting investment. These include high-costs and low efficiency, an uncompetitive financial industry, and lack of transparency in policy-making and implementation. These problems are nei-

Table 3: Major Investors into Korea in 1998*

<table>
<thead>
<tr>
<th>Foreign Investor</th>
<th>Country</th>
<th>Industry</th>
<th>Amount ($ millions)</th>
<th>Ownership Ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bowater, Inc.</td>
<td>USA</td>
<td>paper</td>
<td>230</td>
<td>100</td>
</tr>
<tr>
<td>Norske Skog Asia Pacific Pte.</td>
<td>Singapore</td>
<td>services</td>
<td>175</td>
<td>100</td>
</tr>
<tr>
<td>IR.G. Passchier Mngmt.</td>
<td>Netherlands</td>
<td>services</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Commerz Bank A.G.</td>
<td>Germany</td>
<td>banking</td>
<td>276</td>
<td>29.8</td>
</tr>
<tr>
<td>Interbrew Int. B.V.</td>
<td>Belgium</td>
<td>food</td>
<td>250</td>
<td>50.7</td>
</tr>
<tr>
<td>Wal Mart Stores, Inc.</td>
<td>USA</td>
<td>retail</td>
<td>181</td>
<td>85</td>
</tr>
<tr>
<td>CRI Financial Corp.</td>
<td>USA</td>
<td>food</td>
<td>124</td>
<td>100</td>
</tr>
<tr>
<td>Bell Canada Int. Far East Telecom, Ltd.</td>
<td>Malaysia</td>
<td>services</td>
<td>192</td>
<td>43.5</td>
</tr>
<tr>
<td>Fag Kugelfischer Georg Schafer Aktiengesellschaft</td>
<td>Germany</td>
<td>machinery</td>
<td>130</td>
<td>70</td>
</tr>
<tr>
<td>BT (Netherlands) Holdings</td>
<td>Netherlands</td>
<td>services</td>
<td>397</td>
<td>23.5</td>
</tr>
<tr>
<td>CC KBC (Netherlands) Holdings</td>
<td>Netherlands</td>
<td>food</td>
<td>179</td>
<td>100</td>
</tr>
<tr>
<td>Pan Asia Paper Co. Pte.Ltd.</td>
<td>Singapore</td>
<td>paper</td>
<td>400</td>
<td>100</td>
</tr>
<tr>
<td>Degussa A.G.</td>
<td>Germany</td>
<td>chemicals</td>
<td>170</td>
<td>100</td>
</tr>
<tr>
<td>C.I.L. Ltd.</td>
<td>Canada</td>
<td>electronics</td>
<td>600</td>
<td>100</td>
</tr>
</tbody>
</table>

Note: * These companies invested more than $100 million in 1998.
High inflation in factor costs, combined with a slowdown in productivity growth has brought stagflationary pressures on the economy since the late 1980s. High wages, high rent and high interest rates have been pointed to as key impediments to FDI. In order to cope with these problems, the Korean government has employed various measures. Several industrial estates were constructed and rent exemptions and reductions for up to 20 years were introduced for FDI in the high-tech manufacturing sector. The revised labor laws passed by the National Assembly in March 1997 allow employers to dismiss employees under urgent managerial conditions. On the capital side, the opening of the capital market proceeded more rapidly than scheduled in view of the high capital costs in Korea compared with other major competitors for FDI.

To a certain degree, these problems are structural. Korea cannot compete with China or the ASEAN economies with respect to production costs. Korea needs to develop a unique advantage to compensate for this. In this context, deregulation and strengthening of services to foreign investors have been emphasized. In fact deregulation of business activities has been a principal policy for many years. While the overall assessment by the business community is not generous, there are some notable achievements.

Many foreign investors in Korea complain that the nationalistic perspective of the Korean people has changed little. Adoption of a global perspective cannot be accomplished in a day. However, these attitudes have changed a lot because of the extremely high unemployment rate. Koreans are now realizing that the real meaning of a Korean firm is based on the location, not based on the ownership.

**Prospects for FDI in Korea**

Despite structural problems and the current crisis, the prospects for FDI in Korea are promising. Political stability, a well-developed local economy, proximity of other major Asian markets, a sizable consumer market, a highly skilled labor force, and guaranteed repatriation of profits have all played a positive role in attracting foreign investment to Korea. Since Korea joined the OECD in 1996, the institutional framework for FDI has also focused on leveling the playing field for foreign investors. Restrictions on business categories open to FDI have been further liberalized, and the manufacturing sector is now almost completely open to foreign investors. An objective evaluation of the business environment of the Korean economy should be based on actual FDI flows, and performance during the past few years has been very positive.

The current financial crisis is accelerating the much-needed structural adjustment of the economy, and macroeconomic stabilization will provide a more sound investment environment for FDI in the medium to long run. Comprehensive restructuring of the financial sector will make it sounder and more transparent and efficient. In turn, the normalization of financial operations will promote innovations in the real sector. As problematic loans to highly leveraged conglomerates are held in check, investment efficiency will drastically improve. Moreover, capital market liberalization will ensure the availability of quality financial services to domestic firms. Since the Korean government is determined to embrace FDI as a means of revitalizing the economy, it pays keen attention to improving the business environment for foreign investors. *OECD Economic Outlook* (1998) also predicts the rapid recovery of the Korean economy. According to its prediction, the real GDP growth rate of Korea was estimated at −6.5% in 1998, +0.5% in 1999, and +4% in 2000. The growth rate of private consumption is expected to be −12% in 1998, but +3% in 2000. Korea may face one or two years of relative hardship, but when the crisis is over the Korean economy will be able to make the fullest possible use of its growth potential. The year 1999 seems to be an optimal time for investment in Korea.

Dr. Kang is an Associate Professor in the Department of Economics at Sookmyung Women’s University in Seoul.
KOREA’S EXTERNAL ECONOMIC RELATIONS

KOREA’S TRADE AND CURRENT ACCOUNT

by Kiheung Kim

1998 Trends

In 1998, domestic demand was projected to contract considerably due to the recession caused by the foreign exchange and financial crisis in late 1997 which resulted in the IMF’s bail-out program. The financial crisis, caused by weak corporate balance sheets and problems in the banking sector, has further depressed the business sector and delayed economic recovery. Consequently, industries for which the ratio of domestic sales to total production is high, such as general machinery, consumer electronics and automobiles, are most affected by the recession.

Under the IMF plan, which initially required a high-interest policy, almost all firms with high debt liabilities were forced to choose the option of either bankruptcy or a high degree of restructuring. In 1998 export and import growth rates were a negative 2.8% and 33.6 %, respectively, creating an increase in the current account surplus of $39.2 billion for the year.

Export Structure and Status

Korea’s exports posted double-digit growth rates during the 1994–1995 period, but since 1996 Korean export growth has considerably slowed. Exports grew only 5.3% in 1997, and growth was negative in 1998. This recent downturn in export expansion can be explained by several reasons. Short-term factors for the recent slowdown in exports are largely attributed to the sharp worldwide decline in the price of major export goods such as semiconductors and the lowered price competitiveness of Korean exports caused by the low Japanese yen. Long-term prevailing factors are fundamental and structural difficulties.

Korea’s export structure is excessively dependent on several export goods, such as semiconductors and steel, which are vulnerable to change in external conditions. In the 1980s, heavy industrial goods amounted to 35 to 40 percent of total exports, and light industrial goods amounted to 55 to 60 percent. But in 1998, the export weight of heavy industrial goods rose to 70 percent, while exports of light industrial goods fell by 20 percent. Light industry exports continued to decline during 1998 due to the recession in Asia. On the other hand, heavy industrial exports increased by April 1998 due to such factors as depreciation of the Korean won. However, the depreciation of the Japanese yen has had a negative impact on Korean exports. Since May 1998, heavy industry exports have slowed as the yen depreciated and the industrial countries strengthened their regulation of steel and semiconductor imports.

Another factor contributing to the export fluctuations in the yen exchange rate is that the increase in exports has not been accompanied by a rise in export unit value, but only by an increase in export volume. The export unit value index declined from 82.6 in the first quarter 1997 to 66.6 in the same period of 1998. Korea’s exports are also influenced by changes in the external trade environment, especially because Korea’s export goods have low value added.

Exports of heavy chemical products in 1998 increased overall by 2.4 %. As shown in Table 3, the gratifying performance of iron & steel product exports was largely offset by the decrease in semiconductors and automobiles and the relative flat performance in general machinery exports. Semiconductors continued to lead in 1998 as they have since 1990, but the export weight of semiconductors fell from 30.4% in 1997 to 23.0 % in 1998 (Jan.–July). Overall, the volume of motor vehicle exports showed a slight decrease in 1998 compared to a modest increase in 1997. Exports to developing economies, particularly to Asian markets, decreased, while exports to North America surged. Exports increased in the second half of 1998 due to the won
The world shipbuilding market was booming in 1997. Orders increased largely due to low prices for ships and ship substitution demand. The exchange rate, a very important factor determining the price competitiveness of orders in this industry, has helped both ship and steel exports. Korean firms face intensive competition from Japanese firms for market share in major markets for heavy industry exports. Semiconductors, automobiles and ships, which are the first, second, and third-ranked export items in Korea, are second, first and 7th-ranked exports in Japan.

Exports of light industrial products (see Table 2) shifted from a growth trend to a negative 7.1% compared with the same period in 1997. The rapid increase in textile exports that began in the second half of 1997 did not continue. In 1998, textile exports declined by $17.3 billion due to the slump of polyester filament woven fabric exports in Korea’s largest market, Hong Kong.

Exports of mineral products, which had registered a growth rate of 38.1% in the first half of 1998, led by the export of gold gathered in the “gold collection movement,” showed a negative growth rate of 4.4% for the year.

Table 1: Recent Korean Export Trends

<table>
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</thead>
<tbody>
<tr>
<td></td>
<td>Billions</td>
<td>% Growth</td>
<td>Billions</td>
<td>% Growth</td>
</tr>
<tr>
<td>Total Exports</td>
<td>125.06</td>
<td>30.3</td>
<td>129.72</td>
<td>3.7</td>
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<tr>
<td>Heavy Industry</td>
<td>90.79</td>
<td>37.6</td>
<td>92.97</td>
<td>2.4</td>
</tr>
<tr>
<td>Light Industry</td>
<td>28.16</td>
<td>7.4</td>
<td>27.66</td>
<td>-1.8</td>
</tr>
</tbody>
</table>

Note: Growth percentages indicate change from preceding year.
Source: Korea International Trade Association’s Trade Information System.

Table 2: Exports of Light Industry Products

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>January - June</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Billions % change</td>
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<tr>
<td>Primary Products</td>
<td>9.9</td>
<td>8.9</td>
</tr>
<tr>
<td>Agri/forestry/marine</td>
<td>3.4</td>
<td>-4.2</td>
</tr>
<tr>
<td>Minerals</td>
<td>6.5</td>
<td>17.4</td>
</tr>
<tr>
<td>Light Industry</td>
<td>27.8</td>
<td>0.6</td>
</tr>
<tr>
<td>Textiles</td>
<td>18.3</td>
<td>3.6</td>
</tr>
<tr>
<td>Cloth</td>
<td>10.5</td>
<td>3.3</td>
</tr>
<tr>
<td>Products</td>
<td>5.1</td>
<td>-2.6</td>
</tr>
<tr>
<td>Leather goods</td>
<td>1.7</td>
<td>-1.5</td>
</tr>
<tr>
<td>Plastics</td>
<td>2.4</td>
<td>-2.6</td>
</tr>
<tr>
<td>Tires</td>
<td>1.4</td>
<td>-7.2</td>
</tr>
<tr>
<td>Household goods</td>
<td>2.8</td>
<td>-10.4</td>
</tr>
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</table>

Note: Percentages indicate change over the same period the previous year.
Source: Korea International Trade Association’s Trade Information System.
Table 3: Exports of Heavy Industrial and Chemical Products

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
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</tr>
</thead>
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<tr>
<td></td>
<td>$billions</td>
<td>% change</td>
<td>$billions</td>
<td>% change</td>
<td>$billions</td>
<td>% change</td>
<td>$billions</td>
<td>% change</td>
</tr>
<tr>
<td>Petrochemicals</td>
<td>6.8</td>
<td>25.3</td>
<td>3.5</td>
<td>10.9</td>
<td>3.3</td>
<td>-9.5</td>
<td>6.8</td>
<td>0.0</td>
</tr>
<tr>
<td>Iron &amp; Steel</td>
<td>6.8</td>
<td>12.3</td>
<td>4.2</td>
<td>28.8</td>
<td>3.8</td>
<td>7.3</td>
<td>8</td>
<td>17.6</td>
</tr>
<tr>
<td>Petroleum products</td>
<td>5.3</td>
<td>38.1</td>
<td>2.6</td>
<td>1.5</td>
<td>2.6</td>
<td>-2.9</td>
<td>5.2</td>
<td>-0.7</td>
</tr>
<tr>
<td>Electronics</td>
<td>42.6</td>
<td>0.4</td>
<td>19.7</td>
<td>14.4</td>
<td>21.2</td>
<td>-4.1</td>
<td>40.9</td>
<td>-4.2</td>
</tr>
<tr>
<td>Industrial</td>
<td>9.4</td>
<td>15.5</td>
<td>4.5</td>
<td>0.0</td>
<td>4.9</td>
<td>0.1</td>
<td>9.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Consumer</td>
<td>6.3</td>
<td>-16.5</td>
<td>2.9</td>
<td>-13.1</td>
<td>2.6</td>
<td>-13.3</td>
<td>5.5</td>
<td>-13.2</td>
</tr>
<tr>
<td>Parts (semiconductors)</td>
<td>25.2</td>
<td>0.7</td>
<td>11.5</td>
<td>-3.3</td>
<td>12.8</td>
<td>-3.5</td>
<td>24.3</td>
<td>-3.4</td>
</tr>
<tr>
<td>(other)</td>
<td>17.4</td>
<td>-2.4</td>
<td>8.2</td>
<td>1.0</td>
<td>9.3</td>
<td>-0.1</td>
<td>17.5</td>
<td>0.4</td>
</tr>
<tr>
<td>General Machinery</td>
<td>7.7</td>
<td>7.8</td>
<td>3.3</td>
<td>-12.7</td>
<td>3.5</td>
<td>-11.6</td>
<td>6.8</td>
<td>-12.1</td>
</tr>
<tr>
<td>Motor Vehicles</td>
<td>5.3</td>
<td>-2.1</td>
<td>2.5</td>
<td>4.2</td>
<td>3.1</td>
<td>7.2</td>
<td>5.6</td>
<td>5.8</td>
</tr>
<tr>
<td>Ships</td>
<td>10.7</td>
<td>2.1</td>
<td>4.8</td>
<td>-7.0</td>
<td>5.7</td>
<td>3.8</td>
<td>10.5</td>
<td>-1.5</td>
</tr>
<tr>
<td>Ships</td>
<td>6.5</td>
<td>-8.5</td>
<td>3.3</td>
<td>21.7</td>
<td>4.2</td>
<td>5.8</td>
<td>7.3</td>
<td>12.0</td>
</tr>
<tr>
<td>Total</td>
<td>98.4</td>
<td>5.9</td>
<td>48.4</td>
<td>4.8</td>
<td>52.1</td>
<td>0.3</td>
<td>100.5</td>
<td>2.4</td>
</tr>
</tbody>
</table>

Notes: Percentages indicate change over the same period the previous year.
Source: Korea International Trade Association’s Trade Information System.

During the period 1985–1997, Korea’s exports by region (Table 4) changed priority from developed countries to developing countries. The ratio of the developed countries in total exports, which was above two-thirds until 1985, declined steeply in the 1990s. By contrast, the ratio of exports to the developing countries has been rising continuously as trade expanded with Asian countries such as China and ASEAN. As a result, exports to developing countries exceeded those to developed countries. A change in export structure by region can be shown in the aggressive diversification of Korean exporting firms. The major causes include fierce competition in developed markets and high Chinese growth and import expansion.

This trend reversed slightly in 1998. The export weight of the three major trading regions—the United States, Japan, and the European Union—among developed countries increased from 44.1% in 1997 to 47.6% in 1998, while the weight of East Asian countries declined from 46.5% in 1997 to 39.3% in 1998. The decline of Korea’s export share in developing countries’ markets is due to the currency crisis in East Asian countries (including ASEAN), the sustained recession of the Japanese economy, and the slower Chinese growth rate. On the other hand, the rise of Korea’s exports to the United States and the EU are affected by the business booms in those countries.

Import Structures

During the period 1990–1996, Korea’s import growth rate outstripped economic growth. When we look at import elasticity with regard to economic growth rates, we find that the elasticity grew rapidly in the 1990s. The elasticity between the first quarter of 1987 and the fourth quarter of 1989 was 0.91. From the first quarter of 1990 to the fourth quarter of 1996, however, the elasticity jumped to 4.17. In particular, imports of durable and non-durable consumer goods in-

1. ASEAN = The Association of Southeast Asian Nations. ASEAN includes Indonesia, the Philippines, Thailand, Malaysia, Singapore, Vietnam, Brunei, and Myanmar (Burma).
creased sharply. One reason imports jumped was the opening up of Korea’s domestic market. Much domestic demand is satisfied by imports, and the demand for those imports is increasing. The other reason that import dependency rose was because of larger equipment investments in the semiconductor, automobile, steel, and other industries before the financial crisis.

Korea’s import volume decreased from $144.6 billion in 1997 to $96 billion in 1998. Traditionally, the import growth rate exceeds the export growth rate in the expansion phase of the business cycle, resulting in a widening trade deficit. But in the slowdown phase, the import growth rate falls below the export growth rate, bringing about an increase in the trade surplus. The downturn in imports was sharper for consumer and capital goods than for raw materials. Imports of capital goods dropped by 34.8% in 1998. Among capital goods, general machinery imports decreased significantly, implying reduced investment in the domestic economy. The imports of consumer nondurable and durable goods and crude oil dropped rapidly by 41.1% and 30.2%, respectively, in 1998.

Table 4: Changes in Korea’s Export Shares by Region
(Unit: %)

<table>
<thead>
<tr>
<th></th>
<th>Developed Countries</th>
<th>USA</th>
<th>EU</th>
<th>Japan</th>
<th>East Asia</th>
<th>Greater China</th>
<th>ASEAN</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>69.8</td>
<td>35.5</td>
<td>10.8</td>
<td>15.0</td>
<td>26.0</td>
<td>6.0</td>
<td>5.0</td>
</tr>
<tr>
<td>1990</td>
<td>69.7</td>
<td>29.8</td>
<td>13.7</td>
<td>19.4</td>
<td>35.9</td>
<td>8.6</td>
<td>7.8</td>
</tr>
<tr>
<td>1995</td>
<td>49.9</td>
<td>19.3</td>
<td>13.0</td>
<td>13.6</td>
<td>45.8</td>
<td>19.0</td>
<td>13.2</td>
</tr>
<tr>
<td>1997</td>
<td>44.1</td>
<td>15.9</td>
<td>12.4</td>
<td>10.8</td>
<td>46.5</td>
<td>22.0</td>
<td>13.6</td>
</tr>
<tr>
<td>1998*</td>
<td>47.6</td>
<td>16.6</td>
<td>12.9</td>
<td>9.1</td>
<td>39.3</td>
<td>20.2</td>
<td>9.9</td>
</tr>
</tbody>
</table>

Notes: Developed Countries include the USA, the EU, Japan and other OECD countries.
Greater China includes China, Hong Kong and Taiwan.
East Asia includes Japan, Greater China and ASEAN.
* First seven months.

Table 5: Korean Imports by Usage

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>S billions</td>
<td>% change</td>
<td>S billions</td>
<td>% change</td>
</tr>
<tr>
<td>Raw materials &amp; Intermediate goods</td>
<td>761</td>
<td>2.2</td>
<td>258</td>
<td>-33.7</td>
</tr>
<tr>
<td>Crude petroleum</td>
<td>178</td>
<td>23.1</td>
<td>59</td>
<td>-35.1</td>
</tr>
<tr>
<td>Other</td>
<td>583</td>
<td>-2.8</td>
<td>199</td>
<td>-33.3</td>
</tr>
<tr>
<td>Capital Goods</td>
<td>531</td>
<td>-10.3</td>
<td>172</td>
<td>-37.6</td>
</tr>
<tr>
<td>Machinery</td>
<td>135</td>
<td>-23.7</td>
<td>35</td>
<td>-52.5</td>
</tr>
<tr>
<td>Other</td>
<td>396</td>
<td>-4.7</td>
<td>137</td>
<td>-32.2</td>
</tr>
<tr>
<td>Consumer Goods</td>
<td>155</td>
<td>-7.4</td>
<td>46</td>
<td>-41.9</td>
</tr>
<tr>
<td>Grain &amp; potatoes</td>
<td>25</td>
<td>-21.6</td>
<td>12</td>
<td>-6.3</td>
</tr>
<tr>
<td>Other</td>
<td>130</td>
<td>-4.0</td>
<td>34</td>
<td>-46.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,446</td>
<td>3.8</td>
<td>476</td>
<td>-36.1</td>
</tr>
</tbody>
</table>

Note: Percentages indicate change over the same period the previous year.
Source: Korea International Trade Association’s Trade Information System.
The changing economic environment has shifted the origins of Korea’s imports. Since the early 1990s, the largest share of Korean imports have come from Japan. Over the last few years, however, the share of imports coming from the United States has increased slightly due to Korea’s import liberalization policy, which did not benefit Japan as much as the United States. Additionally, the won appreciated against the dollar. Imports from Japan declined by 17.8% in 1998. Furthermore, imports from China, the third largest import source, dropped by 9.2%.

Prospects for 1999: Korea’s Trade and Current Account Balances

Korea’s external sector outlook for 1999 is unpredictable because the foreign and domestic economic environments are so unstable. With regard to the foreign situation, some analysts are predicting a worldwide recession resulting from continual global contagion, the rapid yen decline and a Chinese currency devaluation in 1999. Domestically, it still remains to be seen as to how successful Korea’s current economic restructuring will turn out. The government’s efforts to overcome the current recession by taking aggressive stimulus measures are key to the outlook for Korea’s external sector in 1999.

The current account is expected to become a surplus of $36.4 billion in 1998, and remain in surplus in 1999, but on a somewhat smaller scale. The current account surplus in 1999 will decrease to $12.9 billion, mainly due to increasing imports as domestic demand slowly recovers.

The export growth rate, which fell as low as -14.3% in July 1998, slowed much less and only dropped by -3.4% year-on-year in September 1998. Exports should increase by 1.6% in 1999, due to the steady growth in Europe and the slow recovery of Japan and Southeast Asia starting in the second half of the year. If the current Korean financial and corporate restructuring process is completed in 1999, and the severe credit crunch is resolved, exports will accelerate.

Russia’s payments moratorium and the devaluation of its currency are expected to have an adverse impact on local industries seeking to acquire raw materials for “re-export.” Imports continued their dramatic decrease, falling year-on-year by 33.6%. Imports should remain far below the level of exports, but with the slow recovery of domestic demand and the technical correction to the sudden contraction in 1998, imports are predicted to increase by 21.1% in 1999. If consumption and investment recover, imports will increase sharply.

The Future of Trade in the Restructured Korean Economy

A wide range of structural reform policy adjustments will have a variety of impacts on Korean trade performance in 1999 and beyond, when the foreign exchange market crisis and financial market crisis have been overcome. Large firms, blamed for excessive borrowing to expand, must take prominent steps toward international standards of management transparency (as called for by the IMF), repeal cross-loan guarantees among complex subsidiaries, and make consolidated financial statements. Financial institutions will be

Table 6: Korea’s Import Share by Region: Major Import Sources
(Unit: %)

<table>
<thead>
<tr>
<th></th>
<th>Developed Countries</th>
<th>USA</th>
<th>EU</th>
<th>Japan</th>
<th>East Asia</th>
<th>Greater China</th>
<th>ASEAN</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>63.9</td>
<td>20.8</td>
<td>9.8</td>
<td>24.3</td>
<td>37.2</td>
<td>4.2</td>
<td>8.7</td>
</tr>
<tr>
<td>1990</td>
<td>71.2</td>
<td>24.3</td>
<td>12.1</td>
<td>26.6</td>
<td>40.1</td>
<td>6.2</td>
<td>7.3</td>
</tr>
<tr>
<td>1995</td>
<td>67.7</td>
<td>22.5</td>
<td>13.5</td>
<td>24.1</td>
<td>39.6</td>
<td>8.0</td>
<td>7.5</td>
</tr>
<tr>
<td>1997</td>
<td>61.8</td>
<td>20.8</td>
<td>13.1</td>
<td>19.3</td>
<td>37.3</td>
<td>9.3</td>
<td>8.7</td>
</tr>
<tr>
<td>1998*</td>
<td>60.8</td>
<td>21.4</td>
<td>12.2</td>
<td>17.8</td>
<td>36.7</td>
<td>9.2</td>
<td>9.7</td>
</tr>
</tbody>
</table>

* First seven months.
restructured so that a sound and competitive financial industry will interact with efficient and transparent business firms. Structural measures of the IMF program will be implemented, including trade liberalization, improved corporate governance and corporate restructuring, and labor market reforms. Trade-related subsidies were abolished in March 1998, and the Korean government agreed to abolish the diversification system by June 1999, earlier than originally planned. The early abolishment of the system will have a substantial impact on Korea’s relatively less competitive products, including large-sized automobiles, portable phones, audio products for automobiles, and cameras. According to the IMF program, the Korean government will set a timetable in line with its WTO commitments to eliminate restrictive import licensing. Korea must adhere to transparency requirements for import procedures related to approval, certification, authorization, notification, and quality testing of imported goods.

### Conclusion

The Korean economy will continue to be sluggish for the time being. Some of the healthy symptoms expected to restore Korean competitiveness are the stabilization of prices of Korea’s major exports, including semiconductors, and the slow and steady appreciation of the Japanese yen since the middle of 1998. As a result, Korea will eventually achieve a moderate increase in total exports in 1999. However, imports will increase significantly because of the rebound of the Korean economy in the second half of 1999. The current account is expected to remain in slight surplus in 1999. If economic restructuring is completed during the year, and economic stimulus measures affect business sentiment positively, the Korean economy will begin to recover gradually.

With all these actions and measures, Korea can reap the benefits of economic reforms in the near future. Productivity as well as non-price competitiveness are expected to increase with successful structural reforms under the IMF program, and the trade regime will be liberalized further. As a result, the sectoral composition of Korea’s trade will shift toward the services sector, and the composition of Korea’s trading partners will be diversified.

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2. The diversification system essentially discriminated against imports from Japan.
The Evolution of APEC and Korea’s Role

by Hongyul Han

As one of the founding fathers of APEC, Korea has been very enthusiastic about the concept of “Asia-Pacific Economic Cooperation” from the beginning. Korea hosted the third ministerial meeting in 1991 and played a critical role bringing the “three Chinas” into APEC membership.

As Trade and Investment Liberalization and Facilitation (TILF) became the central issue in APEC following the Bogor meeting in 1994, however, Korea took a more passive attitude and was also very reserved in the discussion of Early Voluntary Sectoral Liberalization (EVSL) in 1997.

However, as the new administration took office in 1998, Korea changed its trade and investment policy and adopted market opening as one of the major policy goals of the new administration. The complete reversal of trade and investment policy allowed Korea to have more maneuver room at the trade negotiation table.

Korea as One of the Initiators of APEC

APEC was launched in 1989 in response to the growing interdependence among Asia-Pacific economies and at the joint initiative of Australian Prime Minister Bob Hawke and Korean President Roh Tae Woo. Twelve economies around the Asia-Pacific rim participated in the first ministerial meeting. They were Australia, Korea, Japan, Canada, New Zealand, the United States, and six ASEAN nations.1 In the first Ministerial, member economies agreed on general principles of Asia-Pacific cooperation. In Singapore in 1990, members set forth seven work programs in the area of trade and investment: data review, trade promotion, investment and technology transfer, human resource development, energy, fisheries, and marine resource conservation.

At the third APEC ministerial in Seoul in 1991, member economies sought to define APEC’s mission and adopted the major objectives of reducing barriers to trade in goods and services among members and strengthening the open multilateral trading system.

APEC has given rise to new concepts in order to capture the essence of its activities. At the core is “open regionalism.” From its inception, APEC has sought to not become an economic bloc or a free trade area. Instead, APEC has sought to contribute to the enhancement of the global free trade and investment environment through harnessing the dynamism in the Asia-Pacific region.

In Seoul the members also recognized that the contribution of the private sector was essential to the dynamism of APEC economies, and they called for more active participation of the private sector in the development of APEC and the application of free market principles in maximizing the benefits of regional cooperation. The launching of the APEC Business Advisory Council (ABAC) in 1995, as well as the utilization of the Pacific Basin Economic Council (PBEC) for constructive and regular input reflect such commitments.

Korean diplomacy had won the inclusion of Taiwan, China and Hong Kong in APEC at the Seoul meeting, marking the first occasion that the three met in an official, multilateral capacity. Membership of the three Chinese economies had meaning well beyond the substance and protocol of the APEC meeting. The inclusion of senior Taiwanese officials in Seoul led to the first official contact between Japan and Taiwan at the ministerial level since Japan severed ties with Taipei in 1971.

1. ASEAN = The Association of Southeast Asian Nations, at that time including: Indonesia, Malaysia, Singapore, Thailand, the Philippines, and Brunei.
The Blake Island Economic Vision

In 1993, the leaders of the APEC economies met together for the first time, at Blake Island near Seattle. They envisioned a community of Asia-Pacific economies in which the spirit of openness and partnership deepens and dynamic growth continues, contributing to an expanding world economy and supporting an open multilateral trading system. A Committee on Trade and Investment (CTI) was created, aimed at creating an APEC perspective on trade and investment issues in order to promote liberalization and facilitation initiatives. Korea was appointed as the first CTI chair and contributed significantly towards the facilitation of APEC’s move into substantive matters of trade liberalization.

The Bogor Declaration of Common Resolve

In 1994, Indonesia hosted the second APEC Leaders’ meeting. In their Declaration of Common Resolve, the leaders agreed that APEC member economies should work toward achieving free trade and investment in the region, encouraging the industrialized economies to achieve the goal of free and open trade and investment no later than 2010 and the developing economies no later than 2020. Korea was categorized as a developing economy within APEC. However, Korea was committed to make every effort to achieve the goal of free and open trade well in advance the target year of 2020, with a view to playing a bridging role between advanced and developing economies.

The Osaka Action Agenda

In 1995 APEC Leaders meeting in Osaka adopted an action agenda to implement their commitment to free and open trade and investment, business facilitation, and economic and technical cooperation. Part I of the Action Agenda deals with trade and investment liberalization and facilitation (TILF), and Part II deals with economic and technical cooperation. At Korea’s initiative the principle of flexibility was added to the general principles of TILF. The other eight principles are comprehensiveness, WTO-consistency, comparability, non-discrimination, transparency, standstill, simultaneous start (continuous process and differentiated timetables), and cooperation. The principle of flexibility is expected to provide APEC with the mechanism to incorporate the diversity of economic situations, so that member economies may cope with the political difficulties in their liberalization processes.

The Manila Action Plan

In 1996 in Manila an action plan was adopted consisting of three major parts: Individual Action Plans (IAP), a Collective Action Plan (CAP), and the Declaration to strengthen Economic and Technical Cooperation (Ecotech). The IAP specifies separate voluntary plans by the eighteen APEC member economies for trade and investment liberalization and facilitation in fourteen areas, such as tariffs, non-tariffs, investment, customs procedures, and intellectual property rights. The CAP specifies the trade and investment liberalization and facilitation measures that will be collectively pursued by the member economies. The declaration to strengthen Ecotech selected six areas of major focus: human resource development, capital markets, infrastructure, technology, environment, and small and medium enterprises. Through the preparation and submission of the first individual action plans and collective action plans Korea demonstrated its will to open up domestic markets and to facilitate foreign trade and investment.

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5 For an analytic study of these individual action plans, see Yamazawa, Ippei, 1998, “APEC’s Progress toward the Bogor Targets: A Quantitative Assessment of Individual Action Plans,” in Joint U.S.-Korea Academic Studies, Volume 8: APEC—Liberalization or Development Cooperation?
Early Voluntary Sector Liberalization and the Financial Crisis

The fifth Economic Leaders’ Meeting in Vancouver in November 1997 endorsed 15 sectors for Early Voluntary Sectoral Liberalization (EVSL), of which nine sectors were to be pushed in 1998 and implemented beginning in 1999. Leaders also instructed trade ministers to finalize detailed targets and time lines by their next meeting in June 1998.

During the process of sector selection, Korea proposed 3 sectors for EVSL: steel, petrochemicals, and government procurement. However none of those sectors was included in the final list. Actually, Korea was not then enthusiastic with the early voluntary sector approach. The Korean government had painful domestic political experience with market opening during the process of ratification of the Uruguay Round multilateral trade agreement in 1994. Therefore, government officials were very cautious about additional market opening measures and the potential domestic reaction. However, Korea endorsed 15 sectors for EVSL at the end of the year in order to contribute and promote the trade liberalization agenda in APEC.

The year 1997 became the year of financial crisis in Asia. The financial crisis first broke out in Thailand in July and then spread to Indonesia and Korea, destabilizing the Asian and world financial markets. The APEC Economic Leaders’ Meeting was held in the middle of this crisis, and the Leaders expressed their concern and instructed finance ministers to prepare appropriate measures to help resolve the financial crisis. Just before the Economic Leaders’ Meeting, the Korean government had decided to receive IMF assistance. Korea took advantage of this opportunity to seek international assistance to calm down the crisis and to explain Korea’s economic situation to the world.

The 6th APEC Economic Leaders’ Meeting was held in Kuala Lumpur in November 1998. Following instructions from the Vancouver summit, member economies tried to reach a consensus on early voluntary sector liberalization. However, Mexico and Chile decided not to participate in the EVSL initiative at all, asserting that they advocated instead a comprehensive approach to liberalization. Japan did not participate, mainly due to its political difficulties associated with the fishery and forest product sectors. The results therefore did not meet the expectations of Vancouver and were regarded as disappointing. However, member economies agreed to take the current package to the World Trade Organization (WTO) to form a critical mass for worldwide liberalization in those sectors.

As the new Korean administration took office in 1998, Korea’s position on the EVSL initiative changed completely. The new government set domestic economic reform and market opening as the two major instruments for the revival of the Korean economy from the financial crisis. Therefore, the Korean government actively supported the EVSL initiatives and committed itself to full participation in the nine sectors, with minimal exclusion only in the very sensitive sectors of fishery and forest products. Korea’s sudden change of position on EVSL was a surprise to APEC member economies, and a high-ranking official from the U.S. delegation described it as “unbelievable.”

The financial crisis in the Asian region continued in 1998 and spread further to other regions, raising concerns worldwide. APEC Leaders expressed extensive concern about the financial crisis in the region and the economic situation in the world economy. Leaders identified the major challenge as how to support an early and sustained recovery. To meet the challenge, they committed to pursue a cooperative growth strategy with the following dimensions:

- Growth-oriented macroeconomic policies appropriate to the specific requirements of each economy;
- Expanded financial assistance from the international community to generate employment and to build and strengthen social safety nets to protect the poor and vulnerable;
- A comprehensive program of support for efforts to strengthen financial systems, restore trade finance, and accelerate corporate sector restructuring;
- New approaches to catalyze the return of stable and sustainable private capital flows into the region;
- A renewed commitment to the goal of achieving free and open trade and investment within APEC; and
- Looking toward the longer-term, urgent work among ourselves and with other economies and
institutions to develop and implement measures to strengthen the international financial system.

Given the continuing crisis, Korea proposed that APEC should not focus only on TILF and Ecotech, but also on how to prepare concrete measures to overcome the Asian economic crisis. For Korea, Asia constitutes 50% of its export market, and Asia’s economic recovery is critical to the restructuring and recovery of the Korean economy.

Korea further proposed three measures to be taken by the members: First, those economies in financial crisis should make every effort to restructure their own economies. Second, major economies in the region such as the United States, Japan, and China should cooperate to take measures to remove anxiety arising from speculative short-term capital movements.

As it was understood that member economies in financial crisis have their own structural problems, Korea emphasized the need for corporate and financial sector reform based on market economy principles. In addition to the self-help efforts of crisis-stricken economies, cooperation with major economies in the region is critical for recovery. Korea emphasized the importance of further cuts in interest rates in major economies to stimulate regional and world economies, revival of the Japanese economy through increasing domestic demand, and stabilization of the Chinese currency.

Regarding the movement of speculative short-term capital, Korea emphasized the need for strengthening transparency and setting up mechanisms to monitor soundness. Korea opposed direct measures to block capital movement across economies. The three proposals by Korea were widely accepted and incorporated into the Leaders’ Declaration.

Japan and the United States announced an Asian Growth and Recovery Initiative on the eve of the summit. The initiative is to assist the domestic restructuring and economic recovery efforts made by the crisis-stricken economies. This initiative responded to Korea’s call for specific measures to be taken for the usefulness and credibility of APEC.

Besides the proposals on the Asian economic crisis, Korea proposed four major work programs: 1) opening an APEC foreign direct investment mart; 2) stimulating knowledge-based industries and tourism; 3) developing small and medium-sized enterprises; and 4) enhancing the Asia-Pacific information infrastructure. These work programs will be actively sought, with Korea taking the leading role in 1999.

**Korea’s APEC Policy**

Korea is expected to continue to support APEC’s goal of free trade and investment in the region. Market opening and liberalization are central policy goals of the Korean government. Therefore, Korea will actively and positively participate in the EVSL discussion of the remaining six sectors in 1999 and will also make a significant contribution to formulating a “critical mass” in the WTO for the nine priority sectors. The Korean government believes that the economic crisis in the region should not be an excuse for delaying liberalization.

The ultimate goal of APEC is to build an Asia-Pacific community where member economies may achieve equitable growth and sustainable development. In this context, Korea believes that economic and technical cooperation in a balanced manner should be emphasized much more than before. Evaluation of the current status of Ecotech turns out to be unsatisfactory. Most of the programs are not very productive activities such as drafting reports, conferences, and information sharing. More substantive projects should be developed in the future, and cooperation from the developed economies in the region is crucial in the process.

Financial issues had not attracted much attention in APEC before the financial crisis. Discussions on financial issues had been limited to the Finance Ministerial meeting. Korea believes financial issues should be discussed more extensively in the main fora of APEC, that is in the Senior Officials Meetings (SOMs) and ministerial meetings. Finance should become the third pillar of APEC after TILF and Ecotech.

APEC should raise its credibility and increase its usefulness. It should produce more concrete and substantive results in TILF, Ecotech, and financial matters in the region. In addition, APEC may have to develop an enforcement mechanism so that the agreements reached can be implemented without delay or negligence.
Korea’s Major Initiatives and Hosting of APEC Events

At the fourth APEC Economic Leaders meeting held in Subic Bay, the Philippines, in November 1996, Korea pledged $10 million for the APEC Education Foundation. The Grants and Program Secretariat of the Foundation is to be a tool for enhancing people-to-people contact through academic conferences, training programs, etc.  

Korea also initiated the Asia Pacific Information Infrastructure Initiative (APII) at the 1997 Vancouver APEC summit that will serve to facilitate information flows in the region at all levels. The APII serves as a true manifestation connecting the APEC community. The APII Center was established in Seoul, and Korea plans to expand the APII network to an APEC knowledge network in the future.

Korea initiated the APEC Business Travel Card (ABTC) with Australia and the Philippines to facilitate better movement of business people and thereby promote business and economic activities. Several member economies have recently expressed interest in joint ABTC programs.

Korea led the preparation of the 1997 APEC Economic Outlook, which is the third Outlook since the launching of the APEC Economic Committee in 1995. Preparing the Economic Outlook was especially challenging in 1997 because the Asian financial crisis was still unfolding when the Outlook was submitted to the Leaders. Nonetheless, Korea produced a document that provided useful data and analyses of regional economies.

Korea has contributed in various other areas to the APEC process. In November 1996, Korea hosted the second APEC Science and Technology Ministers Meeting in Seoul, and initiated the APEC Youth Science Festival held in August 1998. In September 1997, Korea hosted the second APEC Human Resources Development Ministerial Meeting in Seoul. At the meeting, Korea initiated the APEC Industrial and Technical Training Program for human resources development and the APEC Youth Skills Camp. The main theme of the meeting was to link learning and work and to enhance skill development.

Dr. Han is a Professor of Economics at Hanyang University in Seoul.

Korea and the United States achieved important progress in their trade relationship in 1998, in spite of having to deal with the inevitable effects of the financial crisis that afflicted Korea and other parts of the globe. The conjunction of problems, such as Korea’s sharply reduced import purchasing power, did not prevent Seoul and Washington from strengthening their economic ties in a variety of ways. For example, the two governments reestablished their annual subcabinet-level economic consultations; the U.S. Overseas Private Investment Corporation (OPIC) re instituted its program for Korea; and a number of specific trade disagreements were resolved, including market access for U.S. automobile exports.

The new level of cooperation was perhaps nowhere more evident than in the two countries’ efforts to deal with Korea’s financial and economic crisis. The United States provided indispensable support, including financial assistance channeled through the International Monetary Fund, and encouragement for Korea’s reform efforts from President Clinton at summit meetings in June 1998 (in Washington) and November 1998 (in Seoul). This support contributed greatly to Korea’s ability to regain the confidence of international investors, pursue far-reaching economic reform, and put itself back on the path toward sustained economic growth.

Trade has been an important element in this process of dealing with crisis and strengthening U.S.-Korean ties. Expanded exports are not a panacea for Korea’s economic woes (the government’s economic reform program is the only true remedy), but recovery does depend heavily on continued exports to the United States, which as Korea’s top trading partner takes in more than $20 billion in Korean exports per year. Korea appreciates the U.S. government’s efforts to ensure that access to this market is not hindered as a result of protectionist lobbying by certain domestic industries and pressure groups.

In addition to the joint efforts to deal with the financial crisis—and with trade frictions largely under control—Korea and the United States have continued to expand and strengthen their cooperation on a variety of trade-related matters. For example, Washington and Seoul have: begun negotiations on a bilateral investment treaty (BIT), which will have important trade ramifications; undertaken joint efforts to deal with the Year 2000 (Y2K) computer problem and to promote electronic commerce; and have worked together in the Asia-Pacific Economic Cooperation forum (APEC), pushing in particular the Early Voluntary Sectoral Liberalization (EVSL) initiative.

At the two summit meetings between Presidents Bill Clinton and Kim Dae Jung in 1998, trade issues figured prominently on the agenda. In June, the presidents recognized the importance and complexity of U.S.-Korea economic relations by deciding to reinitiate annual bilateral subcabinet-level consultations on economic issues. This led to the holding of a two-day session in Washington in November, chaired by the U.S. Under Secretary of State for Economics, Business and Agriculture, Stuart Eizenstat, and the Korean Vice Minister of Foreign Affairs and Trade, Sun Joung. Participating officials representing numerous ministries and executive-branch agencies from both countries engaged in constructive dialogue on a wide range of economic policy issues.

Also at their June meeting, the two presidents announced the resumption of the OPIC program for Korea. This should provide a boost for U.S. direct investment in Korea and open associated trade opportunities. The November summit featured, among other things, the signing of a joint statement on Y2K and electronic commerce.

A potentially less fortunate manifestation of high-level interest in U.S.-Korea trade during 1998 was exhibited by the U.S. Congress, which showed an increasing inclination toward involvement in bilateral economic issues. Congress, for example, attached provisions to the 1998 Omnibus Budget Act requiring the U.S. Treasury to certify that Korea is not using IMF
funds to support particular industries, such as steel, semiconductors, automobiles, and shipbuilding. (Korea does not use IMF funds for such purposes.) Congressional interest and activism may intensify in 1999 if the U.S. trade deficit continues to grow. Lawmakers may not always distinguish relatively open economies, such as Korea’s, from other, less open ones.

Trade Issues in 1998

The Trade Balance

Korea’s financial crisis, with the accompanying currency depreciation and domestic recession, generated a dramatic turnaround in Korea’s trade balance, both in trade with the United States and on a global basis. The trade balance itself has become an important issue on the bilateral agenda. From 1990–1997, the United States consistently enjoyed a surplus in its trade with Korea. This belies the common misperception of Korea as a closed market and contrasts with the U.S. experience in some other areas of Asia. The financial crisis turned things around, however, and Korea ran a small bilateral trade surplus (less than $3 billion) in 1998.

Korea’s current trade surplus results from macroeconomic conditions (certainly not something Koreans had sought), rather than from any new protectionist policies. On the contrary, the economic crisis has been one factor that has pushed Korea to intensify its market openness; the automobile sector (discussed below) is a case in point. Nor has the surplus resulted from a surge in Korean exports, as some had expected. Exports to the United States rose by only about five percent during 1998. Korea’s imports from the United States, however, fell sharply, by about one-third.

U.S. officials have observed that the most important contribution the United States can make to Asia’s economic recovery is to maintain the United States’ own economic growth and, consequently, its demand for Asian exports. Likewise, Korea’s early recovery from its economic difficulties will provide the surest way to boost U.S. exports to Korea and restore balance in bilateral trade. This demonstrates the great stake that the United States has in Korea’s early recovery, as officials from both countries recognize.

Automobiles

Perhaps the most significant breakthrough in U.S.-Korean trade relations during 1998 was an October agreement resolving U.S. concerns about access to the Korean automobile market. A year earlier, in October 1997, the U.S. government had identified Korea’s automobile import regime as a “priority foreign country practice” under the terms of the “Super 301” trade law. Despite the fact that Korea’s eight percent tariff on automobile imports ranked among the lowest in the world, the USTR cited a number of regulatory measures which it claimed impeded the entry of foreign cars.

In order to resolve the situation, the Korean government agreed to undertake a series of measures to facilitate market access for foreign-made cars, as well as bind its automobile tariff at the current level. Korea will streamline standards and certification requirements; adjust or eliminate certain vehicle taxes (including a registration tax based on engine-size, which tended to fall disproportionately on larger cars); permit new financing methods for car purchases; and undertake measures aimed at improving consumer perceptions of imported cars. The two governments will continue to consult on the automobile trade on a regular basis.

Korean and U.S. officials hailed the accord, which averted threatened U.S. trade sanctions, as a “win-win” outcome. The agreement will benefit U.S. automakers with increased sales opportunities, while providing Korean consumers with greater product choice and enhancing the Korean government’s overall economic liberalization program.

The Beef Quota Issue

Recent American displeasure at the level of Korean beef imports is one example of a trade problem generated by the financial crisis; it is a sectoral manifestation, in other words, of the trade adjustment phenomenon discussed above. During the Uruguay Round of trade negotiations, Korea agreed to open its beef market fully over a period of several years and instituted a transitional tariff-rate quota which will apply through 2001.
Unfortunately, beef imports in 1998 suffered the effects of the financial crisis, and, indeed, consumption of beef (whether domestic or imported) declined sharply as the population attempted to cope with falling real wages, rising unemployment, and similar difficulties. Washington has strongly encouraged the Korean government to raise beef imports to the quota level, although the problem lies in domestic purchasing power and demand (i.e., the market), rather than in any government action.

The current disagreement aside, Korean policy changes over the past decade have offered significant benefits to American beef producers. Korea has opened its market, instituted a transparent and predictable tariff regime, and is working to ensure that market share is determined by market forces. The Korean government will continue to seek a negotiated resolution to U.S. complaints, but a lasting solution will likely come not from government intervention, but simply through market forces as the Korean economy regains its previous strength.

Resolution of DRAM and Color Television Cases at the WTO

Availing themselves of the dispute settlement procedures of the World Trade Organization (WTO), Korea and the United States successfully resolved a longstanding disagreement over anti-dumping duties applied by the United States to Korean color television exports. A similar disagreement over anti-dumping duties levied against Korean dynamic random access memory (DRAM) computer chips seems likely be resolved as well.

Washington and Seoul settled the color TV case, filed by Korea in 1997, through bilateral consultations within the WTO dispute settlement process, with the United States agreeing to lift the duties. In the DRAM case, a WTO panel in December 1998 ruled that an important aspect of U.S. anti-dumping procedures—which had prevented the revocation of the duties on DRAMs—failed to meet WTO requirements. The Korean government is hopeful that this panel decision will lead to positive changes in U.S. anti-dumping reviews, diminishing the possibility that duties applied to no-longer-dumped products may be used as trade barriers in the future.

Steel

Steel stood out as one of the U.S. industry sectors most affected by the fallout from the global financial turmoil of 1997–98, with American producers squeezed by low-priced imports and declining demand for their exports. U.S. steelmakers responded with a campaign to halt imports, filing anti-dumping cases against producers from several countries, most notably Japan, Russia and Brazil. Early plans to target Korea were generally dropped, as U.S. producers apparently realized that the increase in steel imports from Korea was comparatively small. Moreover, most of Korea’s steel exports are shipped to U.S. affiliates of Korea’s Pohang Iron and Steel Corporation (POSCO) for their own use. An examination of the Korean steel industry reveals that it is “playing by the rules,” with its steel fairly produced, priced and traded, in accordance with international trading rules.

The case of the bankrupt Hanbo Steel Company has continued to attract scrutiny from abroad. The fair and transparent liquidation of the company during 1998–1999, however, should resolve any lingering concerns about the Hanbo situation.

Prospects

The U.S.-Korea trade relationship is growing increasingly important to both countries. Although disagreements may occasionally arise—as they would in any relationship of this nature and magnitude—bilateral economic exchange has proven itself to be mutually beneficial. Korea’s economic difficulties in 1998 led both sides to a greater realization of the importance of this relationship—and caused them to work more closely together to foster it. Government-to-government trade contacts—which in the past had been somewhat superficial and narrowly focused on particular disagreements—have become more varied, collegial and positive. When conflicts do arise, Washington and Seoul work together to seek a win-win resolution, as in the case of the 1998 auto negotiations.

Bilateral trade will continue to grow in importance in 1999, playing a crucial role in Korea’s economic recovery. As the Korean economy recovers, Korea’s imports will pick up. Trade will again become more balanced, and bilateral trade tensions will decrease.
In addition, one should not lose sight of the fact that Korea’s economic crisis—for all its problems—has provided a number of opportunities, particularly in the area of foreign direct investment. The crisis has caused Korea to become more welcoming toward FDI, and indeed to seek investment vigorously. Eventually this will lead to the formation of new U.S.-Korean corporate and industrial alliances, which will further enhance the bilateral economic relationship and lessen trade friction.

A less positive consequence of global economic turmoil is the possibility that protectionist tendencies in the United States will strengthen in 1999, causing new bilateral trade issues to emerge. Korea will continue to seek the resolution of any such issues by means of dialogue and negotiation. Moreover, as the Korean trade regime consolidates its new openness, transparency, and liberalization—and as these policies become better known and understood internationally—bilateral trade issues will almost certainly become less frequent and less contentious.

In fact, Korea and the United States in the future will most likely find much more room for cooperative efforts in multilateral fora and other venues. This will be highlighted in 1999 by the chance to work together for the success of the next WTO Ministerial, which will be hosted by the United States in November.

Korea and the United States have made great strides in their trade relationship over the past year. The future, too, looks bright.

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The year 1998 was tumultuous for the Korean economy, but one of greater bilateral and multilateral economic cooperation and a deepening of economic relations between Korea and the United States. We expect this cooperation and close consultation will continue in 1999, as the Korean economy continues its restructuring and moves toward recovery.

The recent financial crisis underlined the importance and strength of ties between the United States and Korea, and reminded us of the significant economic aspect of the relationship. The United States and the Republic of Korea share the burden of maintaining peace and stability on the Korean peninsula. In 1997, Korea was our fifth largest export market and a major importer of U.S. agricultural products. U.S. companies and workers depend on our exports of goods and services to Korea, while many Americans are employed by Korean companies here in the United States. And, because of its economic size, the health of the Korean financial system was important to the stability of financial systems in the United States and elsewhere.

While the United States has provided international leadership in support of Korea during its financial crisis, the determination to pursue a program of visionary and sweeping economic reform came from Korea itself. The Korean leadership and people recognized early on that such changes were necessary to preserve and continue the much-envied economic progress Korea had achieved over the past several decades. This overwhelming recognition and support for the reform program has distinguished Korea from some other Asian countries hit by the crisis, and has enabled it to focus on and implement the changes necessary to restore growth and enhance Korea’s competitiveness.

Korea has made great strides in restoring stability to its financial system, implementing necessary reforms and undertaking difficult economic restructuring in the financial and corporate sectors. Much progress has been made in shoring up the health of the Korean banking system, which, together with lower interest rates, has gotten credit flowing again. A $40 billion annual trade surplus (from an $8.5 billion deficit in 1997) contributed to the buildup of an astonishing $48 billion in useable foreign exchange reserves by the end of 1998.

Corporate restructuring has lagged financial consolidation, but is now underway. A number of reform measures have been promulgated, which over time should induce lower private debt levels, market-based investment decisions, and improved productivity in the corporate sector. Korea has also made significant progress in its efforts to liberalize its foreign investment regime, progress which will promote stability and dynamism.

The United States, motivated both by the strength of our alliance and our shared economic interests, remains committed to assisting Korea’s return to prosperity and growth. Since the onset of the financial crisis, the United States has provided strong international leadership in support of an emergency multilateral stabilization program through the IMF, the World Bank and the Asian Development Bank. The United States led the effort to put together a supplementary bilateral emergency fund, which, owing to the success of the reform effort, Korea did not need to draw on. With credit allocation in Korea effectively frozen, we extended billions of dollars in export credit guarantees, allowing hundreds of Korean firms to continue their trade operations. These credit programs through the U.S. Export-Import Bank and the Department of Agriculture are among the largest such programs in the world. To further the Korean government’s goal of attracting foreign investment, the United States reopened OPIC1 programs in Korea and has launched negotiations to conclude a Bilateral Investment Treaty. Secretary of Commerce Daley will

1. OPIC = Overseas Private Investment Corporation (an independent U.S. Government agency that sells investment services to assist U.S. companies investing in emerging economies around the world).
lead a Business Development Mission to Korea in March 1999, and will foster business-to-business contacts through his chairmanship of the U.S.-Korea Council for Business Cooperation. In 1998 there were two U.S.-Korean summit meetings, one in Washington and one in Seoul, and visits of numerous cabinet and sub-cabinet officials to Korea. This, together with the reinitiation of the U.S.–Korea Economic Subcabinet Consultations in November, brought an intensification and deepening of our bilateral economic dialogue.

Despite all the hard work to date, however, much remains to be accomplished to ensure the full recovery and future vibrancy of the Korean economy. As President Kim has emphasized, the remaining steps must be implemented as rapidly as possible. Delay will only postpone sustainable recovery. As the sense of crisis recedes, there is a danger that implementation of necessary changes may slow or weaken. These changes, which involve the restructuring of large businesses, will be difficult and costly. Liberalization of investment and trade regimes, so necessary to competitiveness in the global marketplace, may become a focus for frustration or recalcitrance. Social pressures, if not adequately and speedily addressed, could still overwhelm the remarkable consensus for reform.

In addition, the external picture remains murky. Korea’s recovery and progress in implementing further reform will depend, in part, on regional developments, continued global growth, openness of export markets and the presence and effects of additional shocks to the world financial system. This highlights the importance of Korea’s continued efforts to move ahead with reform and differentiate itself from other emerging markets.

As a result of the changes taking place in Korea, U.S.–Korean economic relations may be significantly strengthened. While the recent past has been characterized by chronic trade tensions and incremental improvements, we may now have an opportunity to work toward economic cooperation at a fundamentally deeper level. Of course, the feasibility of such a change will not become clear for some time, possibly several years. It will depend on the outcome of the reforms currently being pursued and the consensus that emerges about Korea’s economic future. The harbingers of such a shift will be Korea’s determination to proceed with fundamental opening up of its trade and investment regimes, a broader appreciation for the benefits of trade and investment, and an abiding commitment to good corporate governance and transparency. As President Kim has stressed, a market economy requires an open and democratic environment in which to thrive.

In the short to medium term, U.S.–Korean cooperation in support of economic recovery will remain strong. We will continue to consult closely on world economic developments and their implications. Korea will also continue to be influential in our deliberations about ways to improve the global financial system.

Trade issues are likely to preoccupy a disproportionate share of the bilateral economic agenda in the near term. Although we made some progress in 1998 on a few longstanding bilateral trade issues such as autos, the list of other issues remains long, and progress has been extremely slow. In addition, because of Asian economic problems and the turnaround in our trade balance with Korea, trade pressures in the United States are likely to focus more attention on the bilateral trade agenda in 1999.

Korea’s economy is heavily trade dependent. It is crucial that the economy be resilient and flexible enough to continue to seek comparative advantages and exploit them in world markets. Liberalization of Korea’s trade and investment regime will have a stabilizing effect over the longer term. In fact, it was Korea’s over-reliance on short-term foreign debt, a result of undeveloped capital markets, that made it vulnerable to a foreign exchange crisis.

Wrapped in every crisis, however, is an opportunity. Korea is determined to seize the opportunity presented by its current crisis to make changes that proved elusive in the past. It is approaching the financial crisis with the same spirit of unity, determination and open-mindedness that has seen Korea successfully through a number of challenges over the past decades. It will succeed again. In doing so, it will open new avenues for economic cooperation and partnership with the United States and the world.

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Since 1995, news media have been reporting on economic crises in North Korea, including starvation in some areas. The North Korean government mainly imputes the economic problems to domestic production decreases caused by natural disasters such as floods. Research indicates, however, that the direct factors involved in the present crises are not natural disasters, but drastic changes in North Korea’s trade with the Soviet Union/Russia and China. The results of this research are set forth below.

Four Difficulties Causing Crises in North Korea

The present difficulties in North Korea’s economy are essentially four: a food crisis; a shortage of goods and services; a reduction transportation capacity; and a confused economic order.

The food crisis is causing an almost complete suspension of state rations, especially in local areas. North Korean authorities claim that this is due to a large decrease of food production resulting from floods in 1995 and 1996 and a drought in 1997. It is well known, however, that there were often decreases and delays in food rations from the 1980s. The condition has rapidly worsened since 1995. Moreover, North Korea’s official assertion ignores the fact that there were not only floods, but a large decrease in the importation of food from China in 1994 and 1995.

In addition to the food crisis, there is a shortage of both consumer and producer goods and services. This also appeared in the 1980s, and the shortages have only worsened since 1991 because of a drastic decrease in imports from the Soviet Union/Russia.

These two difficulties on the supply side are magnified by a decrease of transportation capacity and confusion in the economic order, both of which affect distribution. The decrease of carrying power derives from a shortage of energy such as oil, electric power, and coal, and this difficulty also originated from a reduction in imports from Russia.

Furthermore, the previous economic order, characterized as a planned economy, has been almost ruined by intermediary profiteering, the selling of goods through illegal channels, black marketeering, etc., which are both causes and effects of a shortage of goods.

These four difficulties are interdependent. A confused economic order has been promoted, not only by the other three difficulties, but by the official “autarky” policy. From 1958 North Korea began to construct many consumer goods factories managed by local governments. It is important that in those factories the central government has not guaranteed the supply of investment goods, raw materials, or labor, but they have been relied on by local governments. Such autarky in local areas was also promoted in 1962 and 1970. The more such autarky is promoted, the more the local factories obtain material through illegal means, because there is no market in raw materials in North Korea.

Drastic Decrease in Trade with the Soviet Union/Russia

According to research by the Japan External Trade Organization (JETRO), as shown in Figure 1, the total of imports and exports in North Korea’s trade with the Soviet Union/Russia decreased tremendously from 2,620 million dollars in 1990 to 367 million dollars in 1991 and to 66.7 million dollars in 1997.

The turning point in this change was in a convention signed in November 2, 1990, in which North Korea and the Soviet Union agreed to change the previous
North Korea has operated its national economy under a “materials balancing system,” in which the central government plans and manages almost all inputs and outputs of the state enterprises. In this system, if some of the enterprises significantly cannot attain planned targets, other enterprises planned to receive those outputs must stop production if they exhaust their buffer stocks. If too many enterprises fail to meet their plan, production activities in the whole economy are paralyzed. This mechanism is referred to as a “chain reaction of the production bottleneck.” The North Korean economy at present is in this condition, which began with a drastic decrease of imports from the Soviet Union/Russia in 1991.

Imports from China (See Figure 2) increased significantly from 1990 to 1991 as if to cover the decrease in imports from the Soviet Union. However, this was only an increase in nominal terms. The rate of increase in real terms, valued at fixed year prices, is less than half

“friendly prices and barter trade” system into an “international market prices and hard currency settlement” system. The result was a severe assessment of the value of North Korea’s products, and a shortage of hard currency in the North resulted in a huge decrease in the volume of trade between the two.

Since the North Korean economy up to that time relied heavily on imports from the Soviet Union, especially for oil and producer goods, the decrease of imports damaged the country. Oil imports from the Soviet Union tended to decrease from 1987, but the North imported at least 410 thousand tons in 1990. The volume fell to 42 thousand tons in 1991. The total amount of 2,040 thousand tons of oil imported from the Soviet Union and China in 1987 fell to 1,140 thousand tons in 1991. Since 1992, the North has been relying principally on the supply of about 1,000 thousand tons of oil from China.

the nominal rate. The difference is due to a rise in import prices caused by abolishing “friendly prices,” so that North Korea’s terms of trade with China largely worsened from 1990 to 1991.

In 1991, the North received a double shock, a decrease of imports from Russia and an abolishment of “friendly prices” in its trade with China. It is obvious that there was no way to break through the shocks for North Korea except to rely on the western countries. For this reason the North established a “Free Economic and Trade Zone” in the Rajin-Sonbong area at the end of 1991. From that time, the North began to promote the acceptance of foreign capital. Also from 1991 (see Figure 1) North Korea began to increase exports to South Korea in order to obtain hard currency.

**Large Decrease in Import of Grain from China**

Although a food crisis in North Korea was unveiled in 1995, judging from various information, including research by the media in Japan, it is likely that the decrease in domestic food production began in 1993.

Another evidence is that, at the plenum of the Central Committee of the Workers’ Party in December 1993,
North Korea adopted a new economic policy in which first priority was given to “agriculture, light-industry, and foreign trade” instead of to the heavy and chemical industries as had been the case previously.

The harvest in 1994 was also bad, as the North admitted later. It should be noted, however, that a food crisis was not unveiled until 1995, in spite of the bad harvests in 1993 and 1994. The reason is that the North could make up for the decrease of domestic production by means of imported grain in the earlier years.

JETRO’s data shows that North Korea imported 0.9~1.0 million tons of grain from China, Canada, Australia, and Turkey every year in 1991–93. Imports from China are most significant and stable. Data for 1994 is unavailable.

Table 1 shows the volume of three main crops imported from China. The North obtained 926 thousand tons all together from China in 1993, and 247 thousand tons in 1994. Although the volume in 1994 was small, it was almost similar to the volume in 1990–1991. In 1995, the quantity decreased drastically, however, to 80 thousand tons.

Table 1: North Korean Imports of Grain from China

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<tbody>
<tr>
<td>Corn</td>
<td>586.58</td>
<td>876.22</td>
<td>209.48</td>
<td>11.03</td>
<td>80.98</td>
</tr>
<tr>
<td>Rice</td>
<td>0.02</td>
<td>12.50</td>
<td>28.55</td>
<td>2.34</td>
<td>45.10</td>
</tr>
<tr>
<td>Wheat Flour</td>
<td>60.34</td>
<td>37.37</td>
<td>8.97</td>
<td>67.35</td>
<td>328.91</td>
</tr>
<tr>
<td>Total</td>
<td>646.94</td>
<td>926.09</td>
<td>247.00</td>
<td>80.72</td>
<td>454.99</td>
</tr>
</tbody>
</table>

Source: China Customs Statistics Yearbooks

More surprising, the export price of corn from China to North Korea, computed from the customs statistics in China, was 26% higher than that to the world in 1995, in spite of being almost the same for 1990–94 and a little lower for 1996.

It is well known that in December 1994 China laid an embargo on rice and corn because the domestic demand and supply conditions became tight. This is a factor in the decrease in imports of crops from China in 1994–95 and the higher import price of corn in 1995.

There is considerable information indicating that North Korea desperately tried to purchase grain from countries other than China in 1994. North Korea requested Japan to lend rice in May 1995. After that, on August 17, Nodong Sinmun unveiled the first news about floods.

To sum up, North Korea has relied for part of its domestic food supply on the import of almost one million tons from abroad every year since 1991. Imports from China, the largest supplier, decreased significantly from 1994, and North Korea tried to obtain crops from other countries in 1994 and the first half of 1995, but largely failed. On top of this, floods ruined domestic production, so that a food crisis emerged in 1995.

It should be noted that North Korea had already faced obstacles in purchases of food abroad prior to the floods, and damage by the flood is only the second factor in the food crisis in 1995.

Although North Korea’s official news claimed that floods in 1995 were the worst in a hundred years, we do not have enough information to compare the damage to that by floods in former years. Everyone who has seen the stark-naked land in North Korea without grasses and flowers in early spring can easily imagine that deforestation and an absolute shortage of farm investment are important factors in causing the floods.

Two Turning Points in Trade with China

In addition to the foregoing analyses, I compared China’s trade prices for North Korea with those for the world in order to check “friendly prices” for the years 1985–91 and 1992–96, using the data in China Customs Statistics Yearbook. I calculated indices of China’s terms of trade for North Korea and for the world. These are shown in Figure 3 and Figure 4.

The “terms of trade” are the ratios of prices of export goods to prices of import goods, and express how much goods are importable per unit of export goods. If the terms of trade improve, a country can import more goods with the same exports, but less goods if the terms of trade worsen.

My calculation shows that, for instance, China’s export price for oil to North Korea was 41~77% of that
for the world in 1985–90, but moved up to 97% in 1991. In the case of North Korea’s export goods to China, however, China’s import price of cement from the North was almost the same as that from the world for 1985–1989, but decreased to 86% of the world price in 1990 and 76% in 1991.

Moreover, China’s terms of trade with the world show a large worsening from 1985 to 1986, and get a little worse from 1990 to 1991. This derives from the change in international oil prices. On the other hand, China’s terms of trade with North Korea also get worse from 1985 to 1986, but largely improve from 1990 to 1991, which means a large worsening of North Korea’s terms of trade with China. Figure 2 shows that North Korea’s trade deficit also increased greatly in 1991.

Judging from these results, it is likely that China used “friendly prices” in its trade with the North in 1985–90, but abolished them in 1991. As mentioned above, the North lost the stable imports from its former most significant supplier, the Soviet Union, that year, and at the same time lost its friendly trade prices arrangement with its next most reliable supplier. Thus, I regard the year 1991 as the first “turning point” in the trade with both countries.

It is commonly said that in 1993 or shortly thereafter China changed its trading system with North Korea from the former “friendly prices and barter trade” system to the “international market prices and hard currency settlement” system. This is different from my result. I do not believe that China changed both trade prices and settlement procedures at the same time. If the settlement method had been already changed, I see that a hard currency settlement was adopted in 1995.

The reason is that North Korea’s terms of trade with China worsened significantly from 1994 to 1995, and Figure 2 also shows a re-increase in North Korea’s trade deficit in 1995. The real index of China’s exports to the North decreased from 1994 to 1995 in spite of a small nominal increase (see Table 2). This caused the rise of export prices. On the other hand, both nominal and real indices of imports drastically decreased, while import prices were unchanged. As for individual trade prices, we do not see the recovery of “friendly prices” until 1996.
To sum up, it is said that China gave North Korea 180 thousand tons of food as aid in 1995 after the North announced a food crisis in August, and that China’s custom statistics include all aid. My estimates, however, show that, viewing the total year, China decreased its quantitative volume of exports to the North in 1995 below the level of 1994. This is far from giving aid, and the export prices were higher. The unveiling of the food crisis in the North showed it to be in a severe condition. Thus, I regard the year 1995 as the second “turning point.”

My estimates show that China reinstituted “friendly prices” in 1996. For example, China’s export prices for wheat and oil to North Korea were almost the same as those for the world in 1995, but became 91% and 93% of the latter in 1996. Other information shows that the recovery of “friendly prices” was decided in May 1996.

To my surprise, however, North Korea’s terms of trade with China in 1996 became worse than in 1995. This is because China raised its export prices both for the world and for North Korea. As for products such as corn, soybeans, coking coal etc., whose export prices for the North were lower than that for the world, the range of price rises for North Korea was smaller than the price rises for the world. Only the export prices of wheat and oil for the North are slashed, because it was decided in May that they would be aid products.

Although China gave North Korea grant aid and aid through concessionary “friendship prices,” it is likely that large-scale aid began in May 1996 and that the beneficial effect was significantly decreased by the worsening terms of trade.

**North Korea’s Foreign Relations in the Future**

It is obvious that the economic crises in North Korea have been intensifying. According to the research by JETRO, North Korea’s total imports from the world were 1,473 million dollars in 1997, a small increase from 1,424 million dollars in 1996. The 1,400 million dollar level, however, is lower than the 1,700–1,900 million dollars in the period from 1991 to 1995. Taking account of the fact that almost all factories have stopped production, North Korea has no means to supply people with consumer goods without relying on an imports, foreign aid, and black marketeering. Thus imports are the main measure, and decreases mean the worsening of people’s lives.
### Table 2: Chinese Import and Export Indices for North Korea and the World

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<tbody>
<tr>
<td><strong>North Korea</strong></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Nominal Export Index</td>
<td>1.0000</td>
<td>1.1566</td>
<td>0.7414</td>
<td>0.7666</td>
<td>0.8999</td>
</tr>
<tr>
<td>Real Export Index</td>
<td>1.0000</td>
<td>1.2156</td>
<td>0.8335</td>
<td>0.7841</td>
<td>0.7907</td>
</tr>
<tr>
<td>Export Price Index</td>
<td>1.0000</td>
<td>0.9515</td>
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Imports from China, the principal trade partner, are not profitable for North Korea, and an increase of trade with Japan is not expected at present because of accumulated debts. Judging from such conditions, only South Korea can be a dependable source of imports for North Korea. In the future, therefore, North Korea may seek to increase imports from South Korea and to accept tourists and joint venture enterprises from the South. This tendency will not change for a while, although there may be political or military factors that serve as obstacles. The economic circumstances surrounding North Korea are not positive enough to stop this flow. The acceptance of tourists from the South to Kumgangsan (the Diamond Mountains) and the plan for a South Korean company to construct an industrial base for small and medium sized companies are symptoms of this trend.

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SOUTH KOREAN POLICY TOWARD NORTH KOREA

by Sung-Han Kim

South Korea’s Strategic Culture

The end of the Cold War has changed the overall security situation in Northeast Asia. The bloc-to-bloc ideological confrontation of the past has ended. Nevertheless, the Korean peninsula is often described as “the last bastion of the Cold War” due to the existing confrontation between the two Koreas. Moreover, considerable uncertainties lie ahead as the states in the region are constantly redefining their existing relations and seeking new strategies. Under these circumstances, South Korea has been faced with a more complex and sensitive security environment than in the Cold War era.

Different states have different strategic preferences that are rooted in the early or formative experiences of the state, and are influenced to some degree by the philosophical, political, cultural, and cognitive characteristics of the state and its elites. It is hard to deny that South Korea’s strategic thinking has been influenced by its bitter memories of a territorial division that has lasted for the past four decades, and particularly by the Korean War in 1950–53. South Korea knows that the post-Cold War international system is producing new issues and dimensions that it has to tackle. However, the continued confrontational reality in inter-Korean relations sometimes constrains South Korea’s top decision makers’ responses to the changes in the “objective” strategic environment surrounding the Korean peninsula. South Korea has tended to deal with North Korea in the same manner in which it did in the Cold War period, while it has swiftly adapted itself to the new strategic environment insofar as that environment is not directly related to North Korea policy. In other words, South Korea has a “strategic culture” in which it strongly feels the obligation to dominate North Korea in diplomatic rivalry and in which any failure to do so influences the domestic approval rating of the South Korean regime. Thus, South Korea’s security policy sometimes lacks the rationality of realpolitik.

However, political and economic transitions in both South and North Korea have dramatically changed the context and prospects for initiating a Korean peace process. The South Korean financial crisis and the election of Kim Dae-jung in late 1997 have led to a more conciliatory South Korean policy toward North Korea, while North Korea’s economic distress and the extended process of political transition from Kim Il-sung to Kim Jong-il have increased North Korea’s dependence on international negotiations to gain resources necessary for the regime to survive. The Kim Dae-jung Administration’s “sunshine policy” is based upon the idea that North Korea can be engaged by the international community through reconciliation and cooperation measures between the two Koreas. This is an effort to overcome the South’s strategic culture of trying to dominate North Korea.

Nevertheless, North Korea has responded negatively to the “sunshine policy” by sending submarines off the eastern coast of South Korea in violation of the armistice agreement. In addition, the recent discovery of what may be an underground nuclear facility in North Korea has created concern about the sustainability of the ROK-US policy of engagement of North Korea. Relations between North Korea and the outside world, always tenuous, have become even more strained. Even worse, on August 31, 1998, Pyongyang launched a long-range ballistic missile over Japan, clearly showing its capability to destabilize the Northeast Asian region. The launch has caused the U.S. Congress to question whether the United States and its allies should continue to observe the 1994 Geneva “Agreed Framework” to provide the North with two proliferation-resistant nuclear reactors in return for freezing and eventually dismantling its nuclear program.

South Korea’s Policy of Engaging North Korea

The Policy Structure of Inter-Korean Relations

North Korea’s top priority in its South Korea policy is regime survival, which means preventing the deepen-
ing economic deterioration from developing into a political threat to the Kim Jong-il regime. Communizing the whole Korean peninsula seems no longer to be a valid hope for a North Korea suffering from severe economic difficulties which include massive starvation of its people. In order to achieve this goal, however, the North Korean regime has been trying to de-link South Korean-U.S. relations by driving a wedge between them. North Korea perceives the United States as the sole country which possesses the power to influence the international community to provide humanitarian assistance to North Korea as well as to guarantee regime survival. Thus, North Korea feels the need to put South Korea, which is perceived to be a threat to the North Korean system, at odds with the United States by talking mainly to the United States.

The policy means available to North Korea include large conventional forces compounded by numerous provocative actions, although it is believed that North Korean military forces are inferior to their counterparts in the South in terms of quality. The nuclear option that is suspected by the international community is another North Korean bargaining tool. Chemical weapons that have been pointed out in the Pentagon’s Quadrennial Defense Review can probably also be included in North Korea’s survival kit.

North Korea assumes that its most effective tool is the U.S.-North Korean relationship. North Korea’s bilateral talks with the United States, regardless of their pace, can be regarded as important to North Korea simply because the United States thus recognizes North Korea as a negotiating partner.

Other means for North Korea’s policy toward the South include the food and refugee “cards.” The deteriorating food situation in North Korea has led the international community to prefer a “soft-landing” by North Korea. Also, the growing number of North Korean defectors reminds South Korea and the United States of the Cuban refugees swarming toward the U.S. coast in 1994, thereby putting the U.S. Government in an uneasy position on how to handle the situation.

On the other hand, South Korea’s ultimate goal in its North Korea policy is to reunify the peninsula by peaceful means, although current economic hardship has discouraged this kind of goal setting and has led to a search for realistic ways to manage the division of the peninsula. Thus, the objective of the South’s North Korea policy includes further strengthening the Korea-U.S. alliance in order to deter the North Korean threat and to prepare for unification through management of the division of the peninsula. Overcoming the division requires political as well as military support from the United States. Hence, the consolidation of the Korea-U.S. alliance should be a primary policy objective.

What are the policy means available to South Korea? The first is the ROK-US combined forces working as a deterrent against North Korean miscalculation. The second includes South Korea’s economic capability, even if reduced by the current financial crisis, because South Korea is the country which can still provide the economic and humanitarian assistance to North Korea that it needs. South Korea’s willingness to improve inter-Korean relations, despite North Korea’s reluctance, can be regarded as another means, since the surrounding countries agree with the necessity of inter-Korean talks and reconciliation. Finally, the South Korea-U.S. alliance itself may be the most powerful means that South Korea has, because North Korea feels the alliance to be a big political burden that it has to overcome, particularly in the process of negotiating with the United States.

**Principles of the Engagement Policy**

For the current Kim Dae-jung Administration, resolving the financial crisis and restoring economic stability have taken top priority over improving relations with North Korea. Nevertheless, the financial crisis has broadened public support in South Korea for a policy of engagement toward North Korea, while dampening desires for near-term Korean reunification. In the near term avoiding either military confrontation or political implosion in the North are at the top of the priority list. Even before the financial crisis, the South Korean government was afraid of a German-style absorption scenario.

The Kim Dae-jung Administration hopes to improve inter-Korean relations by promoting peace, reconciliation and cooperation. At the present stage, it is more urgent to establish a durable peace and to assure the peaceful coexistence of the two Koreas than to push for immediate unification. When there is an assurance of durable peace, the administration hopes to promote reconciliation and cooperation with North Korea.
The South Korean government views inter-Korean talks and the Geneva Agreed Framework as two tracks leading toward the larger imperative of reducing the gap between the two Koreas. President Kim Dae-jung has outlined a three-stage process of national unification. His initial moves toward North Korea—calling for direct talks, an exchange of special envoys, and easing restrictions on business and other private contacts—are part of what the President has dubbed his “sunshine policy” of engagement with the North.

President Kim Dae-jung emphasized in his inaugural speech in February 1998 that “Inter-Korean relations must evolve on the basis of reconciliation and cooperation as well as the establishment of peace.” He enunciated three principles re North Korea: 1) no toleration of any kind of armed provocation; 2) no absorption of North Korea; and 3) reconciliation and cooperation between the South and the North.

The administration has emphasized, above all, the maintenance of a strong security posture to deter war by making it clear that the South will respond to any provocation. In this way, it hopes to persuade North Korea to abandon its reliance on violence. At the same time, the administration continues efforts to reduce tension and to build a durable peace on the Korean peninsula, thus creating an atmosphere that would make it more difficult for North Korea to stage a military provocation.

Second, the administration has noted that it has no desire to harm North Korea or to absorb it unilaterally. Rather than promoting the collapse of North Korea, the administration intends to work for peaceful coexistence with the North, thus creating an atmosphere favorable to the formation of a South-North Union. Such a union can gradually lead to peaceful unification according to Kim Dae-jung’s three-stage plan.

Finally, the administration tries to promote reconciliation and cooperation with the North. In order to dissolve the hostility between the two Koreas which has accumulated since the division of the peninsula and to lay down a foundation for mutual understanding, the administration has attempted to promote reconciliation and cooperation in the areas where they are possible and has tried to reactivate the 1991 Agreement on Reconciliation, Nonaggression and Exchanges and Cooperation between the South and the North, often referred to as the Basic Agreement. The administration also emphasizes that it will support North Korea’s own efforts to reform itself in order to restore a sense of national homogeneity between the two Koreas and improve the welfare of the entire Korean people.

Challenges to the South’s North Korea Policy

The financial crisis in South Korea seems to have relieved North Korea’s suspicion that South Korea would seek absorption of the North, and thus South Korea’s engagement policy has become more acceptable to the North. On the other hand, North Korea also seems to be tempted to keep its nuclear option as a bargaining tool toward the United States, which regards preventing nuclear proliferation as a top priority of its North Korea policy. In addition, North Korea’s satellite (or ballistic missile) launch on August 31 represents a willingness to demonstrate that it has the military means for regime survival. At the same time, as food assistance from the international community has been rapidly declining, North Korea seems to be aiming at more concessions from the United States.

The North seems to be trying to find solutions for its economic difficulties through cooperation with South Korean businessmen. However, its “two-pronged strategy” of using moderate gestures to the South and risk-taking behavior toward the United States and Japan signal a potential danger of ending the Geneva Framework and leading to heightened tension on the Korean peninsula.

After what “might be” an underground nuclear facility was discovered in North Korea, the United States told North Korea that it strongly objected to construction of a vast, secret underground facility that U.S. intelligence analysts believe is being dug in a mountainside near the North Korean nuclear research center at Yongbyon. In addition, North Korea launched its “scientific satellite” on August 31. United States and Japanese defense officials believe the launch was the test-firing of a ballistic missile that sailed over northern Japan and crashed in the Pacific Ocean.

The launch has caused the U.S. House of Representatives further to question whether the United States and its allies should keep the Agreed Framework. The
Chairman of the House International Affairs Committee, Benjamin Gilman, emphasized that it is time to rebuild the U.S. stance toward North Korea. He declared that the White House must conduct a serious review of its policies, the U.S. Government should make theater and national missile defense a top priority, and the North Koreans must be made to understand that they will not be rewarded for provocative actions.

The Republican-controlled U.S. Congress, which has never been enthusiastic about the 1994 Geneva nuclear accord, put the brakes on the operation by denying funding of $35 million for the Korea Peninsula Energy Development Organization (KEDO). Subsequently, on October 22, 1998, a House-Senate conference approved the funding, but subject to prior presidential certification that North Korea is complying with all provisions of the Geneva accord. Even though Congress allowed the President to waive the certification requirements if he determines that it is vital to the national security interests of the United States, another nuclear crisis could develop depending on North Korea’s actions. If catastrophe is avoided, the following policy directions should be considered.

The ultimate solution may be found through a reconciliation of interests between the United States and North Korea. North Korea should alleviate the global strategic concerns of the United States, while the United States should find a way to contribute to the North Korean regime’s survival. Otherwise, a vicious circle of “muddling through” is inevitable. North Korea will try to avoid opening up or reforming its system, while the United States and its allies will continue to deal with the North on an ad hoc and reactive basis.

Thus a comprehensive deal between the United States and North Korea could be the ultimate solution. A giant package of economic aid, investment, lifting of sanctions, and diplomatic recognition could be offered in exchange for equally large North Korean concessions such as the elimination of North Korean missiles and nuclear programs and threats. However, such an option presupposes a certain level of mutual confidence between the United States and North Korea. The United States and its allies can provide North Korea with appropriate incentives, while North Korea in turn must implement measures for threat reduction and open up and reform its system.

Future Policy Directions

Confidence Building Measures

We can still pursue a bilateral approach that can contribute to building a working peace regime on the Korean peninsula. In this regard, the Agreement on Reconciliation, Non-Aggression and Exchanges and Cooperation between the South and the North (the Basic Agreement) and the Joint Declaration of the Denuclearization of the Korean Peninsula provide important guidelines. The Basic Agreement, signed in December 1991 with its subsidiary protocols, is an ambitious document committing South and North Korea to build confidence and improve relations in political, security, trade, and other areas. As a road map towards peaceful coexistence, the Agreement contains specific measures for confidence and security-building and arms control, with the goal of ending the costly arms race and confrontation between the two parts of Korea.

The Basic Agreement includes: reconciliation measures (e.g., respect for each other’s political and social systems and a commitment to cooperate in the international arena); nonaggression measures (e.g., non-use of force, establishment of a joint military commission to negotiate confidence-building measures, arms reduction, and accords on notification and limitation of military exercises); and trade, exchange, cultural, and humanitarian measures (e.g., family reunions and visits). The Joint Declaration for Denuclearization, which was also adopted in December 1991, includes a range of confidence-building measures (CBMs) specifically designed to address the nuclear issue. They include: 1) not to test, produce, receive, possess, store, deploy, or use nuclear weapons; 2) not to possess facilities for nuclear reprocessing and uranium enrichment; and 3) to ensure implementation through the establishment and regular meeting of a joint nuclear control commission.

However, most of what both Koreas have agreed upon are declaratory CBMs. Thus we need to think of implementing more concrete and substantive measures. It seems that at the initial stage of building military confidence between the South and the North, transparency measures accompanied by some constraint measures should be applied first, such as the exchange of military information and the operation of a hot line be-
between the high military authorities; notification of military movements, maneuvers, and exercises; demilitarization and conversion of the DMZ into a peace zone; and relocation of offensive weapons.

Although it is meaningful to think about various ambitious measures to build confidence and improve relations between the two Koreas, implementation of such efforts will be possible only when inter-Korean dialogue resumes.

Four-Party Talks

The third round of four-way peace talks, held on October 21–24, 1998, agreed to set up two subcommittees to “discuss respectively the establishment of a peace regime on the Korean peninsula and tension reduction there.” The four-party peace process aims at official termination of the Korean War, thereby establishing a permanent peace structure (or regime) on the peninsula.

The South Korean government is pursuing four-party talks and direct inter-Korean dialogue in a complementary way. If the four-party talks go well, they will also help create a favorable atmosphere for inter-Korean talks. The South Korean government position is that the four-party talks should work on a permanent peace settlement, and that South-North dialogue should deal with issues directly concerning them such as reunions of separated families. In addition, the political and economic aspects of confidence-building measures will be left mainly to inter-Korean dialogue, while military issues will be discussed in the framework of four-party talks.

The objective of the four-party talks is no longer an elusive quest for reunification as in the past but the more limited and realizable interim step of implementing the provisions contained in the 1991 Basic Agreement designed to enhance the security environment on the peninsula (a prerequisite to buttressing a North-South political dialogue). A peace treaty emerging from the four-party talks would not constitute a tabula rasa but would have to take account of both existing political realities and previous agreements, one of which, the 1954 Armistice Agreement, is still in effect but badly fraying at the edges, and the Basic Agreement, whose implementation fell victim to the nuclear inspection standoff in 1993–94.

The Korean Peninsula Energy Development Organization (KEDO)

The KEDO umbrella seems to be an effective CBM to manage the uncertainty of North Korea. This organization is designed to give North Korea a sense of firm assurance of its commitment without being influenced by political ups and downs between the two parts of Korea. The KEDO system is the best to manage and address the concerns which North Korea has in dealing with South Korean participation in the reactor project.

As the KEDO project proceeds, a large number of engineers and facilities continue to be transported to Shinpo in North Korea, where the light-water reactors (LWRs) will be constructed. This will contribute to revitalizing exchanges between the two Koreas. The KEDO project needs to be understood as a long-term policy tool for engagement of North Korea. The tripartite cooperation between the United States, South Korea and Japan that is embedded in KEDO should be reinforced, and coordination with Russia and China should also be encouraged.

Complementary Multilateral Measures

Bilateral security arrangements will remain the backbone of Northeast Asian security for a considerable period of time. Despite the strategic uncertainty and prevailing bilateralism, Northeast Asia needs to search for a multilateral setting such as the Northeast Asia Security Dialogue (NEASED) that was proposed by the Korean government in 1994. The United States, Japan, and South Korea should try to make this feasible as well as actively participate in multilateral activities at the track-II level.

A multilateral security dialogue in Northeast Asia should be seen for a considerable period of time as a supplement, rather than as a substitute, to the system of bilateralism in the region. Bilateralism and multilateralism are not mutually exclusive concepts. In addition, a multilateral security dialogue in Northeast Asia should be pursued in a way which is consistent with and conducive to improved inter-Korean relations. As long as inter-Korean relations remain unstable, real peace and stability in the region will be remote. Tangible progress in inter-Korean relations is a precondition to guaranteeing stability in Northeast
Asia. For South and North Korea, participation in such a multilateral security mechanism could contribute to establishing a solid peace regime on the Korean peninsula.

A multilateral security dialogue in Northeast Asia also needs to maintain a cooperative and consultative relationship with the ASEAN Regional Forum (ARF). A sub-regional security dialogue addressing Northeast Asian concerns is fully compatible with the ARF. Although the ARF will continue to include in its discussions some items involving the Northeast Asian sub-region, a sub-regional dialogue will permit the major actors to address these issues in greater depth.

Finally, a gradual approach should be taken to build a common security framework in Northeast Asia. Given the historic realities as well as the differences in political systems and economic development among the countries in the region, only a gradual approach based on patience will contribute to building the blocks of a “Northeast Asian Home.”

Conclusions

The maintenance of strong national security must be the first basis of an effective North Korea policy. The South is determined to enhance its independent capabilities to defend the nation, while consolidating the ROK-US alliance and working to create a collective security structure with the countries in the Northeast Asian region. Based on a strong national security posture, South Korea tries to be flexible in promoting inter-Korean interaction and various cooperative efforts which can substantively improve inter-Korean relations.

As the regional powers in Northeast Asia move toward a rearrangement of their relationships based upon cooperation rather than confrontation and ideology, a new environment is being created for future multilateral security cooperation. However, in order to establish a new regional order in Northeast Asia, the confrontation on the Korean peninsula must first be ended.

The unification of the two Koreas will be a long and difficult task. At this point, the most urgent tasks are to remove the threat of armed provocation and to achieve peaceful coexistence. While making it clear that the road to unification begins with the two Koreas recognizing and respecting each other’s system as they agreed in the Basic Agreement of 1991, the Kim Dae-jung Administration gives priority to managing the national division in a peaceful manner. Once peaceful coexistence is assured, South Korea seems determined to do its best to improve inter-Korean relations by expanding South-North interaction and cooperation.

It is more appropriate to try to improve relations by inducing gradual change in the North rather than to try and contain the North in the expectation that it will collapse. President Kim Dae-jung does not intend to try and force North Korea to change. He will, however, try to expand engagement with the North in support of Pyongyang’s efforts to reform. President Kim is keeping his composure even when North Korea challenges him with irrational demands and threats and despite criticisms from the conservative public in the South.

Finally, the fate of the nation should be determined by South and North Koreans themselves. Nonetheless, this requires the commitment and support of the international community to end the division of the Korean peninsula and to secure regional peace. Based on the principle that inter-Korean issues must be resolved through direct contact between the two Koreas, the Kim Dae-jung Administration continues efforts to persuade Pyongyang to enter into a dialogue. At the same time, the administration tries its best through various means, including the ongoing Four-Party Talks, to win support from the international community for its efforts to create a durable peace and to reduce tension on the Korean peninsula.

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The year 1998 was loaded with symbolic and memorable images in inter-Korean relations. The story of the octogenarian honorary chairman of the Hyundai group, Chung, Ju-Young, crossing the DMZ with 500 head of cattle to pay off a personally felt debt to his native village was compelling even beyond the Korean Peninsula. Likewise, the inaugural voyage of a Hyundai cruise ship loaded with South Koreans, many of them elderly refugees who fled the North during the Korean War, to the Diamond Mountains even captured the imagination of President Clinton who was visiting Korea at the time. He described the event as “amazing” and “a very beautiful picture.”

Yet, as dramatic as they were, such images were not as dramatic as the changes taking place in South Korean policy toward North Korea. While the South Korean government’s overall approach to North Korea has changed under the unfortunately monikered “sunshine policy,” the most significant initiative is likely the Kim Dae Jung administration’s decision to “separate politics from business” and to reduce government control over the process of inter-Korean economic exchange. Not only was this policy shift responsible for the various Hyundai initiatives, but also for the continued expansion of inter-Korean contacts, even in the midst of a regional economic crisis.

Unfortunately, 1998 also featured North Korean actions, which though equally memorable, were clearly detrimental to inter-Korean relations and regional stability. Incidents throughout the year involving a North Korean submarine, a frogman, and a “semi-submersible craft” all offered potent challenges to the “sunshine policy” of engagement. On a broader level, the discovery of ongoing work on a suspect underground facility in North Korea and the launch of a three-stage rocket over Japan resulted in harsh reactions from both the United States and Japan. As a result, the 1994 Geneva Agreed Framework between the United States and North Korea is in jeopardy and with it the relative stability on the peninsula that has allowed inter-Korean economic relations to develop.

Shedding Light on the “Sunshine” Policy

Misunderstood Intentions

A year after its full implementation, the term “sunshine policy” is well known by U.S. policy makers and those who follow Korea. While most understand the general gist of the policy to be “engagement,” the policy is more complicated than may initially appear. So much focus on the cheery idea of “sunshine” has distracted attention from the intent and the potential efficacy of the policy. It is useful to remember that the term “sunshine” derives from Aesop’s fable of the “The North Wind and the Sun:”

A dispute once arose between the North Wind and the Sun over who was stronger, and they agreed that whoever could first make a Traveler remove his coat should be declared the victor. The North Wind tried first and blew with all his might; but the stronger he blew, the closer the Traveler wrapped his cloak around him. At last the North Wind called upon the Sun to see what he could do. The Sun broke out of the clouds and dispersed the cold and wind, and the Traveler, feeling the genial warmth as the Sun became hotter and hotter, sat down and cast his coat upon the ground.

The moral that Aesop drew from the fable was: “Persuasion is better than force.” In the Korean context, however, it is useful to remember that the objective of both the wind and the sun was to get the traveler to remove his cloak. Likewise, the “sunshine policy” is intended to affect change in North Korea. The tools of persuasion may be different than the tools of force, but the hoped for outcome is the same.

When President Kim Dae Jung visited Washington in June of 1998 for a State Visit, a fawning U.S. media described President Kim’s policy as one of altruism, and some reports even went so far as to link the origins of the policy to his Christian background and beliefs. While there may be some credence to such motivations, it is inaccurate to describe the sunshine policy as one of simple “kindness.” As a lifelong political leader on a divided peninsula, President Kim has presumably thought long and hard about Korean unification and concluded that the most effective way to bring about change in North Korea is through a policy of engagement.

To date, DPRK officials have been extremely wary of the “sunshine policy.” While it provides for the economic interaction with the South that they so sorely need, they too recognize the policy as a threat to their control, their system, and even their regime. From the perspective of the DPRK regime, the “sunshine policy” is the most dangerous policy they have ever faced. It is a strategy that the Chinese disparagingly described early on as “peaceful evolution.”

Core Components

Separating Politics from Economics: The concept of separating politics from business strikes at the very core of South Korean government policy toward the North. It implies an implicit recognition of the North Korean regime, resignation that a near-term collapse of the regime is unlikely and undesirable, willingness to postpone unification, and willingness to sacrifice government control over a sensitive area. For over three decades following the end of the Korean War there were only “political level” contacts with North Korea. Only with the legalization of inter-Korean trade in 1988 and of investment in 1994 did private sector relations become possible. Still, the process of all inter-Korean contacts remained heavily politicized and subject to government approval. The Kim Young Sam administration moved in the direction of de-politicizing economic policy toward North Korea, but the dividing line was frequently blurred under challenges such as the September 1996 submarine incursion on South Korea’s East Coast. It has been the Kim Dae Jung administration that has clearly articulated and doggedly defended the policy of separation of politics from economics.

Given the continuing tensions on the Korean peninsula and the possibility, if not expectation, of continued North Korean “provocations,” the first impact of separating politics and economics is to insulate ongoing business transactions from the crisis de jour. Such insulation is provided on the assumption that private sector contacts have a unique and useful role to play in affecting change in North Korea. The broader the contacts with North Korea, the more “opening” or “adjustment” that will be required. Furthermore, private sector contacts allow market mechanisms to begin to function in North Korea.

Pragmatism: While critics brand the sunshine policy as being “overly optimistic” and even “naive,” it has at its core some very pragmatic assumptions. The first is that a short-term collapse of the North Korean regime is unlikely, and more importantly undesirable from a South Korean perspective. The economic costs of any “collapse” scenario would simply be too much for South Korea to bear, particularly in its current weakened condition. In fact, it is full recognition of national limitations that partially spurs the emphasis on engagement and reconciliation. Dr. Lim Dong Won, National Security Advisor to President Kim, stated succinctly: “Without peace and stability here, no foreign investment and no economic take-off will be possible.” The result is a conscious decision to put off questions of unification for tomorrow in favor of focusing full attention on the first priority of today—rebuilding the economy.

Reciprocity: The “sunshine” policy has also been pilloried as being “soft” on North Korea. Dr. Lee Jong Suk, a Research Fellow at the Sejong Institute, terms

this a “mistaken public perception.” In a recent assessment of the first year of the sunshine policy he argues that the current approach is “based on the principle of reciprocity” and notes that though non-governmental organizations have given rice and other materials to North Korea, the government has not. In fact, the government continues to condition government level aid on North Korean willingness to make progress on issues such as divided families. On a government to government level, the current administration has given less to North Korea than its predecessor. Such a clear distinction is not entirely genuine, however, as many of the private sector initiatives have proceeded with the government’s blessing, if not its encouragement.

**Limitations:** The “sunshine policy” is by its nature a longer-term policy. It is based on the assumption that there will be a slow and gradual change of the North Korean regime. It seeks to bring about such change in the most peaceful, least economically disruptive way possible. Unfortunately, however, the policy does not offer a clear solution to the short-term crises of the day. More specifically, if politics and economics are truly separated, they do not offer policy tools or levers for influencing North Korean behavior. Such limitations have come to light recently in specific regard to the North Korean rocket launch and its suspect underground facility.

**Recent Trends**

**Trade**

With a few exceptions, inter-Korean trade has steadily increased since 1991. However, with the Asian financial crisis in full bloom and the sharp contraction of South Korea’s economy, inter-Korean trade in 1998 contracted 28 percent from its peak of US$308 million in 1997 to $222 million in 1998. (See Table 1) It is probably safe to assume that the impact of the Asian Financial Crisis was muted by the South Korean government’s initiatives to facilitate easier trade and investment with the North under the “sunshine policy.” Though relatively insignificant on an international scale, such levels of trade remain disproportionately important to North Korea. Despite the contraction of inter-Korean trade in 1998, South Korea is still the North’s third largest trading partner, its second largest export market, and its largest source of hard currency.

**Direction:** From its inception, inter-Korean trade has been heavily imbalanced toward imports from North Korea entering the South. This has been due to a number of factors, including North Korea’s lack of hard currency wherewith to purchase South Korean goods, and the political sensitivity in North Korea over goods identifiable from South Korea. With the growth of processing on commission (POC) trade, this trend has eased. Furthermore, progress on the KEDO project and South Korean food aid have also served to boost South Korean exports to North Korea.

In 1998, for the first time since inter-Korean trade was legalized a decade before, South Korea posted a trade surplus with North Korea. The economic crisis in the South and the resulting contraction of the South Korean consumer market led to a 52 percent decline in imports from North Korea compared to 1997. In 1997, South Korean imports from the North were valued at $193 million. In 1998 that number plummeted to just over $92 million. Exports on the other hand expanded by over 13 percent from $115 million in 1997 to nearly $130 million in 1998.

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5. Processing on commission trade is when, rather than invest in production facilities, enterprises ship in unfinished or primary goods, which are then processed and exported. Given the limitations of the current system in North Korea, processing on commission is considered to be the most suitable for inter-Korean trade. Not only is risk minimized by the lack of actual investment in North Korea, but the combination of North Korea’s well-educated workers, low wage rates, and idle manufacturing capacity is matched well with South Korean capital and international business relationships. From North Korea’s perspective, it provides the opportunity to earn needed foreign capital without undue and potentially intrusive involvement from outside. Naturally, POC trade is relatively balanced, as it represents the importation and re-export of what are essentially the same items.
### Table 1: Inter-Korean Trade
(US$ millions, customs clearance basis)

<table>
<thead>
<tr>
<th>Year</th>
<th>North to South</th>
<th>South to North</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>18.7</td>
<td>—</td>
<td>18.7</td>
</tr>
<tr>
<td>1990</td>
<td>12.3</td>
<td>1.2</td>
<td>13.5</td>
</tr>
<tr>
<td>1991</td>
<td>105.7</td>
<td>5.5</td>
<td>111.3</td>
</tr>
<tr>
<td>1992</td>
<td>162.8</td>
<td>10.6</td>
<td>173.4</td>
</tr>
<tr>
<td>1993</td>
<td>178.2</td>
<td>8.4</td>
<td>186.6</td>
</tr>
<tr>
<td>1994</td>
<td>176.3</td>
<td>18.2</td>
<td>194.5</td>
</tr>
<tr>
<td>1995</td>
<td>222.9</td>
<td>64.4</td>
<td>287.3</td>
</tr>
<tr>
<td>1996</td>
<td>182.4</td>
<td>69.6</td>
<td>252.0</td>
</tr>
<tr>
<td>1997</td>
<td>193.1</td>
<td>115.3</td>
<td>308.3</td>
</tr>
<tr>
<td>1998*</td>
<td>92.3</td>
<td>129.7</td>
<td>221.9</td>
</tr>
</tbody>
</table>

Source: Korean Ministry of National Unification.
Note: *1998 figures are estimates.

**Composition:** As a general rule, South Korean imports from North Korea have been primary products. North Korean imports from the South have been more diverse, though limited in scope. In 1997 the top imports from North Korea in terms of value were metals (49.7%), textiles (24.7%), marine products (7.5%), and chemical goods (6.5%). During the same period, South Korean exports to North Korea were primarily textiles (34.9%), chemical goods (26.6%), and goods for the Light Water Nuclear Reactor project (15.5%). The textiles exported to North Korea were largely for use in POC trade and are also reflected in textile imports from North Korea. The bulk of the chemical goods exported was heavy fuel oil (286,000 metric tons, valued at $29 million) for the KEDO project as contracted for with South Korean firms. The most significant growth in exports occurred in a category entitled “goods for the Light Water Nuclear Reactor.” This trend continued in 1998 as nearly a third of South Korean exports (over $39 million) were humanitarian assistance, KEDO related materials, and KEDO related heavy fuel oil. Although detailed year-end numbers were not yet available as of the writing of this article, approximately another third of South Korean exports to North Korea were shipments related to the processing on commission (POC) trade. The trade in goods related to the construction of light water nuclear reactors in North Korea by KEDO can be expected to expand dramatically provided the KEDO process remains on track.

**Investment**

With the notable and still nascent example of the Hyundai deals, there has been little meaningful South Korean investment in North Korea since investment was allowed in 1994. What little investment that has occurred to date has mostly been in association with processing commission ventures such as Daewoo’s efforts in Nampo. While greatly improved, the government approval process for investment remains somewhat cumbersome, and separate approval is required for a “cooperation partner” and a “cooperation project.” As of the end of 1998, some 40 South Korean firms had been given “cooperation partner” status, while only 15 had actually been given approval for a “cooperation project.” Even these numbers do not reflect actual investments undertaken, however, as the “cooperation project” approval only denotes South Korean government approval, not successful completion of an investment or even securing a firm agreement with North Korean counterparts.

**Recent Developments**

Considerable attention was given to Hyundai group initiatives in 1998. The success of the Hyundai cruise ship visits to North Korea was called the “first fruits” or the “first son” of the “sunshine policy.” Despite such justifiable attention however, the real fruits of the policy are more clearly seen in the broadening of contacts with North Korea. At the end of 1998, Unification Minister Kang In-duk announced that, even excluding participants in the Hyundai tours, the number of South Korean visitors to North Korea in 1998 exceeded the combined total of all such visitors in the nine years since visits were first allowed.

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6. This does not reflect South Korean contributions to KEDO to purchase heavy fuel oil, but rather South Korean firms contracting to provide and ship oil purchased by KEDO.

Broadening Levels of Contact: The over 2,000 South Korean visitors in 1998 referred to by Minister Kang still represent a small number of people, but a dramatic increase in the number and breadth of contacts between North and South. Perhaps one of the greatest impacts of the Hyundai initiatives has been “re-igniting the North Korea rush” among South Korean firms. As Hyundai moved forward, the other major business groups began to reevaluate their own activities in the North. Despite ongoing efforts to restructure the chaebol, the degree of competitiveness among the groups and the impact a successful Hyundai venture upon its peers should not be underestimated.

In December, the Korea Federation of Small Businesses (KFSB) visited Pyongyang and focused on efforts to transfer idle South Korean production facilities to the North and on steps needed to open outlets for North Korean products in the South. The Federation of Korean Industries, the Small and Medium Industry Promotion Corporation, the Korean Fisheries Cooperative and numerous other organizations, firms, and individuals visited North Korea in 1998 to explore the potential of everything from processing on commission, to agricultural exchange, to over-flight rights.

Hyundai Group Projects: In the wake of the historic meeting between Chung Ju-Young and Kim Jong Il, the Hyundai group’s initiatives in North Korea were described in considerable hyperbole. In addition to heralding the birth of the “first son” of the “sunshine policy,” some claimed that the deal fulfilled the “goals outlined in Article 15 of the inter-Korean basic agreement” thus giving “life” to the inter-Korean accords. The Blue House was more circumspect, calling the meeting “a very significant development.s” While detractors questioned the tight control over South Korean tourists and what appeared to be the unfavorable terms of the deal, there was broad support for the initiative in South Korea.

Through numerous trips to North Korea and symbolic gestures, including the provision of over a thousand head of cattle as a gift (500 head in June and 501 head in late November, plus 20 cars), the Hyundai group was able in 1998 to gain unprecedented access to the North Korean leadership and to negotiate a series of deals that may prove to be a catalyst for future inter-Korean economic ties.

• Tours: In the less than two-month period from the November 18 inception of the ongoing Hyundai cruise ship visits to the Diamond Mountains to the end of the year, over 10,000 South Koreans stood on North Korean soil. The Hyundai agreement with the Asia Pacific Peace Committee obligates Hyundai to pay a per-head “entrance fee” for the tourists it takes into North Korea. For the first two months of the tour, Hyundai transferred some $2.6 million dollars in fees. Presumably such fees provide an ongoing incentive for North Korea to keep the tours operating smoothly.

• Diamond Mountain Development: Although there are still difficulties to be worked out, in mid-January 1999 the South Korean government gave approval for a Hyundai tourism development project that goes far beyond the current cruise ship traffic. The approval allows Hyundai to proceed with its plans to obtain exclusive tourism development rights to the Diamond Mountains for the next 30 years. For this right, they are reportedly obligated to pay the DPRK $942 million over the next six years, through early 2005. As of this writing, the agreement was still pending a formal written guarantee from North Korea’s Asia-Pacific Peace Committee. If successful, Hyundai ultimately plans to develop ski resorts, hot spring resorts, hotels, condominiums, etc.

• Special Economic Zone: Presuming its tourism ventures continue to go well, Hyundai has also reached a tentative agreement with DPRK officials to develop the Haeju District on North Korea’s western coast—just North

of Inchon—as a Special Economic Zone for a period of 10 years. If realized, Hyundai would develop much of the required basic infrastructure at the site and then lease areas in the zone to smaller South Korean and other foreign companies. Hyundai officials claim that 200 small and medium-size business have already applied to lease facilities.9

- **Other Projects:** Though still in the exploratory stage, the Hyundai group is also reported to be discussing with North Korean officials the development of a power plant in Pyongyang, a ship repair yard, and oil exploration off North Korea’s West Coast.

**Forecast: Sunny Weather?**

While the initial success of the Hyundai initiatives has given some cause for optimism, the short range forecast for the Peninsula remains overcast.

**Storm Clouds on the Horizon**

**North Korean Recalcitrance:** The greatest area of uncertainty is the willingness or the capacity of the North Korean regime to respond positively to the “sunshine policy.” How they respond to the “catch 22” of desperately needing South Korean investment, yet fearing South Korean contact will ultimately determine the pace of inter-Korean economic relations. If 1998 is any indication, particularly with the apparent blessing of the Hyundai deal by Kim Jong Il, North Korea appears to be more open than ever to private sector contacts with the South.

However, the Hyundai deals cannot be looked at in isolation. In judging North Korean intent and likely future direction, the continued military tension in the seas off the peninsula, the North Korean missile program, recent scalding rhetoric from the Korean Central News Agency, and growing concerns about a North Korean nuclear program must also be considered.

**Political Opposition in the ROK:** Though the Kim Dae-Jung administration has been relatively successful at separating politics from economics, it has had less success at separating the “sunshine policy” from domestic politics. The first year of the Kim Dae Jung Administration was also marked by repeated clashes between the ruling and opposition parties on issues that spilled over into North Korea policy. Hard-liners have called the “sunshine” policy a “one-sided peace gesture” and “naïve optimism,” have not wasted an opportunity to call for rolling back the separation of politics and economics, and specifically have called for a government response to North Korean provocations that includes curtailing private sector relations.

President Kim has staunchly rejected such calls, even following the failure of fertilizer/family reunion talks in March 1998 and incidents involving a submarine incident in June, a frogman in July, a rocket launch in August, and a semi-submersible craft incident in December. However, it is unclear at what point a perceived North Korean “provocation” would go too far. Furthermore, most analysts agree that strong support for the policy has yet to penetrate deeply into the government bureaucracies and is instead maintained by a small number of ardent supporters at the top.

**External Threats:** The threat to the sunshine policy that has generated the most concern in South Korea has come from what supporters of the policy see as a dangerous “hard line” approach in the United States and Japan. While unprecedented efforts have been made to ensure alliance cohesion, South Korea, the United States and Japan have different priorities on the Peninsula. South Korea’s primary concern is the short-term maintenance of peace and stability to enable the recovery of its economy. Japan’s attention is focused on the North Korean missile program, and the United States’ top priority appears to be the North Korean nuclear program. Such disparities have thrust South Korea into a new role as referee. South Korea played a key role in convincing Japan to resume full support of the Agreed Framework following North Korea’s missile test. South Korea has also made its concern

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over the growing tensions between the United States and North Korea abundantly clear.

**Rays of Hope**

**Market Forces:** The most positive factor driving the growth of inter-Korean economic relations over the long term is likely to be the market forces that have been unleashed by the “sunshine policy.” The Daewoo joint venture in Nampo is now reported to have turned a profit, and the Hyundai deal will possibly pave the way for small and medium-size firms, as well as push rival conglomerates to step up to the competition.

Given geographic proximity, linguistic compatibility, and complementary resource bases, it is easy to see the potential for much greater levels of inter-Korean economic activity. Current levels of interaction pale in the face of such potential, which will likely be slowed by the political challenges of a divided peninsula. However, as political barriers are eased, and presuming the sunshine policy stays on track, inter-Korean trade and investment will continue to expand.

**Economic Recovery in South Korea:** While inter-Korean trade totals were down in 1998, exports to North Korea actually increased, and the number of people and firms involved in the process expanded dramatically. The real decline was in imports from the North, and that was largely attributable to the contraction of imports mirrored in broader South Korean trade. Presuming that the recent bullish prognosis for the South Korean economy is correct, imports from the North should pick up in 1998. This trend will be accelerated by the growing number of South Korean firms seeking to expand their processing on commission activities in the North.

**High-Level Political Commitment:** The current South Korean administration has promoted the “sunshine policy” and the expansion of private sector interaction with the North in the face of daunting opposition. In the short run, it is likely that the same high-level commitment to the policy that will ensure the expansion of inter-Korean economic relations will continue. Though North Korea shows little sign of responding to official South Korean initiatives, Kim Jong Il’s meeting with Chung Ju-Young indicated a willingness at the highest levels in North Korea to move ahead with expanded private sector contacts.

Given the intractable nature of the political and security problems on the peninsula, it appears inevitable that the cold wind will likely blow on North Korea for some time to come. Though the analogy fails here, the North Korean regime is hardly an unsuspecting traveler. In fact, in many cases, the wind is a direct result of North Korean solicitation or provocation. Yet even North Korea recognizes the need for the sun. If sufficient political and diplomatic focus can be brought to bear on North Korea to avoid a conflict or unduly heightened tensions, the sunshine will continue to gradually warm the North Korean traveler. It may be some time, however, before this traveler sheds his cloak.

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The demilitarized zone (DMZ) on the Korean peninsula represents what many experts regard as the world’s most dangerous flashpoint. During a visit to the DMZ a few years ago, U.S. President Bill Clinton was moved to call it “one of the scariest places on earth.” The fragility of Northeast Asian security is underscored by North Korea’s military and technological capabilities and 1.2 million active conscripts, most of whom are massed on the DMZ. North Korea has one of world’s largest armies as well as massive artillery within easy range of Seoul. On August 31, 1998, Pyongyang added to its military threat when it launched a multi-stage Taepodong I missile that can strike any point in the Republic of Korea (ROK) or Japan.

These capabilities make North Korea a serious threat in the eyes of Japan, the ROK, and the United States. China, too, views the DPRK as a key component of Northeast Asian security. As the only immediate regional power with which Pyongyang maintains formal relations, Beijing’s long-standing ties and support for North Korea reflect the importance it places on the stability of the Korean Peninsula. Beijing fully realizes that instability in North Korea would affect the security and prosperity of the entire region.

The broadest initiative to engage North Korea to date began in the spring of 1994, when Pyongyang openly threatened the peace and security of Northeast Asia by announcing its intention to withdraw from the Nuclear Non-proliferation Treaty (NPT). In response to this threat, the United States and its allies began preparations to pursue sanctions against North Korea in the United Nations Security Council, sanctions which Pyongyang explicitly stated it would view as a declaration of war. Washington’s decision to augment its forces on and near the peninsula and to evacuate U.S. civilians indicated that the United States and its allies may have been much closer to war than we believed at the time. After many tense moments between the United States and the DPRK,1 the two parties reached a compromise in the form of the 1994 “Agreed Framework,” under which the Korean Peninsula Energy Development Organization (KEDO) was created.

It is in this context that I would like to share my thoughts about the strategic situation in Northeast Asia and the role that KEDO plays therein.

Recent Developments

In his inaugural address in February 1998, ROK President Kim Dae Jung spoke of “reconciliation, exchanges, cooperation and non-aggression.” He also spoke of the implementation of the 1991 North-South “Joint Declaration on Denuclearizing the Korean Peninsula.” These statements, as well as calls for family contacts, for cultural, economic and communications exchanges, and the decision to lift the ceiling on South Korean investment in North Korea, suggested that a spirit of hope and reconciliation might be in the air. The Hyundai cattle runs and Mount Kumgang tours,2 the resumption of Military Armistice Commission talks at the general officer level, and the initiation of the Four Party Talks3 were further welcome signs of greater openness from both the South and North. President Kim’s calls for separating economics from politics are a marked change from the crisis of 1994.

1. The formal name of North Korea is the Democratic Peoples’ Republic of Korea, abbreviated the DPRK.
2. The large South Korean industrial conglomerate, the Hyundai Corporation, donated many head of cattle to North Korea to alleviate food shortages and undertook a tourism project to transport South Koreans and others to the Diamond Mountains (Kumgangsan) in the southeastern part of North Korea and to develop the area’s tourism potential.
3. The Four-Party Talks (United States, China, South Korea, North Korea) formally opened in Geneva in December 1997.
Events in the latter half of 1998, however, have tested the resolve of President Kim as well as that of the United States and Japan. In August 1998, public reports surfaced of “suspicious underground activity” that could be nuclear in nature 25 miles north of Yongbyon in North Korea. If true, this would be a clear violation of the Agreed Framework. In response to these reports, the U.S. House of Representatives voted to eliminate all U.S. contributions to KEDO from the FY-1999 budget, while the Senate attached severe restrictions. Several members of Congress charged that they had been misled by the Administration. As part of the final budget negotiations, Congress agreed to restore funding, but with stringent conditions requiring clarification of the suspicious underground facilities, the promotion of North-South talks, and progress on missile controls.

On August 31, 1998, just as KEDO was on the verge of finalizing the cost-sharing arrangements for the $4.6 billion light water reactor (LWR) project, North Korea again exacerbated tensions when it fired a three-stage “missile” (later claimed by the North to be a failed satellite launch) over Honshu in northern Japan. Tokyo immediately announced a list of tough measures it was taking to demonstrate its outrage, including the suspension of its role in KEDO’s LWR project. Tokyo lifted its suspension in mid-October 1998, and the cost sharing arrangements were approved on October 22.

In November 1998, on the eve of President Clinton’s visit to Japan and South Korea, U.S. Special Envoy for Peace on the Korean Peninsula Charles Kartman traveled to Pyongyang to negotiate access to the suspicious underground site in Kumchang-ri, but Pyongyang failed to ease the tension it had created. The DPRK, as expected, insisted that the facilities concerned were constructed for civilian purposes and demanded monetary payments in exchange for access, a position the United States had previously rejected as ludicrous. Further negotiations in early December still failed to reach an accommodation.

The North’s recent behavior has endangered the Agreed Framework and has come at a time when the Clinton Administration is receiving heavy criticism for its North Korea policy on many fronts, most notably from Congress. In November 1998, President Clinton appointed former Secretary of Defense William Perry as “North Korea Policy Coordinator,” to undertake a comprehensive review of U.S. policy toward Korea. In 1999, Northeast Asian security issues will likely remain at the forefront of U.S. foreign policy.

**What are the Real Threats We Face?**

Despite this scenario, Northeast Asia is not as dangerous today as it was in 1994. Why is this the case? Because the United States, the Republic of Korea, Japan and the European Union are all engaged with Pyongyang and have a hold, however tenuous, on the nuclear activities at Yongbyon. If clarification of the suspicious underground facilities can be obtained, the Agreed Framework and the work of KEDO will have served as the centerpiece of a changing strategic environment in Northeast Asia.

I will not claim that KEDO alone is responsible for the change from a war footing to the current situation today, but I do believe that the Agreed Framework and KEDO have been an important part of the process which has brought more stability to Northeast Asia than many thought possible in 1994. In its first three years of operation, KEDO has achieved greater success than most observers thought possible and more than many of its current critics will acknowledge. This success has occurred on several levels.

**General Accomplishments**

On the nuclear non-proliferation level, KEDO’s success has ensured the continued freeze of the suspected nuclear facilities at Yongbyon, including the experimental five megawatt reactor and the 50 and 200 megawatt graphite-moderated reactors which were under construction, the spent-fuel reprocessing facility, and other related facilities. Additionally, dangerous spent fuel rods from the five megawatt reactor have been removed and the canning of those rods, after some delay, is to be completed promptly. The DPRK also remains a party to the NPT and has allowed the International Atomic Energy Agency (IAEA) to resume its monitoring activities at Yongbyon. These are hard won and highly significant accomplishments.

KEDO has further served an important diplomatic function. Through its daily work in New York, in negotiations with the DPRK, and at the Kumho site on North Korea’s east coast, KEDO has provided a continuous
and crucial link between Pyongyang and the outside world. In particular, during the occasional flare-ups that have occurred, KEDO has provided a formal and an informal forum for regular contact and interaction with the North.

In addition to being a window onto the world for North Korea, KEDO has provided an opportunity for direct contact between North and South Koreans. Under KEDO’s institutional umbrella, South Koreans at KEDO have directly negotiated agreements with North Koreans. At the negotiating table and in the field at the LWR Project Site in the North, the learning curve from KEDO’s interaction with the North has been steep, and agreement has never been easy. However, KEDO and North Korean negotiators have learned to work with each other and to listen to each other’s concerns.

There has also been considerable interaction between the more than two hundred South and North Korean workers at the site. It has been a remarkable benefit of the project to have workers from the two Koreas, which remain emotionally and technically at war, laughing, sharing cigarettes, and in general learning each from the other for the first time. As the LWR project progresses, eventually thousands of South and North Koreans will work side by side jointly building the two light water reactors. If all goes well, these workers will also eventually build a foundation of understanding and perhaps even confidence.

Finally, KEDO has also provided important political benefits to its founding members. KEDO has become an important feature of the landscape on the Korean peninsula and in Northeast Asia, where it serves as an example of how a cooperative and targeted international diplomatic effort can lead to resolution of regional security or political crises. KEDO has become an important mechanism for coordinating and harmonizing Japanese, South Korean, American, and European interests and policies. This is especially important given the historical tension between Japan and Korea.

**Accomplishments at the Site**

Under the Agreed Framework, KEDO must supply two 1,000 megawatt light water reactors, which do not pose a nuclear proliferation threat, and 500,000 tons of heavy fuel oil (HFO) per year until the completion of the first reactor. In return, the DPRK has agreed to dismantle its suspect nuclear program. In December 1995, KEDO concluded a Supply Agreement with the DPRK that serves as a road map for the LWR project, outlining the project’s scope, terms of repayment, and general terms and conditions under which KEDO and its prime contractor and subcontractors will operate at the site.

Since the Supply Agreement, KEDO has negotiated and signed six additional protocols with the DPRK, which address issues such as KEDO’s juridical status, transportation, communications, takeover of the site, DPRK provision of labor and services, and penalties for non-payment of financial obligations by the DPRK or KEDO. In addition to the Supply Agreement and the protocols, KEDO and the DPRK have also concluded dozens of other agreements on issues such as: medical services; procedures for sea, land and air transportion; and guidelines and principles for contracts to be signed between KEDO, its contractors or subcontractors, and DPRK companies. These protocols and agreements are unprecedented, and have required creative thinking by both sides to resolve sensitive issues.

With respect to actual work on the ground, following conclusion of the necessary protocols and agreements, KEDO officially broke ground for site preparation in August 1997 at our site in Kumho, about half way up North Korea’s east coast. Since then, we have undertaken considerable site preparation at a cost of $48.5 million provided primarily by the South Korean Ex-Im Bank. We have begun to level the mountain where we will construct the reactors. We have further built a small village from nothing, including housing facilities, a medical facility, roads, and water and electricity services. The village also has a karaoke bar or norebang, a soccer field, a branch of a South Korean bank, and a restaurant for North and South Korean workers. It is interesting to point out that North Koreans eat twice as much as South Koreans and 110% on Mondays following the weekend.

As you might suspect, undertaking a project of this magnitude and complexity can be difficult and somewhat surreal. However, it is a testament to the desire of both sides to see this project to fruition that KEDO and the DPRK have been able to work through these events without serious disruption to the project. Political issues which arose early on were resolved and have not been repeated.
Other Components of Engaging the North

KEDO’s mandate is actually quite narrow, but its impact is broad. Our work serves as a first step, the start of a foundation for a new structural relationship that the outside world is attempting to build with North Korea. If all goes well, KEDO can be a vehicle to begin the process whereby Pyongyang might be enticed from its isolation and brought into the broader regional and international community.

Upon this base, the other components of this relationship with Pyongyang can be built. This includes the Four Party talks to end the current state of war and achieve force reductions and military transparency, North-South talks which are crucial to a long-term solution on the Peninsula, and normalization talks with the United States and Japan to resolve issues such as DPRK missiles and humanitarian matters.

It is very clear that at least some key North Koreans understand this bigger picture and attach great importance to the light water reactor project. Even when various components of the structural relationship seem stymied, there has been no diminution of Pyongyang’s enthusiasm for dealing with KEDO on the LWR project. In effect, KEDO is a classic confidence building measure, part of a foundation for Four Party talks, North-South dialogue, and bilateral normalization talks. But, it is not enough to construct only a foundation. All parties concerned, the ROK, Japan, the United States, and the DPRK, must have an architectural design of the new structural relationship they seek, including how to build it and some vision of what ultimately may emerge upon the foundation.

Pyongyang’s Dilemma

We are never certain about developments in North Korea, but recent, seemingly illogical events such as the missile firing, which occurred on the day we were to sign the cost sharing agreement for the LWR and during the middle of U.S. bilateral talks, suggest contradictory internal views in Pyongyang about North Korea’s future.

On the one hand, there are North Koreans who favor KEDO, some opening to the outside world, and some degree of internal economic reform. To my knowledge, this view seems most prominent in the foreign ministry and economic ministries. On the other hand, there appear to be hardliners throughout the power structure, particularly in the military and party, who prefer to sustain North Korea’s more isolationist, self-reliant stance of the past, and to develop nuclear facilities. They may have been encouraged by the Indian and Pakistani nuclear explosions.

The military prominence in the new line-up in Pyongyang, reports of the execution of Kim Jong U, a pro-reform director of the Rajin-Sonbong economic zone, and the reported arrests of seven other pro-reform officials all suggest that hardliners may have gained an upper hand, at least for the moment. I suspect that, whatever their actions, the underlying motivation for all factions remains the quest for survival, both personal and national, laced recently with a need to demonstrate nationalistic pride to welcome the ascension of Kim Jong Il to the highest state position as Chairman of the National Military Commission.4

Economic Normalization

The 1989 collapse of the Soviet Union (including its financial assistance), and China’s 1992 policy decision to normalize ties with South Korea (including ending its preferential commercial treatment of the DPRK) cut North Korea adrift from its financial moorings. Together, Moscow and Beijing had provided the subsidies which sustained North Korea since its founding. The ensuing economic decline in GDP of four percent annually in the late 1980s, increasing to 10–20 percent annually since, has reduced North Korea’s GDP by roughly 70 percent over the past decade. The result has been disastrous. North Korea today is an economy

4. In August 1998, North Korea altered its constitution, declared the late Kim Il-Sung to be “eternal President;” created the National Defense Commission (NDC) as the nation’s highest governmental organ; and named Kim Chong-Il NDC Chairman and the nation’s “supreme leader.”
which has virtually ceased to function industrially and is producing only about half the food needed to survive.

During my visit to North Korea in November 1997, in some 13 hours of travel during daylight by automobile and train, I got a good glimpse of the country from the Eastern seacoast to the West in Pyongyang. There were very few cars, but a huge number of people walking along the roads and paths. The infrastructure was in desperate need of repair. I also saw quite a few factories during my visit, but they did not seem to be operating, and energy was clearly in short supply. As has been reported, I saw some signs of local farmers selling or exchanging their produce.

The International Monetary Fund (IMF) visited North Korea in September 1997 and the World Bank visited North Korea in early February 1998, and they reached similar conclusions. Both are prepared to play roles to the extent that their mandates (and the absence of North Korean membership) allow. But the common judgment is that North Korea cannot recover economically without massive external assistance.

The most important observation I had from my visit was the pragmatism of sophisticated North Korean interlocutors. They understand that KEDO must be part of a broader process that ultimately involves normalization of relations with Washington and Tokyo, reconciliation with Seoul, and access to the IMF, the World Bank and the Asian Development Bank. I also detected an interest in foreign private sector participation in the development of North Korea.

**Implications**

The coming few months are crucial politically, and, to an extent, economically for the North. Pyongyang appears to be contemplating its basic policies. We should do nothing which would undermine the belief in North Korea that its future is better assured by cooperating with KEDO, broader interaction with its neighbors, and internal economic reform. The alternative would return us to the dangers that almost resulted in war in 1994, except this time the danger of war would be exacerbated by greater internal crisis in the North.

It is therefore imperative that the United States, the ROK, Japan, and the EU ensure that KEDO, the centerpiece of current efforts to draw North Korea into the broader community, remain effective and in full operation, even as we collectively try to deal with the most urgent of the new issues—missiles and the suspicious underground activity.

As we address these security matters, we must ask ourselves if we are more likely to sustain our national security interests by dismantling KEDO. To me the answer is obvious. We must maintain KEDO, provided North Korea abides by its commitments to the Agreed Framework. This requires fully funding KEDO’s activities.

Only if KEDO and the Agreed Framework are fully implemented can Pyongyang continue to pursue a more promising route to the future rather than a dangerous road to the past. We should remember that if we scrap the Agreed Framework, the DPRK can reactivates its reprocessing facility, uncan the spent fuel rods, and produce plutonium in a matter of weeks or months.

**Perspectives in the Capitals**

In closing, let me return to the question of reality by looking at what I perceive to be the current perspectives of the ROK, Japan, and the United States in the wake of the missile and suspect underground facilities crisis.

The Kim Dae Jung Administration has made a major investment in a serious attempt to separate economics from politics and to eschew early reunification or the collapse of the DPRK. Seoul’s reaction to a string of provocations, including these latest two, has been patient and visionary. Nonetheless, the political cost has been serious, and the “sunshine policy” has been put at risk by Pyongyang’s failure to reciprocate the constructive policies in Seoul.

In Tokyo, Pyongyang’s obduracy in negotiating important humanitarian issues (such as further visits to Japan by Japanese wives of North Koreans and resolving alleged kidnapping cases) had already hardened attitudes and cost Pyongyang considerable goodwill. The missile launch “broke the camel’s back,” provoking outrage and anger and further creating the perception that the DPRK represents a security threat to Japan. This radical change in perception resulted in
calls for stepped up research on a theater missile defense system (TMD) and on Japan’s own intelligence satellite system. Japan remains seriously concerned over the possibility of further missile tests, as well as clarification of the nature of the “suspicious underground activity.”

In Washington, reports of the suspect facilities and the new threat from the missile launch drastically undercut congressional support for U.S. policy toward North Korea. This, in turn, forced the Administration to resolve the ambiguities of the underground facilities in the near future or sacrifice the Agreed Framework, with all the dire consequences this would entail.

Despite the current domestic difficulties in all three countries, I remain confident that, because of the history they encompass, the Agreed Framework and KEDO remain the most promising and viable mechanisms for dealing with the North Korean nuclear issue. My cautious optimism is based on the firm commitment of the ROK, Japan, the United States, and the EU to KEDO and the opportunity for expanded engagement that KEDO affords. My optimism is also based on the belief that at least some key elements within the DPRK hierarchy recognize that KEDO and the broader benefits it represents are too important for North Korea to jettison.

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The Korea Caravan consists of two principal elements. The key event in each Caravan stop is a speech by the Korean Ambassador to the United States and the U.S. Ambassador to Korea before a group of civic leaders at either a lunch or a dinner function sponsored by a local organization. The other main event is a 2½–3 hour “Doing Business with Korea” panel discussion comprised of Korean and American business and government officials from Seoul and other experts. The Ambassadors also usually speak at a local university and meet with the media at each stop. The overall purpose of the Caravan is to increase understanding of Korea and the importance of the U.S.-Korean relationship among opinion leaders in major metropolitan areas of the United States and to promote trade, investment, and commercial opportunities between the two countries.

The following are the 1999 Caravan stops and the Principal sponsoring organizations in each city.

**April 19th  Seattle, Washington**
World Affairs Council of Seattle  206-682-6986
Trade Development Alliance  206-389-7255

**April 20th  Portland, Oregon**
World Affairs Council of Oregon  503-274-7488
Pacific Northwest Int'l Trade Assoc.  503-471-1399

**April 21st  San Francisco, California**
World Affairs Council of Northern California  415-982-2541
San Francisco Chamber of Commerce  415-392-4520

**April 22nd  Los Angeles, California**
Pacific Council on International Policy  213-740-8118
Los Angeles Area Chamber of Commerce  213-580-7552

**April 22nd  Orange County, California**
World Affairs Council of Orange County  949-363-0735

**April 23rd  San Diego, California**
World Affairs of San Diego  619-543-5100
World Trade Center San Diego  619-615-0868

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