Korea’s Economic Dilemma

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June 1997
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Executive Summary

Korea’s first full year as a member of the Organization of Economic Cooperation and Development, 1997, was supposed to be a banner year for the Korean economy. Instead, the economy got off to a rough start. Korea’s exports during the year’s first quarter were stymied by strikes and depressed semiconductor prices, its current account moved deeper into the red, and two major steel producers filed for bankruptcy protection. Once viewed as Asia’s fiercest tiger, Korea was routinely cited in stories about “struggling” Asian economies.

The timing of Korea’s troubles is unfortunate, coming, as they have, on the heels of the country’s many multilateral and bilateral commitments to improve access for foreign goods, services, and capital. Press accounts from Korea reveal a country that has liberalized only partially and reluctantly, and the country’s current economic ills provide ample ammunition to Koreans arguing against further reform. With the U.S. economy growing rapidly, some U.S. policymakers also might be inclined to give Korea a break on its commitments.

Such a strategy is not in Korea’s best interest. Neither is it in the best interest of Korea’s trading partners.

This paper argues that, despite recent, well publicized Korean economic reforms and OECD membership, Korea’s market is far from open. The government’s
past industrial policies, its plans for the future, and its history of failed reforms suggest that Korean reform efforts will not move forward unless international organizations and Korea’s trading partners nudge the process along.

**Looking at the Numbers**

Korea’s economy has performed spectacularly during the past thirty-five years. From 1962 to 1995, real GDP advanced 8.7 percent per annum and real per-capita GDP grew nearly 7 percent per year. Korean growth has been achieved through high investment and saving rates, low government spending, and vigorous export expansion. Korean investment and saving rates are fifty percent higher than the average for all OECD countries and, in 1996, Korea was the world’s twelfth largest exporter.

Ironically, expectations of rapid growth are etched into the Korean mindset to such an extent that the 7.1 percent economic growth rate in 1996, and the even slower growth expected for 1997, have created a sense of crisis in Seoul.

**The Secret of Korea’s Success**

Korea’s “economic miracle” was not achieved in a policy vacuum; nor was it the result of policies aimed at creating a *laissez faire* economic environment marked by the free flow of goods, services, and investment.

To the contrary, since the early 1960s, the Korean government has practiced industrial policies aimed at developing, guiding, and supporting Korean industrial development. These policies effectively raised Korean public and private saving rates, directed investment capital to producers in favored industries, limited imports in key sectors, promoted exports, and limited the inflow of foreign capital.
In so doing, the government shaped Korea’s economic structure. Thirty-five years ago, primary industries, such as agriculture, accounted for more than one-third of Korea’s economic output. Since then, Korea’s economy has been transformed by waves of development in light, heavy, and high-tech industries. Similarly, Korea went from being an exporter of shoes and shirts to being an exporter of higher-tech products, such as automobiles and semiconductors.

**Legacies of Korean Industrial Policies**

Though Korean industrial policies have served the country well in many ways, and have been tolerated by the international community, they are no longer appropriate for a country as developed as Korea, and they may prove dangerous to Korea’s economic well being.

Korea’s industrial policies have created three problem areas that Korean policymakers must address:

- **the chaebol.** Korea’s mammoth industrial groups, known as chaebol, have come to dominate Korea’s economic landscape. In the process, they have accumulated dangerously high debt levels and a dangerous habit of investing in projects of dubious economic value. The groups are increasingly distrusted in Korea, and their dependence on rapid expansion and rapid sales growth means they are more likely to cut exclusive and trade-distorting deals with developing country governments. Kia Motor’s exclusionary deal in Indonesia is a case in point.

- **the financial system.** Despite liberalization measures negotiated with the OECD, Korea’s financial system remains protected and underdeveloped. Its banks, for decades the main conduit of Seoul’s industrial development plans, have been so weakened by government-directed lending decisions that their long-term solvency is increasingly questioned.

- **past successes.** Many Koreans recognize that past industrial policies are at the root of current economic problems. Yet, thirty-five years of rapid growth, a string of policy successes, and institutional reluctance to embrace free markets suggest that Seoul will have trouble jettisoning its interventionist ways. As long as past policy successes
cloud the thinking of politicians and bureaucrats, policy reversals and contradictions will be commonplace.

**Whither Reform?**

Despite decades of incremental tariff reductions and other promising developments, such as reforms promised during WTO, OECD, and APEC discussions, Korea’s tendency toward protectionism and intervention remains strong. Korea remains a difficult market in which to do business.

Problem areas include:

- **automobile trade.** The automobile sector has been promoted for decades. Korean producers are very competitive and are major foreign investors in developed and developing markets. Nevertheless, Korean tariffs remain high for a major exporter, and its domestic market remains relatively closed to imports. Though bilateral deals with the U.S. government in 1994 and 1995 eliminated several non-tariff barriers, foreign sales in 1996 and early 1997 were disturbingly low. In fact, the Korean auto market is six times less open than Japan’s auto market.

- **the telecom market.** Korea is making a big push to modernize its domestic communications networks. At the same time, Seoul is nurturing domestic producers of telecommunications equipment by encouraging them, through formal and informal means, to purchase equipment from domestic sources. Korean law until recently required that service providers disclose the nationality of their equipment suppliers.

- **anti-import campaign.** When Korea’s trade deficit grew during the late 1980s, foreign products disappeared from shelves and showrooms. Government officials harassed importers and citizens’ groups railed against excessive consumption of luxury goods. This so-called frugality campaign was clearly aimed at reducing imports, and it succeeded. Korea’s trade deficit began rising again in 1996. Even though the imbalance is the result of factors affecting Korean exports, Korea is waging another anti-import campaign. The European Union has threatened to take South Korea to the WTO over the campaign.

- **exchange rate manipulation.** In the mid-to-late 1980s, Seoul clearly manipulated the value of the won to gain a pricing advantage for
Korean exporters. In 1996, the depreciating yen again put pressure on Korea’s exporters, who complained loudly, and often, to the government that they needed a weaker won in order to stay competitive with Japan. Since May of 1996, the won has depreciated fourteen percent versus the dollar.

- **Subsidies.** Subsidies remain a key weapon in Korea’s industrial policy arsenal. Subsidies include below-market interest rates, preferential access to loans, and the government’s unwritten promise to bail out overextended firms. Seoul recently has allowed certain firms to go belly-up, but this does not mean that subsidies are not continuing. Hanbo’s steel mills are still operating, and its capacity expansion continues despite mountains of debt. Korea’s plans to fund high-tech industries and its social overhead capital scheme can also be considered subsidies.

### What Should Be Done?

The preponderance of evidence demonstrates that, if left to its own devices, Seoul will reform only haltingly, and with frequent policy reversals. In order to ensure that reform continues in a healthy direction, the United States should:

- **Let Seoul know that its decisions on reform will color future U.S. trade policies toward Korea.** If Korea chooses to rely on market-distorting industrial policies, the United States should not hesitate to use remedies specified in U.S. law or, when appropriate, take Korea to the WTO.

- **Enforce compliance with prior market-opening promises.** Washington should retaliate if Korea breaks past promises, such as those made in the 1995 auto accord.

- **Seek out allies in third countries.** The U.S. government should ally with other governments that feel Korean policies are breaking WTO rules.

- **Insist on a significant increase in Korean conformity to OECD codes.** The OECD approved Seoul’s membership application despite Korea’s closed capital markets and weak protection of worker rights. Seoul rewarded the OECD with a new labor law that, in some ways, is more restrictive. The United States should encourage the OECD to make clear that it expects Korea to live up to the letter of all the pledges it made to secure OECD membership.
• seek allies in Korea. Many Koreans, in both public and private life, agree that their government should liberalize and deregulate the Korean economy. Liberalization has already led to lower prices, improved choice, and safer buildings and bridges. The U.S. government should build on these and other successes.

• monitor Seoul’s subsidies. Subsidies associated with Korea’s high-tech development programs, and with the arrangement underpinning the “social overhead capital” projects, could distort international trade or cause injury. To ensure they do not, the U.S. government and others should make sure that these programs conform to WTO subsidies guidelines.

Korean liberalization is not just in the best interest of Korea’s trading partners. Koreans themselves would be the ultimate beneficiaries of successful reform efforts. In order to secure the benefits of market opening and deregulation as quickly as possible, and to forestall retaliatory action by Korea’s trading partners, Korea should:

• get serious about reforming the chaebol. Government policy has been far from resolute in dealing with the chaebol. If Seoul is serious about reforming these conglomerates, it should expose them to more foreign competition, hold the course on internal reform measures, and beef up Korea’s Fair Trade Commission.

• establish a reasonable timetable for liberalization. The decision to liberalize aggressively should be made as soon as possible. Seoul should also produce a credible roadmap to guide the reform process, commit to a major reduction of market-distorting subsidies, and ease tariffs in sectors where Korean companies are competitive.

• open its capital markets. Even after Korea implements the liberalization measures it promised the OECD, its financial markets will still be highly regulated. In order to avoid a worsening of the bad-debt problem and to provide more capital to finance-starved small-to-medium-sized businesses, Seoul should liberalize its financial markets further.

• promote inward FDI. Potential foreign investors still perceive Korea’s market to be rigged against outsiders and, thus, expensive to penetrate. Less restrictive policies toward FDI would bolster smaller
Korean firms and force the chaebol to use their financial resources more wisely.

- *take international commitments seriously.* By joining the OECD, Korea has committed itself, in effect, to act like an advanced country in conducting its international economic affairs. Anti-import campaigns, exchange rate management, and frequent policy loans are no longer appropriate.

**Conclusion**

The Korean economy is at the crossroads. If left to its own devices, Seoul seems likely to choose the road of selective liberalization, continued industrial promotion, and protection of key industries. This choice is not in Korea’s long-term interest, nor is it in the interest of the global economy.

With the help of a serious and sustained effort by Korea’s more liberalized trading partners, however, Seoul could still choose the road of market opening and less government intervention. Given the stakes, the world’s major economies would be foolish not to respond to the challenge.
Chapter I: Introduction

While commentary has been lavished on Japan’s economic miracle, the growth experienced by the Republic of Korea from 1962 to 1994 has actually been more rapid than Japan’s growth. Indeed, Korea’s real GNP has tripled in every decade since 1962,\(^1\) making it the fastest-growing Asian GNP of the past three decades.

Particularly significant about this – in terms of Korea’s economic situation and its interaction with the global economy – is the fact that, while Korea is a capitalist country, its growth has not been based primarily on free-market mechanisms. Since the 1960s, Korea’s central government has played a prominent role in the country’s economy. In fact, the World Bank’s groundbreaking study of East Asian economies indicates that, among the Asian countries that have industrialized rapidly, no other government has intervened as heavily as has Seoul.\(^2\)

Yet, as successful as government intervention has been during the past three decades, the Korean model is now showing signs of strain. Labor union demands for pay increases that match productivity gains, the existence of corporate giants (chaebol) so large that they no longer readily comply with the

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government’s wishes, a visibly backward financial system, and efforts by trading partners to open Korean markets are just some of the factors complicating the job of Korea’s economic bureaucracy. As the World Bank study concluded, in 1993, Korea’s industrial policy “is showing its age.” Thus, the pressing question for Korea and its trading partners today is whether it can adopt a new model, and what the consequences may be if it can not.

Conscious that many of their past policies may no longer be appropriate for one of the world’s largest economies, Korea’s elected officials during the 1990s have taken a number of steps that contribute to deregulation of the country’s economy and liberalization of trade in goods, services, and capital. They have privatized some state-owned enterprises; lowered tariffs on several items, including semiconductors; and tried to increase transparency in the financial sector. As a result of this recent liberalization, and of Korea’s economic achievements, they were invited, in October 1996, to join the Organization of Economic Cooperation and Development (OECD), the global club of industrialized nations.

However, despite some noticeable improvements in market access, Korea’s bureaucrats still remain heavily involved in the domestic economy and are resisting major reforms. Pohang Iron and Steel Company (Posco), for example, the government-owned steel conglomerate, is the world’s largest producer of steel and is currently branching out into other industries. Discriminatory tariffs and nontariff barriers in key product categories, such as automobiles and telecommunications equipment, continue to hamper exports from the United States and from other foreign firms. Meanwhile, efforts to reform Korea’s inefficient financial sector are proceeding only slowly, held back by a bureaucracy reluctant to leave the country’s destiny to the whims of market

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4 See, for example, “Backsliding in South Korea,” *Financial Times* (15 October 1995), 19.

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forces. In addition, the Korean government is still conducting industrial policies that put it at odds with Uruguay Round and APEC commitments.

Also disturbing, Korea recently reneged on its OECD commitment to guarantee the right of free association to Korean workers. Seoul’s promise of labor reform was critical to its joining the OECD, and, without the understanding that significant improvements in labor rights would be forthcoming, Korea’s application would have been torpedoed. Yet, the government’s implementing legislation, passed the day after Christmas, at 6:00 A.M., with no opposition lawmakers present, delayed the onset of improved labor rights for three years. Worse, the legislation gave the chaebol what they wanted: the right to lay off workers and to hire replacements during strikes.

At the same time, however, Korea’s policy toward the chaebol\(^3\) – distinct, family-owned-and-managed, corporate groups that dominate particular product lines and industries – can be described as ambivalent. Backbone of the Korean manufacturing and construction industries, the chaebol are major producers of semiconductors, automobiles, petrochemicals, and consumer electronics; and they are increasingly involved in outward foreign direct investment (FDI) to developed and developing countries. The chaebol are a byproduct of the Korean government’s industrial policies, but perhaps, like Frankenstein’s monster, they have become too strong for the government to control. Their dominance of economic activity, as well as their involvement in major scandals with former Korean presidents, have made the chaebol relatively unpopular at home. Their propensity to invest heavily in industries already burdened by excess production capacity have made the chaebol an enigma to foreign companies that

can not help but wonder where the chaebol secure their seemingly endless supply of investment capital.

In light of all these realities, it is of enormous importance – not only to Korea but also to the United States and other countries – that Korea be willing and able to reform its internal and external economic relations in a timely fashion. A Korea that continues down the sometimes difficult path of reform will provide its own citizens with lower prices, increased choice, and increased efficiency. For foreign companies, a more open Korea would mean greater access to the world’s eleventh largest economy. Just as important, U.S. firms would be competing with Korean companies that respond to market forces rather than to the artificial incentives created by government policy makers.

On the other hand, a Korea that retrogresses on its commitments to liberalize and deregulate, and that continues to foster an economic environment conducive to chaebol dominance and to huge investments in excess capacity, risks creating major imbalances in important global industries, and in Korea. As an example, chaebol investments in production capacity for dynamic random-access memory chips (DRAMs) have already led to excess capacity and plummeting prices during 1996. In addition, two major Korean steel producers have already been bankrupted in 1997 by their reckless investment practices. Similar scenarios are possible with other industries in the not-so-distant future, if current trends continue.

During the past two decades, successive U.S. administrations have discovered that opening Korean markets is difficult, and they have had to resort to Section 301, Super 301, Special 301, and even the GATT, in order to secure market-opening in specific areas. There have been some successes. For example, pressure to avoid a Super 301 designation provoked, in 1995, an agreement to improve foreign access to Korea’s automobile market and, in 1989, an agreement.
Reducing discriminatory practices toward U.S. investments in Korea. Special 301 has generated various improvements in Korea’s intellectual-property-rights protection. The Section 301 process was also instrumental in reducing Korean import quotas on beef and in improving foreign access to Korea’s insurance market.⁶

Nevertheless, substantial barriers to freer trade and investment relations remain. Given the layered nature of Korean protection, the violations of existing bilateral accords, and the tendency of other trading powers to rely on U.S. market-opening efforts, continued pressure by Washington is needed to ensure that the reform process moves forward.

Some may criticize the continuation of pressure – in view of the current U.S. trade surplus with Korea – but such criticism is misguided, for three reasons. First, despite its deficit with the United States and other countries, Korea is far from being an open market. Japan (in the 1950s and 1960s) and, most recently, China (in the mid 1980s and 1993) have proven without a shadow of a doubt that it is possible to run trade deficits while keeping domestic markets relatively closed.⁷ Furthermore, now that Korea’s economy has matured, faster growth will inevitably draw more imports and lead to rising deficits.

Second, as the following figure demonstrates, Korea’s deficit with the United States has more to do with declining Korean exports to the United States than it does with liberalized Korean markets. Indeed, U.S. exports to Korea have been in a holding pattern since April 1995.

Exhibit I.1


The third and most important reason why the U.S. government should not shirk the task of market-opening is that Korean trade barriers and industrial policies in certain sectors are preventing competitive firms from exercising their comparative advantage in the Korean market. Ultimately, these lost opportunities are a drag on the growth and the welfare of the United States and the rest of the world, and they undermine support for free trade and the WTO.

The goal of this paper is to provide policy makers with background on the Korean economy, to consider its impact on the United States, and to suggest policies that will promote economic reform in Korea. The paper will trace Korea’s economic performance, as well as the Korean government’s involvement in the domestic economy; examine Korea’s past and current industrial policies; and analyze Korean reform efforts. Also included is a brief case study of Korea’s automotive sector, underscoring both the role of Korea’s industrial policies in the development process and the difficulties facing reform in Korea. Finally, a set of policy options for the U.S. and Korean governments will be proposed.
Chapter II: Korea’s Economic Performance in Perspective

Looking at the Numbers

Korea’s economic performance over the past three decades has been nothing short of spectacular (see exhibit II.1). In terms of sustained, rapid GDP growth, their record stands unmatched: from 1962 to 1995, real GDP advanced 8.7 percent per year, on average, and real per-capita-GDP grew nearly 7 percent per annum. In 1962, Korea’s GDP – in 1990 dollars and prices – was $23 billion, only one-tenth the OECD average. By 1995, the GDP had soared to $364 billion, making Korea one of the world’s largest economies.
Korean growth has been propelled by investment and by exports. Investment, as a share of GDP, has reached extraordinary levels, rising from 12.9 percent in 1962 to 39 percent in 1991. Even in 1995, a banner year for investment in the United States, gross domestic investment totaled only 17.8 percent of GDP, and Japan, during the height of the bubble years, in 1990, achieved only a 32.8 percent investment ratio. As the figure below demonstrates, investment accounts for a much higher share of output in Korea than it does in other industrialized countries as a group.
As for the contribution of exports to Korean growth, merchandise exports grew from 2 percent of GDP in 1962 to a high of 34.7 percent of output in 1987. Imports also rose dramatically, but not as fast as exports. Thus, net merchandise exports increased from a near-crippling, minus 9.7 percent of GDP during the 1962-1966 period to a minus 0.38 percent of GDP during the 1991-1995 period. Given that Korean growth has far outpaced the growth of its major trading partners, this long-term improvement in the trade balance is all the more remarkable.

Back when exports were almost nonexistent and domestic saving rates were extremely low, during the late 1950s and early 1960s, much Korean investment was initially funded by U.S. aid money. During the mid 1960s, however, Seoul began implementing a series of measures aimed at simultaneously increasing both net exports and national savings. The financial reforms announced in 1965 required banks, by then government-owned, to double the interest rates they offered on time deposits. Interest rates went from 15 percent to 30 percent

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virtually overnight. As net exports and domestic saving grew, Korea was able to wean itself from foreign aid.

Although Korea also relied heavily on funds borrowed from abroad, foreign direct investment (FDI), which entails a greater measure of foreign control, remained only a small variable in the country’s growth equation. Like Japan, Korea came to eschew FDI in favor of indirect investment, primarily in the form of foreign bank loans. Consequently, despite near-double-digit growth rates, low labor costs, and a favorable legal climate from 1966 to 1971, inward FDI made up only 7.3 percent of the country’s net foreign borrowing during the period. Subsequently, from the 1970s through the mid 1990s, FDI has continued to be a minor source of growth in Korea, even as the country’s economy has been booming. From 1979 to 1994, for example, Korea’s inward FDI, as a share of domestic investment, averaged only 0.3 percent and, from 1990 to 1994, foreign firms invested four dollars in China for every one dollar they invested in Korea.

While domestic investment, saving, and net exports have been growing, relative to GDP, the flip side has been a significant drop in Korea’s consumption ratio. In 1962, total public and private consumption amounted to 91.9 percent of GDP, but, by 1995, the ratio of government and private consumption to output was only 63.3 percent.

Korea’s economic success, moreover, was accomplished with relatively little government spending. According to the OECD, general government spending

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9 Woo, 101-106.
10 The reliance on loans, as opposed to FDI, had its costs. Korea’s heavy borrowing from abroad during the 1970s and early 1980s led to extremely high debt levels. Thus, by the mid 1980s, Korea’s foreign debt was the world’s fourth largest, amounting to more than 50 percent of GDP. The currency reserves that resulted from Korea’s massive exports enabled the government to maintain its credit worthiness and to pay down its debts ahead of schedule. See World Bank, *East Asian Miracle* (New York: Oxford University Press, 1993), 113-114. For a description of Japanese government policies toward FDI, see Mark Mason, *American Multinationals and Japan* (Cambridge, MA: Council on East Asian Studies, Harvard University, 1992).
expenditures, as a share of output in Korea from 1976 to 1992, were less than half the OECD average.\textsuperscript{12} Meanwhile, Korea has also managed to keep its fiscal house in order: its budget deficit averaged 0.48 percent of GDP from 1990 to 1994.\textsuperscript{13}

Korea’s sound fiscal management has come at a price, however: government investment in public goods has not kept up with the country’s needs. Improvements in transportation infrastructure, power generation capacity, sewerage, water treatment, and other public goods have taken a back seat in Seoul’s drive to promote industrial competitiveness and, therefore, they are underdeveloped. In order to prevent bottlenecks and to enhance quality of life in the future, Korea’s latest five-year plan includes massive increases of government investment in so-called social overhead capital, which likely will raise the share of domestic demand accounted for by central and provincial governments.

In regard to unemployment, Korea’s low numbers stand in stark contrast to the current situation in European Union member countries. Korea has managed to reduce unemployment from 8 percent during the early 1960s to about 2.5 percent during the 1990s (see exhibit II.3). Of course, thirty years of near-double-digit growth would be expected to raise employment levels anywhere. The Korean manufacturing sector was the main engine of job creation, responsible for 36 percent of the increase in non-farm jobs between 1970 and 1990. Within manufacturing, the major gains occurred in the machinery and transport equipment subsector.\textsuperscript{14}

\begin{center}
\textbf{Exhibit II.3}
\textit{Korea’s Inflation and Unemployment, 1963-1995}
\end{center}

\begin{center}
\textbf{Percent}
\end{center}

\textsuperscript{11} Woo, 101.
\textsuperscript{12} \textit{OECD Economic Surveys}, 132.
\textsuperscript{13} However, like Japan, Korea’s fiscal situation may deteriorate quickly if the government is forced to assume the debt of state-owned entities as they are privatized in the coming years, or if it is forced to bail out failed banks.
\textsuperscript{14} Figures on sector employment in Korea were derived from \textit{OECD Economic Surveys}, 77.
Also noteworthy is Korea’s success at reducing inflation, which was flirting with the 30 percent level during the early 1960s. Interest rates on bank loans were raised in 1965, and annual inflation was kept around 15 percent from 1965 to 1974, even as the won was progressively devalued throughout the period to help stimulate exports. The oil crises and the investment boom resulting from the government’s industrial policies during the mid 1970s and early 1980s led to spiraling prices, but inflation has remained under control since 1982 (see figure II.3).

Analyzing the Performance

Due to its sustained growth and solid macroeconomic performance, Korea became the second Asian member of the OECD. The key to its success, however, has been widely debated. Some contend that Korea simply got the fundamentals right. Others argue that government policies generally steered Korea’s economy down the path of prosperity by promoting exports and nurturing the large industrial conglomerates. Still others, believing the government’s incursions into

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the economy to have been little more than counterproductive, declare that the
Korean economy flowered in spite of the government’s attempts to manage it.

At the heart of this debate lies the concept of industrial policy – i.e., the
development, guidance, or supervision of industry – and the issue of whether
such policy was instrumental in the Korean success story. Injecting industrial
policy into any discussion about economic performance always generates
predictably polarized responses, which ultimately focus on whether or not a
given set of policies was economically efficient. That debate, however, is mere
diversion.

Far more interesting, and far more pragmatic as well, is the question of whether
industrial policies in Korea have somehow affected the United States and other
world economies. That is to say, debating the question, “Was Korea’s industrial
policy successful?” is not nearly so important as answering the question, “Did
Korea’s policies, in the process of nurturing the domestic economy, somehow
alter economic outcomes outside Korea?”

Though some economists argue that government trade policy does not
necessarily influence trade patterns, the same cannot be said about Korea. Korea’s trade and other policies most certainly have helped to determine what
Korean companies produce and what they export. The following table, which
lists the top-20 U.S. imports from Korea in 1980 and 1994, dramatically illustrates
the extent to which Korean companies, with Seoul’s help, have been able to alter
the composition of Korean exports.

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16 Definition of “industrial policy” is taken from Chalmers Johnson, Japan: Who Governs? (New
York: W.W. Norton & Company, 1995), 64.
17 Gary R. Saxonhouse, for instance, argues that Japan’s trade policies have had little to do with
the evolution of Japan’s trade patterns. See Gary R. Saxonhouse, “Economic Growth and Trade
Relations: Japanese Performance in Long-Term Perspective,” In Takatoshi Ito and Anne O.
Exhibit II.4
As a Share of Total U.S. Imports from Korea

<table>
<thead>
<tr>
<th>Product Description</th>
<th>1980</th>
<th>Product Description</th>
<th>1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>Radio and tv receiving equipment</td>
<td>9.52%</td>
<td>Electronic components and accessories</td>
<td>21.82%</td>
</tr>
<tr>
<td>Blast furnace, steel works</td>
<td>8.53%</td>
<td>Office, computing, and accounting equip.</td>
<td>12.76%</td>
</tr>
<tr>
<td>Men's or boys' shirts, trouser</td>
<td>8.15%</td>
<td>Motor vehicles and parts</td>
<td>8.44%</td>
</tr>
<tr>
<td>Footwear, rubber or plastic</td>
<td>7.50%</td>
<td>Radio and tv receiving equipment</td>
<td>6.62%</td>
</tr>
<tr>
<td>Electronic components and accessories</td>
<td>6.41%</td>
<td>Men's or boys' shirts, trouser</td>
<td>3.67%</td>
</tr>
<tr>
<td>Footwear, except rubber</td>
<td>6.17%</td>
<td>Blast furnace, steel works</td>
<td>3.25%</td>
</tr>
<tr>
<td>Toys and amusement, sporting,</td>
<td>5.51%</td>
<td>Communication equipment</td>
<td>3.09%</td>
</tr>
<tr>
<td>Outerwear of textile material</td>
<td>4.48%</td>
<td>Outerwear of textile material</td>
<td>2.53%</td>
</tr>
<tr>
<td>Fabricated metal products</td>
<td>4.18%</td>
<td>Women's, girls', and infants' apparel</td>
<td>2.45%</td>
</tr>
<tr>
<td>Women's, girls', and infants' apparel</td>
<td>3.01%</td>
<td>Household appliances</td>
<td>2.33%</td>
</tr>
<tr>
<td>Wearing apparel and accessories</td>
<td>2.97%</td>
<td>Footwear, except rubber</td>
<td>2.09%</td>
</tr>
<tr>
<td>Millwork, plywood, and veneer</td>
<td>2.96%</td>
<td>Electrical machinery, equipment</td>
<td>1.74%</td>
</tr>
<tr>
<td>Men's or boys' suits and coats</td>
<td>2.77%</td>
<td>Wearing apparel and accessories</td>
<td>1.74%</td>
</tr>
<tr>
<td>Tires and inner tubes</td>
<td>2.27%</td>
<td>Silk and manmade fiber broad weave</td>
<td>1.58%</td>
</tr>
<tr>
<td>Costume jewelry, costume novelties</td>
<td>1.52%</td>
<td>Fabricated metal products</td>
<td>1.42%</td>
</tr>
<tr>
<td>Handbags &amp; other personal leather goods</td>
<td>1.51%</td>
<td>Footwear, rubber or plastic</td>
<td>1.26%</td>
</tr>
<tr>
<td>Silk and manmade fiber broad weave</td>
<td>1.49%</td>
<td>Miscellaneous plastics products</td>
<td>1.20%</td>
</tr>
<tr>
<td>Miscellaneous manufactured products</td>
<td>1.33%</td>
<td>Toys and amusement, sporting,</td>
<td>1.20%</td>
</tr>
<tr>
<td>Luggage of leather, textile materials</td>
<td>1.15%</td>
<td>Tires and inner tubes</td>
<td>1.08%</td>
</tr>
<tr>
<td>Fish, fresh, chilled, or frozen</td>
<td>1.07%</td>
<td>Construction, mining &amp; oil-field mach.</td>
<td>1.01%</td>
</tr>
</tbody>
</table>

Source: Foreign Trade Division, Bureau of the Census, U.S. Department of Commerce.

As the table illustrates, textile, apparel, and footwear products in the 1980 top-twenty comprised 36.5 percent of total U.S. imports from Korea. By 1994, the textile-apparel-footwear share had dropped to only 15.3 percent. By contrast, motor vehicles and parts did not even come close to making the top twenty in 1980, when they accounted for a mere 0.22 percent of U.S. imports from Korea, but, by 1994, that figure had jumped to 8.44 percent. Even more remarkable, more than one-fifth of Korea’s 1994 exports to the United States consisted of electronic components and accessories – which includes semiconductors – and more than half of its U.S.-bound exports were in the top five categories.
It is very doubtful that a Korean economy shaped only by Adam Smith’s invisible hand would have generated such export patterns.

Another controversy surrounding Korea’s economy concerns the sources of its growth, as distinguished from its causes. According to one group of theorists, economic growth in Korea, as with other industrial newcomers in Asia, has been almost completely input driven – meaning that increases in levels of employment, investment, and education underlie the Korean economy’s sustained expansion.\(^{18}\) At the other end of the spectrum are economists who argue that increased inputs were augmented by improvements in efficiency, measured as increased output per unit-of-inputs.\(^{19}\)

This debate, though academically interesting, is of little pragmatic use to U.S. policymakers interested in Korea, because Korea’s economic mavens have already recognized that input-driven growth is not the wave of the future, and they have decided to pursue economic efficiency by increasing the level of technological sophistication embodied in the country’s manufacturing industries.

U.S. policymakers will derive much more pragmatic benefit from examining the history of government policies in Korea, the economic entities those policies have spawned, and their effects on the U.S. economy, as well as looking at current reform efforts and their prospects for success. These offer concrete guidance to U.S. policymakers, and it is to these topics this paper now turns.

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\(^{19}\) See, for example, Nam, 153-176. Nam estimates that growth in total factor productivity explains about 40 percent of Korea’s growth from 1963 to 1988.
Chapter III: Korean Industrial Policies – A Primer

It is no secret that Korean industrial policy has played a major role in Korea’s economic development. The government has remained unabashed in its desire to do what it believes necessary to promote Korean industrial development. Mistakes were made, some of which are still being paid for today, and there remains much disagreement among economists and other observers about the efficacy of the government’s involvement in the economy.

There is little debate, however, about whether or not government policies have shaped Korea’s economy. They have. The large conglomerates that dominate Korea’s economic landscape provide ample testimony to the success of determined government policies in altering the economic structure and the economic balance of power within a country and, in so doing, drastically affecting competitiveness among companies in major global industries.

This section provides a brief history of Korea’s industrial policy over the past four decades.
The Early Years: the 1950s through the Second Five-Year Plan

The South Korea emerging from the Korean war was poor and highly dependent on U.S. aid to finance economic growth. Lacking extensive production capacity, postwar Korea experienced high current-account deficits and also high inflation. Although the government had some weak export incentives, these were rendered ineffective by the country’s extensive import-substitution policies. Korean protection raised input prices for potential exporters, thereby pricing Korean exports out of international markets. Consequently, Korea’s economic performance was poor: real GDP grew at a compound annual rate of only 3.7 percent from 1953 to 1962.

In 1962, the government of Park Chung-Hee began inaugurating policies aimed at increasing the country’s exports. Within the next few years, the government devalued the won by more than fifty percent and introduced a broad range of export incentives that provided exporters with preferential tax treatment, preferential loans, and preferential access to imports.

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Korea’s Five-Year Plans

The Korean government has been announcing five-year plans since 1962. These plans have been less comprehensive than were those of the old Soviet Union, and they have often been revised. The formulation and issuance of such plans signal the private sector about the government’s intentions, which have evolved as Korea’s economy has matured. For instance, the sixth plan (1993-1997) called for an increase in resources devoted to the improvement of health care, housing, and welfare. The plans also help to reduce uncertainty, risk, and information costs.

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21 Nam, “Policy in Korea’s Growth,” 154.
23 Nam, “Policy in Korea’s Growth,” 154-155. The preferential tax system exempted tariffs on raw materials and capital equipment used for export production, reduced taxes on export-
Export promotion activities gave Korean exporting firms significant advantages in foreign markets and at home, and the drive to increase exports became the national obsession. Exporters, bankers, shippers, and union representatives met monthly with the president and other key government officials in order to evaluate the previous month’s export activity and to plan for the future. The government padded exporters’ profits by providing access to imports that could be sold on the protected domestic market for high profits, and it conditioned future benefits on each company’s success in meeting or exceeding export targets. The government also lubricated the wheels of export expansion and economic development with low-interest-rate loans.

At the same time Korea’s planners were vigorously supporting the country’s export sector, they were also encouraging the private sector to replace imports with domestic products. Certain infant industries received additional benefits, and tariff and nontariff barriers remained high, especially in sectors where Korea lacked a comparative advantage. Although Korea’s average tariff rate declined somewhat during the late 1960s and early 1970s, tariffs actually rose for a number of high-value-added products, with average tariffs growing in 17 of the 24 major heavy-industry sectors.

related profits, increased depreciation allowances for fixed investments used in exports, and set up reserve funds to cushion export losses. The government also gave exporters access to prohibited imports and allowed them to purchase excess imports that could then be sold for high prices on the domestic market.

24 Weaker-than-expected exports would lead to enhanced efforts from bankers and government officials to see that future targets were met. See Joo Kyung Kim, Sand Dal Shim, and Jul-II Kim, “Industrialization and Human Capital Accumulation in Korea,” in Takatoshi Ito and Anne O. Kreuger, eds., Growth Theories in Light of the East Asian Experience (New York: University of Chicago Press, 1995), 185-186.


Clearly, the trade regime of the 1960s was far from neutral. Korea carried out export promotion in sectors with comparative advantage while protecting noncompetitive ones. Imports also grew rapidly during the late 1960s, but this pattern is normal for countries experiencing rapid growth and is, in part, due to the structure of Korea’s incentives.  

By any measure, Korea’s export promotion policies were successful. From 1964 to 1971, light-industry exports grew at a compound annual rate of 46 percent, while the rest of Korea’s exports grew at a 24-percent clip. By 1971, light-industry exports comprised two-thirds of Korea’s total exports, up from 45 percent in 1964. Total exports, as a share of GDP, had increased by a factor of three, and Korea’s foreign-exchange holdings by a factor of four.

By the late 1960s, it had become increasingly clear to policymakers that continuing rapid growth was impossible if they remained focused on light industry. If Korea was to become rich, it needed to produce more than shoes and shirts. Thus, the Korean government made a conscious decision to pursue policies aimed at transforming its economy from one based on light industries to one based on higher-value-added, heavy industries, such as steel and petrochemicals. As part of Seoul’s second five-year plan (1968-1972), these industries were designated strategic industries and targeted for expansion. The government began work on the Pohang Integrated Steel Mill and the Wulsan Petrochemical Complex at that time and enacted many of the industry-promotion laws that formed the bedrock of the industrialization drive during the mid and late 1970s.  

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27 The rise in imports occurred because Korea promoted gross, not net, imports, which gave companies an incentive to import semi-finished products. See Noland, Pacific Developing Countries, 41.

Promoting the Heavy and Chemical Industries

In 1973, Korea embarked on a far reaching drive to remake its economy when it announced its intention to promote heavy and chemical industries (HCI) even more than it had done in the past. The government not only promoted HCI sectors with selective protection, subsidized credit, and entry restrictions, but also became directly involved in industrial decision making. Their goal was straightforward: to promote the competitiveness of strategic industries by raising the size of domestic factories to international levels.

Since Korea’s market was not large enough to absorb the output of these factories, this strategy also required vigorous export promotion. Therefore, to augment the policies begun in the 1960s, the government facilitated the creation of general trading companies. Unlike their Japanese counterparts, which dominated both exporting and importing, these companies focused almost exclusively on exports and soon came to control the majority of Korean export activities.

The government also redoubled its efforts to secure capital and to distribute it to favored industries. Financial authorities set financial prices low at government-owned banks in order to subsidize HCI and export industries. In 1973, the government established the National Investment Fund, a system that helped the government finance HCI-related investment in plants and equipment. The government also lent money directly out of its own budget. The financial mavens took measures to increase domestic savings further, and when the general government’s budget moved into the black, it became a major

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29 HCI sectors include steel, petrochemicals, machinery, electronics, metals, and shipbuilding.
31 Noland, Pacific Developing Countries, 41-42. In 1985, trading companies were responsible for 51.3 percent of total exports.
contributor. In 1979, for example, government savings contributed nearly seven percent to Korea’s domestic saving rate.32

Consequently, Korea’s saving rate continued to expand during the 1970s (see exhibit III.1), but it was still too low to finance domestic investment. Hence, Seoul was forced to tap foreign sources of capital. To compensate for Korean firms’ lack of creditworthiness, the government guaranteed all foreign lenders that they would be repaid.33

Exhibit III.1
Korea’s Saving Rate, 1962-1972
Percent

![Graph showing Korea’s saving rate from 1962 to 1979.]

Bank of Korea data, in Lee, Appendix 6

By the close of the 1970s, therefore, Korea had succeeded in remaking its economy (see exhibit III.2). Whereas HCI industries accounted for 11.9 percent of economic output and 12.8 percent of exports in 1970, they accounted for 26.3 percent of output and 38.3 percent of exports by 1980. The ratio of imports to total supply for HCI products declined from 36.9 percent in 1970 to 23.7 percent in 1980.34

Exhibit III.2
Light and Heavy Industry Exports, as a Share of GDP, 1964-1985

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32 Woo, Race to the Swift, 161.
There were some rough patches during the late 1970s that led many analysts to condemn the whole exercise as a failure. In particular, the HCI drive resulted in relatively high levels of excess capacity in several industries.\(^{35}\) Further, Seoul’s decision to rely on indirect financing, in the form of both foreign loans and policy loans, led to high levels of corporate and national debt, and inflation. As will be discussed later, the drive to invest also burdened the country’s banks with bad loans.

Despite these problems, the HCI drive is now viewed more favorably than it was in the early 1980s, when its costs were more visible and its future benefits unknown. In the view of the World Bank, most distortions spawned by the government’s industrial policy were eventually reversed.\(^{36}\) Moreover, the HCI drive did create competitive industries, radically alter the composition of the Korean economy, and dramatically increase exports of higher-value-added products. In fact, some of the sectors that the government supported during the 1970s became major Korean exports in the 1980s and 1990s, so that one could

\(^{35}\) Nam, “Policy in Korea’s Growth,” 162. In 1989, for instance, capacity utilization was 82 percent for manufacturing as a whole, but only 35 percent for transportation, 60 percent for machinery, and 69 percent for electrical appliances.

\(^{36}\) Kim and Leipziger, Lessons of East Asia – Korea, 25. In 1987, a World Bank’s assessment of the HCI drive concluded that “it is difficult to demonstrate that an alternative policy would have worked better.”
argue that the HCI drive set the table for Korea’s economic successes in the 1980s and early 1990s.

As demonstrated by exhibit III.3 below, which shows U.S. HCI imports from Korea, not all of the promoted sectors became export juggernauts. Nevertheless, the success of exporters from the electronics, machinery and, to a lesser extent, the transportation sectors was critical to continuing Korea’s export-driven growth during the 1980s and early 1990s. That success is even more significant in light of the fact that the phenomenal growth of China as an export competitor since the late 1980s has limited Korea’s light-industry exports, so that U.S. imports of non-HCI products from Korea actually declined 35 percent between 1988 and 1994. Clearly, without the rapid development of these new exporting industries, the Korean economy would have seen its export markets wither.
The HCI Drive Ends and Liberalization Begins

By the late 1970s, it became clear that the HCI drive could not last forever. Wage hikes, high levels of foreign debt, the second oil crisis, inflation, problems in nontargeted industries, and the bad publicity resulting from HCI failures convinced the government that the policy had outlived its usefulness.

Consequently, during the 1980s, the government moderated and even dismantled many industry-specific HCI policies in favor of more functional policies aimed at promoting activities rather than industries. In the early 1980s, Seoul focused on eliminating the overlap of investments in HCI industries, bailing out insolvent companies, reducing policy loans, and eliminating the fiscal and other incentives available to HCI projects. The government also took some small steps toward liberalizing imports and finance, including the Fair Trade Act of 1981 and a five-year tariff-reduction plan that began in 1984.37 Finally, in the mid 1980s, Seoul consolidated the HCI-enabling legislation into a new, more market-friendly Industrial Development Law.

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The government’s reforms in the early and mid 1980s, however, were not driven by a sea change in Korean government attitudes toward intervention. To the contrary, Seoul – preferring not to leave restructuring to the market – became an active participant in decisions concerning mergers, refinancing, capacity reductions, and market entry.\textsuperscript{38} In all, seventy-eight corporations were rationalized between 1985 and 1988.\textsuperscript{39} The government also remained an integral part of Korean finance. The share of policy loans in total domestic credit averaged a high 35 percent from 1982 to 1988.

Moreover, by 1988, tariff and nontariff barriers remained substantial. Tariffs averaged 18.1 percent for all products, 16.9 percent for manufactured goods, and 25.2 percent for agricultural products. Nontariff barriers included officially sanctioned import diversification, import surveillance, and various industry-specific laws, as well as time-consuming and expensive procedures for clearing customs.\textsuperscript{40}

Further, it should be remembered that liberalization was also driven by outside forces. U.S. pressure, a reaction to the burgeoning U.S. trade deficit with Korea, was instrumental in bringing about Korean tariff reductions.\textsuperscript{41}

Liberalization of formal trade barriers has continued, unevenly, during the 1990s, and Korea is more open today, on average, than it was during the previous three decades. Korea made substantial tariff concessions in the Uruguay Round and, as part of the APEC forum talks, has committed to further liberalization with other Pacific Rim economies. The seventh five-year plan

\textsuperscript{38} Kim and Liepzig, Lessons of East Asia – Korea, 23-24.  
\textsuperscript{40} Realigning Korea’s National Priorities for Economic Advance, (Seoul, South Korea: Presidential Commission on Economic Restructuring, 1988), 28-29.  
\textsuperscript{41} Noland, Pacific Developing Countries, 45.
(1992-1996) called for increased foreign access to markets for services and agriculture, as well as increased foreign participation in domestic financial and capital markets.\textsuperscript{42}

Though positive, these reforms leave a glass that is only half full. Korea’s WTO concessions still leave it with higher average tariffs than many of its major trading partners, and its APEC commitments provide an excuse to delay, rather than to accelerate, the liberalization process. The reforms made to date have not produced a market in which foreign companies can freely do business, or to which they can freely export. As in Japan, lower tariffs have not generally translated into greater openness.

More telling is Seoul’s insistence on remaining an integral part of Korea’s economic fabric. The government may be shifting the focus of its industrial policy, but it is certainly not planning to abandon the role it played in shaping its domestic economy. This is truly unfortunate, because the legacy of its past industrial policies weighs heavily on present reform efforts, and could easily doom them to failure.

\textsuperscript{42} Kuznets, \textit{Korean Economic Development}, 100.
Chapter IV: Legacies of Korean Industrial Policies

The very visible hands of state planners clearly have molded Korea’s industrial structure and generated rapid growth by fostering high investment levels and by promoting exports.

Despite this success, there is a growing consensus in Korea, and elsewhere, that its economy would benefit from internal deregulation and a more liberal trade and investment regime. The concentration of economic power, as well as the bad-debt loads accumulated by domestic banks and the high debt-levels of the chaebol, threaten to cause problems similar to those currently plaguing Japan. The government’s initial efforts to encourage reform have been hindered, however, by the legacies of the industrial policies, which are proving difficult to overcome. In addition, the market-oriented reforms needed to address these issues become snagged in a web of vested interests – i.e., few bureaucrats relish the prospect of relinquishing the powers and benefits that accrue with regulation.

All of this suggests that guidance and pressure from the United States and other countries could help relieve the logjam that is blocking substantial reform in Korea. Given the importance of Korea to the global economy, and the economic damage that could result from a sudden reversal of reform, the stakes are high for the United States, and other countries as well. In addition, the potential
benefits of Korean liberalization would be more than just purely economic. The occasional waves of U.S.-bound Korean exports, in sectors where U.S. access to Korean markets is limited, cause trade friction and cast a shadow over the bilateral relationship. That issue, too, sorely needs to be acknowledged and addressed.

**The Chaebol: Domestic Dominance and Global Expansion**

The chaebol are a natural byproduct of the industrial policies carried out during the 1950s, 1960s, and 1970s. Most of today’s top chaebol can trace their beginnings to the late 1940s and 1950s. Many of them made money from Korea’s import-substitution policies, but it was the implementation of export-promotion policies in the 1960s, the HCI drive during the 1970s, and the creation of general trading companies in 1975 that solidified the chaebol’s preeminent position in the Korean economy.

Today, the chaebol are large, broadly diversified, and vertically integrated conglomerates that dominate Korea’s economic landscape. Typically, each chaebol’s affiliates produce goods and services across an array of sectors, to such an extent that even America’s most widely diversified corporations seem focused by comparison. In terms of product coverage, for example, Samsung – founded as a trading company in 1938 – is ADM, Weyerhauser, Trammel Crow, Macy’s, *The Washington Post*, Chrysler, Boeing, AIG and Salomon Brothers rolled into one. In addition to those core industries, Samsung is also a player in sugar manufacturing, the pulp and textile industries, engineering and construction,

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43 Fields, 30-35; and Soon, 63.
44 In 1992, there were seventy-eight such conglomerates classified as chaebol. Since April 1993, only the top thirty of these groups are considered chaebols. See *OECD Economic Surveys, 1993-1994 – Korea*, 59 and 171.

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retail, hotels, and newspapers. It will soon be manufacturing automobiles as well.45

**Exhibit IV.1**

_Samsung and Hyundai at a Glance, as of Year-End 1994._

<table>
<thead>
<tr>
<th></th>
<th>Samsung</th>
<th>Hyundai</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rank</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Domestic subsidiaries</td>
<td>50</td>
<td>47</td>
</tr>
<tr>
<td>Incorporated foreign affiliates</td>
<td>97</td>
<td>56</td>
</tr>
<tr>
<td>Sales (billions of dollars)</td>
<td>64.9</td>
<td>64.9</td>
</tr>
<tr>
<td>Exports (billions of dollars)</td>
<td>14</td>
<td>12</td>
</tr>
<tr>
<td>Core sectors:</td>
<td>Electronics</td>
<td>Heavy machinery</td>
</tr>
<tr>
<td></td>
<td>Machinery</td>
<td>Automobiles</td>
</tr>
<tr>
<td></td>
<td>Chemicals</td>
<td>Electronics</td>
</tr>
<tr>
<td></td>
<td>Aerospace</td>
<td>Chemicals</td>
</tr>
<tr>
<td></td>
<td>Finance</td>
<td>Steel</td>
</tr>
<tr>
<td></td>
<td>Insurance</td>
<td>Construction</td>
</tr>
</tbody>
</table>

_Source: “South Korea’s Chaebol,” _Portland Oregonian_ (July 2, 1995), F1.

Unlike the ties binding together corporate entities in the United States, the ties binding chaebol affiliates to each other are usually financial and economic, not legal; yet, each chaebol’s owner maintains a secretariat, or planning office, responsible for setting and implementing conglomerate-wide policies. Although affiliates within each chaebol can legally make decisions on their own, final decision-making authority has historically rested with the conglomerate owner. Affiliates are usually run by family members or by people having close personal relations with the owner.46

The chaebol’s formidable role in the Korean economy can not be overemphasized. The larger chaebol consist of dozens of subsidiaries in both service-producing and goods-producing industries. Sales of the top four chaebol (Samsung, Hyundai, LG, and Daewoo, as of 1995) amount to 84 percent of

45 National Trade Data Bank, Market Research Reports, IT Market 960911.116.
Korea’s GDP. These four conglomerates were also responsible for 60 percent of Korean exports in 1995.47

Government policies not only enriched the chaebol, but they also created an environment that facilitated corporate risk taking. Seoul was a de facto risk partner in all strategic enterprises that it supported, thereby encouraging entrepreneurs to take risks. The government shared risk by guaranteeing foreign debt, by setting interest rates for pet projects below market-determined interest rates, and by providing debt relief, or finding buyers, for companies in distress. In 1972, prompted by a sharp rise in foreign debt service, the government even declared a moratorium on, and then restructured, corporate debt owed to curb-market lenders.48 More recently, in 1989, Seoul bailed out Daewoo when its shipbuilding losses threatened it with bankruptcy.49

This seemingly ironclad government commitment to the chaebol’s success led the chaebol, of course, to put long-term results ahead of short-term profits. The implicit guarantee encouraged them to venture into new industries, to invest in domestic production facilities at capacity levels that, given the size of Korea’s domestic market, were virtually unheard of in the United States, and to carry debt loads much greater than those typically carried by U.S. firms. From 1963 to 1971, the average debt-to-equity ratio of the Korean manufacturing sector skyrocketed from 92 percent to 394 percent.50 By 1985, Korea’s corporate-debt ratio was still 350 percent, two-and-a-half times the prevailing levels in the United States.

Gradually, over a number of years, the chaebol’s vast wealth and ubiquity have become more and more a source of public discontent in Korea. In addition to the

48 Kim, Shim, and Kim, 191-193; Soon, 62-63; and Fields, 52.
scandal surrounding chaebol donations to presidential slush funds, there is a feeling that the chaebol’s riches have come at the expense of other economic players. For instance, government policies that favored the chaebol during the HCI drive, by extension, discriminated against the country’s small-to-medium-sized enterprises (SMEs). Though the government has often championed the interests of SMEs, actual practice over the decades gave chaebol the best access to human and financial resources.\(^{51}\) Whereas the chaebol had easy access to bank loans, for example, SMEs were often forced to borrow from the informal market, where interest rates were two-to-three times higher. In an effort to compensate, the government for years has subsidized and set aside certain industries for small business, but these have become woefully inefficient.

Ironically, whenever an innovative smaller enterprise does introduce some new and profitable product or service, the highly leveraged chaebol quickly establish similar companies that can compete without regard for profit. Thus, Korean government policy has left the country with an endemically weak SME sector.

The stunting of its SMEs partly explains how a relatively closed market like Korea’s manages to run trade deficits. Absent strong intermediate industries to supply them, the chaebol, unlike the keiretsu in Japan, are forced to rely on foreign suppliers for key components and machinery – a situation that current industrial policy is geared to correct. Thus, while the chaebol’s share of domestic sales is high, their share of value added and employment is relatively low, and the more the chaebol sell, the more Korea’s trade deficit grows.\(^{52}\)

The chaebol’s formidable competitiveness is driven, in large part, by their ability to invest without regard for short-term profits. Like their Japanese counterparts

\(^{50}\) Kim, Shim, and Kim, 192.
\(^{51}\) Soon, 64-65.
of an earlier era, Korean firms do not seem to be constrained by shareholder demands for higher dividends and profitability. As in Japan, also, a significant portion of company shares are in friendly hands (see exhibit IV.2). Thus, chaebol manufacturers can sell at a loss for prolonged periods of time in order to secure market share.

52 For instance, larger firms in 1993 accounted for 49.7 percent of value added in manufacturing and only 31.1 percent of employment. See “Korea’s Faceless Small and Medium Companies,” Korea Trade & Investment (March-April 1996), 27.
Exhibit IV.2  
Example of Chaebol Ties to Their Major Affiliates.

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Affiliated Firms</th>
<th>Ownership Share</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Hyundai Heavy Industries of Hyundai Group</strong></td>
<td>Hyundai Mipo Dockyard</td>
<td>49.00%</td>
</tr>
<tr>
<td></td>
<td>Inchon Iron &amp; Steel</td>
<td>41.79%</td>
</tr>
<tr>
<td></td>
<td>Hyundai Motors</td>
<td>13.98%</td>
</tr>
<tr>
<td></td>
<td>Hyundai Wood Industries</td>
<td>12.68%</td>
</tr>
<tr>
<td></td>
<td>Hyundai Precision &amp; Industry</td>
<td>12.13%</td>
</tr>
<tr>
<td></td>
<td>Hyundai International Merchant Bank</td>
<td>10.54%</td>
</tr>
<tr>
<td></td>
<td>Hyundai Marine &amp; Fire Insurance</td>
<td>9.52%</td>
</tr>
<tr>
<td></td>
<td>Hyundai Corp.</td>
<td>6.57%</td>
</tr>
<tr>
<td></td>
<td>Hyundai Securities</td>
<td>3.11%</td>
</tr>
<tr>
<td><strong>Samsung Group</strong></td>
<td>Samsung Securities (through Samsung Life Insurance)</td>
<td>10.00%</td>
</tr>
<tr>
<td></td>
<td>Samsung Fine Chemicals</td>
<td>9.93%</td>
</tr>
<tr>
<td></td>
<td>Samsung Fire &amp; Marine</td>
<td>9.84%</td>
</tr>
<tr>
<td></td>
<td>Samsung Electronics</td>
<td>8.49%</td>
</tr>
<tr>
<td></td>
<td>Samsung Aerospace Industries</td>
<td>7.61%</td>
</tr>
<tr>
<td></td>
<td>Hotel Shilla</td>
<td>6.95%</td>
</tr>
<tr>
<td></td>
<td>Samsung Corporation</td>
<td>6.07%</td>
</tr>
<tr>
<td></td>
<td>Samsung Display Devices</td>
<td>6.01%</td>
</tr>
<tr>
<td><strong>LG Chemicals of LG Group</strong></td>
<td>LG Construction</td>
<td>11.27%</td>
</tr>
<tr>
<td></td>
<td>LG Metals</td>
<td>9.41%</td>
</tr>
<tr>
<td></td>
<td>LG Merchant Banking</td>
<td>9.01%</td>
</tr>
<tr>
<td></td>
<td>LG Electronics</td>
<td>7.05%</td>
</tr>
<tr>
<td></td>
<td>LG Securities</td>
<td>6.15%</td>
</tr>
<tr>
<td></td>
<td>LG Cable &amp; Machinery</td>
<td>0.53%</td>
</tr>
<tr>
<td><strong>Daewoo Electronics of Daewoo Group</strong></td>
<td>Daewoo Telecommunications</td>
<td>5.65%</td>
</tr>
<tr>
<td></td>
<td>Daewoo Heavy Industries</td>
<td>5.30%</td>
</tr>
<tr>
<td></td>
<td>Keang Nam Enterprise</td>
<td>5.13%</td>
</tr>
<tr>
<td></td>
<td>Daewoo Securities</td>
<td>3.98%</td>
</tr>
<tr>
<td><strong>Ssangyong Cement Co. of Ssangyong Group</strong></td>
<td>Ssangyong Heavy Industry</td>
<td>35.10%</td>
</tr>
<tr>
<td></td>
<td>Ssangyong Paper</td>
<td>33.86%</td>
</tr>
<tr>
<td></td>
<td>Ssangyong Oil Refining</td>
<td>28.41%</td>
</tr>
</tbody>
</table>


The chaebol’s long-term focus also perseveres, and is sustained in large measure, because they enjoy an increasing control over the financial sector. Since the government divested itself of the banking sector in the early 1980s, the chaebol
have acquired large shares of major banks through the shareholdings of related companies. In addition, the chaebol moved quickly to gain ownership of new sources of capital. Through shareholding and through interlocking directorates, the chaebol control about three-fourths of the investment and finance companies, which charge somewhat higher rates than do the banks, but lower rates than those found on the curb market. Korea’s conglomerates also dominate insurance funds and receive funds from them in the form of equity investments and loans. In 1990 alone, Samsung Life is said to have loaned related firms $800 million.\(^{53}\)

Technique is at least as important as ownership when it comes to the chaebol. Besides securing funds from companies they own, group members also use cross-guarantees of loans and so-called ping-pong equity investments – that is, increasing capitalization via simultaneous cross-investment between two member firms.\(^{54}\) These financing tools are especially important when member companies are performing poorly. Rather than disinvesting from unprofitable ventures, or restructuring, firms that have fallen on hard times can secure funds directly from a healthy relative or acquire a bank loan with the help of the healthy firm’s guarantee. A loss-making firm can even use the credit rating of the group’s healthiest member to apply for loans overseas.

Though the existence of these financing techniques is rarely publicized, and occasionally denied, the cat is now clearly out of the bag. According to one estimate in *Business Korea*, the country’s top thirty chaebol held $66 billion in cross-guarantees at the end of 1988.\(^{55}\) More recently, reports have surfaced that Samsung Motor Company’s ambitious investment plans have been jeopardized

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\(^{53}\) Fields, 111-116.
\(^{54}\) Fields, 124-127.
\(^{55}\) Fields, 125.
by the current slump in DRAM prices, which helped knock down Samsung Electronics’ 1996 profits more than ninety percent.\textsuperscript{56}

Recognizing that the chaebol’s techniques promote excessive debt and asset overvaluation, Korea’s Fair Trade Commission recommended in May of 1996 that the government force the conglomerates to eliminate their cross guarantees by the year 2001. \textsuperscript{59} The FTC’s ability to curtail chaebol excesses, however, is by no means assured.

The chaebol have taken their act on the road in recent years, by investing in overseas markets (see exhibit IV.3). Their sudden interest in foreign direct investment is driven by a number of factors. First, with global markets becoming increasingly competitive, Korean companies are finding it necessary to locate closer to the end-users of their products. This has led to higher Korean FDI in advanced countries, as well as in the so-called big emerging markets.

\textbf{Korea’s Fair Trade Commission}
\begin{quote}
Whereas the U.S. Federal Trade Commission has historically focused on protecting consumers and enforcing domestic antitrust legislation, the similarly named Korean Fair Trade Commission has played a far different role. It exercises oversight of Korea’s web of government sanctioned cartels, the groups of suppliers permitted by government ministries, via special legislation, to regulate price or output for their mutual benefit.\textsuperscript{57} For instance, Korea’s Ministry of Finance and Economy supports fifteen cartels and the Ministry of Trade, Industry, and Energy supports eleven. President Kim elevated the FTC to cabinet status in 1996, but the agency has been hampered by scandal and by chaebol opposition.\textsuperscript{58}
\end{quote}


\textsuperscript{57} “FTC to Overhaul Cartel Practices,” \textit{The Korea Herald} (19 March 1997).

\textsuperscript{58} See, for example, “Bribery Charges Tarnish FTC Image as ‘Economic Police,’” \textit{The Korea Herald} (18 April 1996), and Zeno Park, “South Korea’s New Industrial Policy Meets Opposition, Skepticism,” \textit{Agence France-Presse} (15 May 1996).
Second, in the past, Korean producers of consumer electronics, and even autos, were always able to gain global market share at Japan’s expense whenever the rising yen raised the prices of Japanese exports. Now, however, Japanese firms have transferred substantial production capacity abroad, particularly to low-wage countries in Southeast Asia, and, therefore, are largely protected from currency fluctuations. No longer benefiting from the competitive advantages previously conferred by relatively low wages and the rising yen, Korean companies have begun following Japanese companies abroad.

Third, the revolution in information-and-computer technology has left Korean companies feeling vulnerable. Historically, Korean companies have spent less on R&D than have their counterparts in the United States, Europe, and Japan. With product cycles shortening and the value of innovation rising, Korean firms realize that the nature of competition is changing, and that their competitive

edge – low-cost, mass production of high quality goods – is less important than it used to be. As part of their strategy to remain on the technological forefront, the chaebol are purchasing foreign high-tech firms, such as Zenith and AST Research.

Finally, the chaebol are hoping to counter the impact of a completely open Korean market. Accustomed to steady revenue growth driven by rising overseas sales and a protected home market, Korean companies have counted for decades on protected home markets to subsidize incursions into foreign markets. As a result of the increasing pressure on Korea to remove tariff and nontariff barriers to trade, Korean companies will eventually face greater competition and, thus, lower profits in their home market. In order to compensate, they are establishing factories in emerging markets and in the so-called transition economies, and making other investments they hope will provide stable sources of revenue.

In view of the chaebol’s extreme diversification, dominant position in the domestic economy, high debt burdens, and sudden infatuation with FDI, the Korean government now finds itself in an unusual, and difficult, position. The policies so desperately needed to reform the domestic economy and to conform with international free-market norms would put at risk the competitive position of the country’s preeminent players. This fundamental obstacle explains, in large part, why Korea’s financial system remains so underdeveloped and why the economic reform process in Korea seems so schizophrenic.

For example, Seoul has occasionally proposed measures to limit the cross-guaranteeing of loans among chaebol members. Such a policy would limit chaebol access to investment capital, thereby decreasing diversification and debt while also protecting small, entrepreneurial firms from predatory chaebol competition. The downside, however, is that the chaebol would be hampered in


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their ability to conduct R&D and to invest in plants and equipment. It is no wonder that the chaebol have routinely ignored these government initiatives, and that government enforcement has been weak.

**The Financial System: Opening, but Dangerously Weak**

One of the most potent tools for shaping the process of economic development is a country’s financial system. Government control of the flow of money – or, more broadly, the flow of credit – can have a major impact on economic activity and economic structure. In the United States and other industrialized countries, for example, the flow of money is used to smooth short-term fluctuations in the business cycle but, in Korea, the government has used credit to determine the long-term structural development of their economy.

Korean authorities realized very early the power conferred by financial control. In 1961, the government of Park Chung-Hee took over the country’s banks, which had been owned by the country’s fledgling industrialists, and the government quickly discovered that ownership of the banks greatly facilitated its export promotion activities. To encourage exports, the government instructed banks to set interest rates on export-related loans below the rates for other types of commercial loans. Consequently, from 1962 to 1970, banks charged interest rates of 8.3 percent, on average, for export-related borrowing, 13.2 percent lower than bank rates available to other borrowers. Rates on the informal curb market, which tend to reflect the true cost of credit, averaged a whopping 55.75 percent during the same period.⁶⁰

During the HCI drive, the government also began providing other types of so-called policy loans, which likewise carried low interest rates. In fact, the real
interest rates for export and other policy loans were often negative, because they were almost always lower than the inflation rate (see exhibit IV.4). Moreover, the government helped companies borrow abroad at rates even lower than those available at home. With incentives like that, it is no wonder that the chaebol did the government’s bidding.

**Exhibit IV.4**  
**General and Policy Loans (Percent) in Korea, 1973-1979.**

<table>
<thead>
<tr>
<th></th>
<th>General Loans</th>
<th>Export Loans</th>
<th>Machinery Promotion Fund</th>
<th>National Investment Fund</th>
<th>GNP Deflator</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td>15.5</td>
<td>7.0</td>
<td>10.0</td>
<td></td>
<td>12.1</td>
</tr>
<tr>
<td>1974</td>
<td>15.5</td>
<td>9.0</td>
<td>12.0</td>
<td>12.0</td>
<td>30.4</td>
</tr>
<tr>
<td>1975</td>
<td>15.5</td>
<td>9.0</td>
<td>12.0</td>
<td>12.0</td>
<td>24.6</td>
</tr>
<tr>
<td>1976</td>
<td>18.0</td>
<td>8.0</td>
<td>13.0</td>
<td>14.0</td>
<td>21.2</td>
</tr>
<tr>
<td>1977</td>
<td>16.0</td>
<td>8.0</td>
<td>13.0</td>
<td>14.0</td>
<td>16.6</td>
</tr>
<tr>
<td>1978</td>
<td>19.0</td>
<td>9.0</td>
<td>15.0</td>
<td>16.0</td>
<td>22.8</td>
</tr>
<tr>
<td>1979</td>
<td>19.0</td>
<td>9.0</td>
<td>15.0</td>
<td>16.0</td>
<td>19.6</td>
</tr>
</tbody>
</table>

*Source: Woo, Race to the Swift, 164.*

While the government was essentially paying the chaebol to borrow, it was also trying to promote Korea’s stock market. Seoul directed the chaebol to issue stock at prices below market value and to pay off bank debt with the proceeds. The availability of cheap bank funds predictably stunted the development of well-functioning capital markets, which, on average, from 1966 to 1981, supplied less than 25 percent of the funds used by the corporate sector.

Spurred by the economic problems of the late 1970s, the government has slowly been trying to modernize and to solidify Korea’s financial system. In 1980, it began selling its stake in the country’s banks. Two years later, it eliminated the interest rate differential between general and policy loans, though a small

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60 Fields, 104.  
61 OECD, 91.
difference was restored for export-related loans in 1984. During the early 1980s, Seoul also began opening domestic financial markets to foreigners, deregulating interest rates paid to depositors, and allowing new financial instruments.

Despite these real reforms, Korea was still clearly reluctant to hand over the financing reins to the free market’s invisible hand. Though Seoul no longer owned the banks, it continued setting interest rates, rationing policy loans, and selecting top bank officials. In 1989, the government also backtracked on implementing fully the far reaching interest-rate deregulation that had been set in motion one year earlier. In fact, in an effort to reverse the ill effects of past financial discrimination, Seoul has even used policy loans to favor SMEs.

Seoul has also been slow to implement major improvements in foreign access to domestic capital markets. Foreigners are still unable to invest in unsecured convertible bonds, to own more than twenty percent of a given company’s outstanding shares (four percent for individuals), and to transfer capital freely between parent companies and their Korean subsidiaries. These restrictions – in place because the Korean government fears the impact of capital liberalization on the country’s exchange rate and export competitiveness – are contradictory to the spirit of international cooperation embodied in the OECD, and they were major hurdles to Korea’s OECD entry. In fact, Korea’s financial sector will surely remain highly regulated, despite its OECD membership. Seoul accepted

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62 Fields, 106.
63 The East Asian Miracle, 282.
65 Fields, 94-95.
66 Dalla and Khatkhate, 9.
only about two-thirds of the OECD liberalization codes, well below the near-90 percent average for current members.\(^{68}\)

In order to reform the domestic economy, Korea clearly should liberalize access to its financial sector, a policy that would narrow, and eventually eliminate, the difference between domestic and foreign interest rates. Yet, the government’s hands are tied. Liberalization, by encouraging capital inflows, risks increasing the won’s value, thereby pricing chaebol exports out of key foreign markets and eroding profits at home by lowering the domestic price of manufactured imports.

The banking sector is also in need of more reform but, here too, Seoul’s task is difficult. Korea’s banks are laboring mightily under the weight of poor lending practices, nonperforming loans, and past industrial policies that required them to lend money at negative real-interest rates. Nonperforming loans, including those related to the bailout of the construction and shipping industries during the mid 1980s, are estimated to be Won 10 trillion, or about $13 billion.\(^{69}\) Banks have also been saddled in recent years with government directives aimed at promoting small businesses, which has the effect of preventing the banks from lending more to the chaebol.

Bank profits in recent years have also been poor. Banks’ equity investments, not their core banking operations, drove earnings during the years when Korean stocks were rising. Combined earnings of the country’s twenty-five commercial banks declined in 1995, even as the economy was booming, because of a subpar performance by Korean stocks. In order to boost bank earnings, Seoul has lowered reserve requirements to prevent stock market losses from decimating bank balance sheets. Such short-term measures, however, have not eliminated


\(^{69}\) This calculation assumes an exchange rate of about Won 800 per dollar.
the banking industry’s structural problems. Hence, an economic slowdown that further increases the amount of nonperforming loans could leave Korea with a banking problem rivaling Japan’s.\textsuperscript{70}

A financial sector that is underdeveloped, and protected, has important implications for foreign firms competing with the chaebol. In the past, Seoul guaranteed that foreign loans to Korean companies would be repaid. Although there have been occasional high-profile failures, such as Kukje in 1985 and Hanbo in 1996, these have usually been driven by political expediency or have been part of the government’s broader industrial policy. On the other hand, the government generally has not allowed firms in a favored industry to go under, thereby providing an implicit guarantee to foreign lenders.\textsuperscript{71} Thus, despite debt loads that far exceed levels prevailing in the West and Japan, Korean firms have been able to borrow at competitive rates in overseas capital markets.

The banking industry’s precarious situation does have a bright side: Korean officials can scantily expect the country’s weak banks to continue providing loans for heavily indebted companies, such as Sammi steel, to keep them out of bankruptcy. The combination of banking weakness and an economic slowdown means that the government is more likely to allow Korea’s most debt-burdened companies to fail, and that would be a necessary first step in a restructuring that could shoehorn Korea’s economic system into conformity with those of other OECD countries. By shining a bright light on the precarious state of Korean finance, such episodes might also give a healthy pause to overseas lenders who, until now, have readily financed the chaebol’s overseas expansion.

\textsuperscript{71} The government’s role as an implicit guarantor of foreign loans was recently acknowledged by Minister of Finance and Economy Woong-Bae Rha, months before he was relieved of his duties: “Businesses may think they can borrow from abroad with their own credit, [but] backing them up is the credit of the country.” See “DPM Rha to Push Greater Financial Transparency,” \textit{The Korea Herald} (15 May 1996).
Old habits die hard, however. Korea’s central bank is making emergency loans to the banks hardest hit by the Sammi and Hanbo bankruptcies and, despite Hanbo’s obvious over-expansion, the government has asked creditor banks to provide the company with $1.2 billion in loans to continue construction of a new steel mill complex.\footnote{Shim Jae Hoon and Charles S. Lee, “Two Down,” \textit{Far Eastern Economic Review} (3 April 1997), 45; and Tsukasa Furukawa, “New Ideas to Rescue Hanbo,” \textit{American Metal Market} (4 February 1997), 8.}

\textbf{The Government: Still a Major Player}

Despite some steps in the direction of liberalization, and despite membership in the OECD, there are many indications that Seoul will not be coming into conformity with OECD objectives.

To say that Koreans are divided on the questions of liberalization and OECD membership would be an understatement. The Kim administration – determined to leave its mark on Korean history by engineering the country’s entrance into the prestigious, Paris-based club of industrialized nations – has been the driving force behind the rush to secure OECD membership. Some elements and personalities in both government and industry have decided the country must liberalize to maintain its competitiveness. Others, however, especially in the bureaucracy, are loathe to loosen their grip on the domestic economy. Still others believe that Korea must liberalize if it expects to maintain access to developing markets, but that liberalization should proceed as slowly as possible.

The political leadership has received mixed signals from its constituents as well. According to a survey taken just three weeks before the OECD accepted Seoul’s application, sixty-three percent of 212 surveyed economists, academics, businessmen, and journalists supported a five-year delay on the country’s OECD...
membership. Opposition to trade agreements from various interest groups is not unusual, of course – U.S. debates over NAFTA and the Uruguay Round are cases in point. However, in the United States, economists, academics and businessmen generally favor liberalization. Korea seems nowhere near such a consensus. The contention among varying viewpoints, and the general opposition to rapid liberalization, ensure that reform in Korea will occur only haltingly and will be characterized by delays and policy reversals reflecting the country’s ambivalence toward reform.

It comes as no surprise, therefore, that Seoul has taken several steps over the past two years that betray its intention to remain a major actor on the country’s economic stage. As mentioned previously, during the 1960s and 1970s, Seoul routinely picked what companies would be allowed to enter promoted industries, and then it showered these favored companies with tax preferences, cut-rate financing, tariff rebates, and outright subsidies. Today, though Korea’s economy has maintained a nine percent average growth rate for more than three decades and has produced fifteen companies in Forbes magazine’s Global 500, the government is still not shy about flexing its muscles in ways that would make even Japan’s MITI blush.

For instance, Seoul continues to dictate which industries Korea’s chaebol can enter. In December 1994, after fourteen years of delay, it finally gave the Samsung group permission to begin producing automobiles. The government previously had signed on to the argument, advanced by Korea’s existing car makers, that Korea already had too many auto companies. It is certainly remarkable that Korea’s market, which consumes less than two million cars annually, already supports more car companies than does the United States; but it is even more remarkable that Samsung, Korea’s largest and most

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internationalized chaebol, needs the government’s blessing to enter a
competitive domestic industry.\textsuperscript{75}

This is no aberration. One has only to look at the latest battle over Hyundai’s
bid to enter the steel-producing industry. Hyundai’s plans fly in the face of the
government’s policy intended to limit diversification and compel the chaebol to
focus on core competencies. Moreover, the new Hyundai mill would be
competing with Pohang Iron and Steel (POSCO), the world’s second largest steel
maker, one third of which is owned by the government. To make matters even
worse, Korea’s bureaucratic planners believe POSCO’s planned capacity
increases will create excess capacity in the Korean market, and exports may be
out of the question, because other Asian countries, where growth in steel
demand is most rapid, are anxious to establish domestic sources of supply.\textsuperscript{76}

Despite the lip service accorded liberalization, Korea also continues to practice
import substitution and to encourage production in sectors where Korea runs a
trade deficit. For example, the government announced in 1995 an import
substitution program affecting trade in machinery, electrical components, and
other products, as well as a plan to promote the design of technologically
sophisticated, application-specific, integrated circuits.\textsuperscript{77} Officials have also taken
initiative in the aerospace sector. President Kim Young-Sam’s trip to China in
early 1994 resulted in a memorandum of understanding with China to develop

\textsuperscript{75} This is not to say that governments in liberalized economies do not intervene in the market.
In the United States and Europe, governments occasionally block certain mergers on antitrust
grounds. The difference is that these decisions are aimed at preventing an anticompetitive
market structure from developing. Microsoft, for instance, was barred from purchasing
Quicken, but it is free to develop its own financial software.
\textsuperscript{76} “The War Goes On,” \textit{The Economist} (2 march 1996), 62.
\textsuperscript{77} Emiko Terazono, “Survey of South Korea - Trade, Industry and Finance,” \textit{Financial Times} (20
October 1995), 33; and “Semiconductor Manufacturers Seek Ways to Strengthen Non-Memory,”
jointly a medium range aircraft, with Seoul promising to pick up half the development costs.\(^78\)

The Korean government’s involvement in the economy also extends beyond mere plans and promotion to actual corporate ownership. Though state ownership is usually associated with the former communist countries and, more recently, with China and other mixed economies, governments in the so-called capitalist countries also own and operate businesses. In Korea, there are dozens of firms owned by the state. There is nothing WTO-illegal about state ownership of firms so long as they do not interfere with the flow of goods and services across borders.

\(^{78}\) “Airplanes Made in Korea,” Korea Trade & Investment (September-October 1994), 28; and Shim Jae Hoon and Michael Westlake, “Flight of Fancy,” Far Eastern Economic Review (3 August 1995). The project was scrapped in 1996 due to differences over the location of final assembly.
In actual practice, however, state ownership can be incompatible with the market principles enshrined in the WTO.\textsuperscript{82} Many of Korea’s state-owned firms are involved in raw materials industries, where they act as monopsonists for Korea in international markets. Others are found in industries where they are positioned to limit foreign goods and services and otherwise affect the competitiveness of foreign-based firms. The most well known of these state-funded corporations is POSCO, but there are others – in the printing, chemicals, telecommunications, and banking industries, to name only a few – that have the potential to affect U.S. economic activity in Korea and elsewhere.

In 1994, the government announced plans to merge, liquidate, or privatize about half of the country’s 133 state-funded corporations, but it has been slow to put those grand plans into action. By the end of 1995, only twenty-one small firms had been sold outright or partly privatized.\textsuperscript{83}

\textsuperscript{79} Committee on Pipe and Tube Imports, “Petition for Relief under Section 301 of the Trade Act of 1974, as Amended,” public version, 1 June 1995, 3-4.
\textsuperscript{81} “Petition for Relief under Section 301 of the Trade Act of 1974, as Amended,” 17 and Exhibit 27.
\textsuperscript{82} Greg Mastel, \textit{Trading with the Middle Kingdom} (Washington, DC: Economic Strategy Institute, 1995), 8.
In seeming contrast, privatization of the Korean telecommunications industry appears to be proceeding on schedule. Yet, even there, the manner in which the privatization is proceeding illustrates perfectly how the government’s ambivalence toward economic reform, and lingering concerns about international competitiveness, lead to contradictory policies that often place U.S. and other foreign interests at a disadvantage in the Korean market.

When the government broke Korea Telecom’s monopoly over international services in 1991, allowing Dacom to compete for international calls, Korea Telecom was the new entrant’s largest shareholder. In 1996, Dacom was also permitted to begin competing in the domestic long-distance services market, but Seoul has decreed that Dacom can only undercut Korea Telecom’s prices by three percent.

In 1994, Korea Telecom sold its stake in Korea Mobile Telecom, but the buyer was the Sungkyong group, the country’s fifth largest chaebol. Moreover, POSCO, the government-owned, and increasingly diversified, steel giant recently joined a consortium that will compete with the Mobile Telecom spin-off next year.\(^4\)

With Korean demand for telecommunications services booming, U.S. equipment and service providers should stand to gain handsomely, but, if history repeats itself, the gains may only materialize if the U.S. government closely monitors the situation. Seoul has already designated telecommunications to be a strategic industry and, despite its policy of limiting chaebol diversification, it has allowed telecommunications equipment manufacturers to become major shareholders of the country’s service providers - a move reminiscent of Japanese countermeasures taken during the 1960s and 1970s to shut foreign manufacturers out of the Japanese market.
The Korean government has also supported a successful joint project, involving Korea’s four telecommunications equipment giants, to develop a high-capacity exchange system. To protect the domestic system, the government announced that a competing system manufactured by AT&T would be subject to two years of testing before being sold in Korea.\(^85\)

Furthermore, substantial evidence has emerged suggesting that domestic service providers are under pressure to purchase equipment from domestic manufacturers. When the U.S. government sought an agreement with Seoul to remedy these purchasing patterns, Korea’s response, straight out of Japan’s play book – and dripping with irony – was to declare that an official agreement affecting private-sector procurement “would be an inappropriate intrusion of the government into private-sector business matters.”\(^86\)

With those negotiations going nowhere, the USTR identified Korea in late July 1996 as a “priority foreign country,” under section 1374 of the 1988 Trade Act for Telecommunications Practices, a step that could lead to retaliatory sanctions within the year. As negotiations continue, Washington’s ongoing interest in the matter, and the threat of punitive tariffs on Korean exports such as cars and computer chips, appear to be paying dividends. Up until 1994, Korea had enjoyed a trade surplus with the United States in telecommunications equipment trade, despite the U.S. comparative advantage in the sector. In 1995, however, the United States surplus in the sector was about $300 million, a reversal indicative of the impact that past Korean policies have had on U.S. exports.\(^87\)

\(^85\) The government eventually backed down during the Spring of 1995, in the face of U.S. criticism.
That Korea’s road to liberalization will be rocky is further underscored by the manner in which its government reacted to the country’s burgeoning trade and current account deficits during the first five months of 1996. The proximate causes of the trade deficit are well understood. Prices of memory chips, the country’s top export in 1995, have been plummeting, and the value of the Japanese yen has also been dropping, putting downward pressure on Korean exports. Korea’s traditional light-industry exports have also been hard hit by rising competition from China. For example, while Korea’s exports to the United States of textiles and apparel (SIC 23), and leather and leather products (SIC 31), have been declining since the 1990s, those from China have been rising rapidly (see exhibit IV.5).

**Exhibit IV.5**


![Graph showing U.S. imports of textiles and apparel from Korea and China](image)

*Source: Bureau of the Census*

At the same time, increased expenditures for foreign travel, increased royalty payments for technology licenses, and increased imports of capital goods and raw materials are putting upward pressure on imports. As a result, the current account deficit for 1996 surpassed two percent of GDP.

This rapid increase in the deficit caused something of a sensation in Korea. Government officials, as they have done in the past, urged Korean citizens to
limit foreign travel and overseas spending, to tone down wage demands, and to cut down on “conspicuous consumption” – a phrase that historically has connoted import purchases. The Minister of Finance and Economy also pledged to process an extra 10,000 low-cost foreign workers, in order to reduce wage pressure in export-related industries. In a meeting with representatives of Korea’s major chaebol and state-owned enterprises, President Kim Young-Sam promised to stimulate exports and to get tough with trade partners demanding improved access to Korean markets. Within days of that meeting, Minister Rha Woong-Bae, increasingly blamed for the country’s rising deficits, was fired.

Since that time, it has become increasingly evident that Seoul succeeded in generating an old-fashioned anti-import campaign. In a promising sign that others may join U.S. efforts to open the Korean market, the European Union’s Sir Leon Brittan has threatened WTO action against Korea for its anti-import railings and its “administrative harassment of importers and consumers of foreign goods.”

These policies may have been appropriate for Korea twenty years ago, but they are inappropriate for a country on the verge of joining the OECD. The railings against conspicuous consumption are especially ironic. Korea’s consumption, as a share of GDP, is already relatively low. Moreover, many believe the rise in imports of luxury goods during the first half of 1996 was merely a temporary phenomenon caused, in part, by pent-up demand for products kept out of the country by tariff and nontariff barriers. The balance of payments obviously deteriorated because of other factors – primarily the drop in memory chip prices,

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increasing foreign travel, high royalty payments for foreign technology, and underdevelopment in the SME sector.

Another disturbing development, for those observers who thought Korea had changed its interventionist ways, is the recent depreciation of the won.

In the past, the Korean government was not shy about managing the won’s value. Seoul devalued the currency in 1964 as part of its five-year plan to promote industrialization through exports, and then kept the exchange rate artificially low throughout the decade.\textsuperscript{92} To control inflationary pressures resulting from the HCI investment drive and the first oil shock, the government fixed exchange rates in 1974 at 484 won to the dollar, where it remained until 1979.\textsuperscript{93}

During the next seven years, the won depreciated steadily against the dollar, giving Korean exporters substantial price advantages in their trade with the United States. Despite an accumulation of $17.5 billion in trade surpluses with the United States from 1979 to 1986, the won-dollar rate actually depreciated by 46 percent during the period. Moreover, the won remained artificially weak against the dollar, even after the U.S. currency had began its downward adjustment against major global currencies in the mid 1980s. The yen began appreciating in February 1985 and, by May 1987, the dollar had lost 46 percent of its value against the Japanese currency. The won, on the other hand, continued to depreciate until October of 1985 and then appreciated only slowly, indicating that Korean authorities were keeping the won weak. Not until May 1987 did the dollar dip below its February 1985 value against the won (see exhibit IV.6).

\begin{center}
\textbf{Exhibit IV.6}  
\textit{Monthly Won/dollar and Yen/dollar Exchange Rates}  
\textit{1981-1996}
\end{center}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{92} Noland, 40.
\item \textsuperscript{93} Nam, 62.
\end{itemize}
\end{footnotesize}
This foot dragging did not go unnoticed. Treasury Secretary James Baker began publicly calling on the Korean government to allow the won to appreciate and, in 1988 and 1989, the Treasury included Korea on a list of countries accused of manipulating their exchange rates.\textsuperscript{94} Although Korea was removed from the list in April 1990, Korea appears to be keeping the won weaker than it otherwise would be. One recent study concluded that Korea’s monetary authorities maintained a weak won from 1990 to 1993 to maintain export competitiveness.\textsuperscript{95}

The won began appreciating slightly in early 1994, primarily due to the strong rise of the yen. As the yen began weakening during the summer of 1995, however, Korean businesses and government officials began worrying aloud about the potential loss of price competitiveness.

Korean officials, knowing the OECD would frown upon currency shenanigans, have publicly forsworn manipulation of the won as a means to deal with the

\textsuperscript{94} Noland, 49-51. The won’s value is determined, in part, by the movements of five major currencies and, in part, by Korean authorities. According to Noland, this policy adjustment factor tends to predominate.

\textsuperscript{95} Park and Song, 23 and 26-27.
recent rise in the deficit, but their actions are speaking louder than their words. It is clear that Korea’s trade deficit is not the only factor behind the falling won. During the summer of 1996, President Kim’s office announced that industrialists had asked the president for an exchange rate of 800 won per 100 yen at their August meeting. Because the yen was trading in the range of 106-to-108-per-dollar range at the time, that request was tantamount to a won/dollar exchange rate of about 850-to-one.96 As of February 1997, the Korean currency was trading at an exchange rate of 870 won per dollar, a rate not seen since December 1986.

Furthermore, even though the Bank of Korea had been selling dollars, which should have firmed the won, rumor had it that some government ministries favored a weaker won, and that a devaluation was inevitable. Adding fuel to the fire, finance and economy minister Rha’s replacement hinted that vigilance against inflation, which would require further central bank intervention to keep the won strong, might have to be sacrificed to save other goals.97

There is, of course, a surefire way for Korean monetary authorities to halt the sliding won, if they are serious about doing so. The aforementioned restrictions on foreign capital flows keep the flow of dollars to Korea lower than otherwise would be the case, thereby keeping the won/dollar rate weaker than its free-market value. Korea has promised to loosen those controls as part of its OECD entrance fee, but Seoul’s final offer still leaves Korean capital markets highly regulated. In short, evidence suggests that Seoul wants a weaker won and continues to maintain enough influence on, and control over, exchange rates to ensure that the value of the won does not damage Korea’s export prospects.

**Between the Rock and the Hard Place**

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It seems clear that coming to grips with the chaebol’s economic dominance, the financial sector’s weakness, and Seoul’s tendencies toward market intervention is going to require tough choices. A more balanced economy can only be created by diluting the concentration of economic power, but doing so would weaken the country’s dominant corporations just as Korea’s politically sensitive trade deficit is rising. Such a policy would also risk retarding growth at a time when the country’s banks are barely profitable and are weighed down by bad loans.

The alternatives are also unpalatable. Allowing the chaebol to do as they please risks increasing their preeminence and accentuating the market distortions fostered by their dominance: overinvestment, weak SMEs, and export concentration. The government’s current approach – gradual liberalization peppered with ad hoc damage control – lacks credibility both at home and abroad, because Seoul has frequently reversed course or failed to enforce its own laws.

To exacerbate matters, the Korean economy has reached a critical point in its development. Its firms are now major producers of a wide array of advanced, manufactured goods and, consequently, they compete in global markets with the industrialized world’s major producers. Korean companies, in short, have finally caught up with their western and Japanese counterparts, but it now appears that the frontier of technological development and industrial competitiveness is about to be transformed by the advent of the information revolution. The manner in which the Korean government has decided to handle the challenges of the information age speaks volumes about the kind of Korean economic policies that can be expected in the future.

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Chapter V: Industrial Policies in the Future: Prospects and Pitfalls

During this decade, traditional practitioners of industrial policies have been reevaluating their strategies. For instance, after four years of stagnant growth, Japan has begun deregulating certain sectors of its economy. The government of Prime Minister Ryutaro Hashimoto recently announced sweeping (by Japanese standards) financial sector reforms aimed at deregulating the country’s capital markets by 2001.98

Some have suggested that this reevaluation will lead countries such as Japan and Korea to embrace U.S. style capitalism, but that is not likely. It is more likely that the governments that use industrial policies will adapt to new circumstances by developing new techniques for influencing their economies, and by identifying new industries and activities to promote.99 Korea is a case in point.

99 Ironically, just as Tokyo is announcing plans to deregulate its financial sector, Japan’s MITI is putting together a series of consortiums and research projects aimed at recapturing lost ground in the semiconductor industry. Andrew Pollack, “Japan Aims to Regain Semiconductor Leadership,” The New York Times (19 November 1996).
Targeting the High-Tech Industries

Seoul is wedded to the continuation of its industrial policies even as it joins the OECD, and despite WTO commitments that may preclude such policies.\(^{100}\) In 1991, for example, the government announced the so-called Han Project, which aims to bring Korea’s technological capabilities in line with those of the Group of Seven industrialized countries. The project calls for more than $6 billion in spending between 1992 and 2001, about half of which is being borne by the government, and it targets specific industries, and even products, for development, in order to secure Korea’s international competitiveness\(^{101}\) (see exhibit V.1).

Exhibit V.1
A Sampling of Korea’s Officially Supported High-Tech Projects
Costs in Fiscal Year 1995
Millions of Dollars

<table>
<thead>
<tr>
<th>Promoted Product or Technology</th>
<th>Development Timetable</th>
<th>FY 1995 Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>Drugs and agrochemicals</td>
<td>1992-1997</td>
<td>20.3</td>
</tr>
<tr>
<td>Broadband-integrated service and digital network (ISDN)</td>
<td>1992-2001</td>
<td>7.6</td>
</tr>
<tr>
<td>High definition television (HDTV)</td>
<td>Comp. 1994</td>
<td>0</td>
</tr>
<tr>
<td>Next generation vehicle technology</td>
<td>1992-1996</td>
<td>5.8</td>
</tr>
<tr>
<td>Application-specific integrated circuit (ASIC)</td>
<td>1995-1999</td>
<td>NA</td>
</tr>
<tr>
<td>Advanced technologies for flat panel displays</td>
<td>1995-2001</td>
<td>19.0</td>
</tr>
<tr>
<td>Micro-machining technologies and micro-machines</td>
<td>1995-2001</td>
<td>13.9</td>
</tr>
<tr>
<td>Next generation semiconductor</td>
<td>1993-1997</td>
<td>11.4</td>
</tr>
<tr>
<td>Advanced manufacturing system</td>
<td>1992-2001</td>
<td>5.4</td>
</tr>
<tr>
<td>Total for specific R&amp;D projects</td>
<td>--</td>
<td>253.2</td>
</tr>
</tbody>
</table>

Source: *Korea Trade & Investment, May-June 1996*; and National Trade Data Bank, Market Research Reports, 950412.016.


\(^{101}\) Hence, the plan’s more catchy moniker, the “G-7 plan.” See Seoungjae Yu, “Korea’s High Technology Strategy,” in Denis Fred Simon, ed., *The Emerging Technological Trajectory of the Pacific Rim* (Armonk, NY: M.E. Sharpe, 1995), 93-94.
The Korean government has also targeted the information and communications industries for development. Whereas the information revolution in the United States has been largely private-sector driven, in Korea the government is taking a more prominent role.\textsuperscript{102} Seoul is expecting the so-called infocommunications industry (roughly speaking: the information technology, information services, computer systems, software, and telecommunications services industries) to be its fastest-growth sector, and the various ministries are making huge investments. The Ministry of Trade, Industry and Energy will be shelling out about $180 million in 1997 alone. The Ministry of Information and Communications is teaming with the Federation of Korean Industries to construct Multimedia Center, “a technology complex housing software, electronics and computer manufacturing plants, and information and telecommunications research centers.”\textsuperscript{103}

Seoul’s deep involvement in R&D is cause for concern. WTO rules do not prohibit government funding of R&D so long as the resulting research is precompetitive, but they do preclude such funding for products that are meant to compete in global markets. On this score, Korea’s past is alarming. Earlier research projects in high-tech industries, such as semiconductors, were aimed at cloning existing U.S. products. The government also reportedly offered bonuses for chip designs submitted by patent officers, the very people who examined blueprints of foreign chips to determine whether they warranted a Korean patent.

The scope of Seoul’s high-tech plans also raises questions. When the government takes an active role in financing R&D projects, the issue of fungibility ultimately

\textsuperscript{102} U.S. government institutions have played an important role, however. The internet, after all, is an outgrowth of the Department of Defense’s ARPANET, and the Clinton administration has pushed for the development of a national information infrastructure.

\textsuperscript{103} National Trade Data Bank, Market Research Reports, IM960819.014.
arises – i.e., companies that receive the government’s won to perform research are able to divert internal funds to other activities. This is, to some extent, true of any public-private partnership, but the proliferation of public participation into so many areas, coupled with the fact that the same Korean companies are partnered with the government in so many cases, means that the potential for public funds to shape market outcomes is high.

Improving the Physical Infrastructure and Aggravating Current Problems

The government’s plans for improving the physical infrastructure also have the potential to run afoul of its WTO commitments. As discussed earlier, development of the Korean transportation infrastructure has not kept pace with the country’s economic growth over the past three-and-a-half decades. The shortage of roads, railroads, power generating facilities, and other forms of infrastructure has now reached a critical stage and has become an expensive drag on Korea’s industrial competitiveness and quality of life.

Recognizing this deficiency, Korea’s planners made the improvement of social overhead capital (SOC) the centerpiece of the country’s most recent five-year plan. Spending on SOC projects is expected to rise to 5.5 percent of GDP by 1999, and will total nearly $120 billion during the five-year period. The central and provincial governments will fund 87 percent of the total, with the private sector picking up the rest. Spending on transportation infrastructure projects in 1995 alone was $8.7 billion, up 22 percent from year-earlier levels.  

The government’s decision to address such long-neglected needs is a welcome development, but years of neglect mean that the government cannot fund the projects alone – hence, the participation of private capital. The manner in which

\[104\] National Trade Data Bank, Market Research Reports, IS9506.359.
private firms will participate, however, raises some concerns about whether the Korean government is unfairly subsidizing domestic firms.

More specifically, in order to attract private capital, Seoul has ensured a substantial profit to participating firms. Most private participation is on a build-own-transfer basis: the government contracts domestic firms to build the facilities, to collect user fees for up to thirty years – with annual investment returns of ten percent – and ultimately to transfer ownership to the public sector. In addition, investors in the main transportation projects can receive government subsidies or long-term loans (presumably at below-market interest rates), as well as various tax incentives, and will also be exempted from prohibitions on investing in other companies (see exhibit V.2).
### Exhibit V.2
Potential Gains from Participation in Social Overhead Capital Projects

<table>
<thead>
<tr>
<th>Guaranteed profits:</th>
<th>$1.5 billion annually for 30 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guaranteed investment funds:</td>
<td>• Subsidies and access to long-term government loans</td>
</tr>
<tr>
<td></td>
<td>• $200 million in Korea Development Bank (KDB) credit guarantees</td>
</tr>
<tr>
<td></td>
<td>• Credit guarantee fund, run by KDB and others, largely funded by the central and provincial governments</td>
</tr>
<tr>
<td></td>
<td>• Permission to borrow abroad</td>
</tr>
<tr>
<td>Tax incentives:</td>
<td>• Fifteen percent tax deduction on total investment</td>
</tr>
<tr>
<td></td>
<td>• Fifty percent reduction on the capital gains tax on real estate transactions</td>
</tr>
<tr>
<td></td>
<td>• Tax deduction on interest payments resulting from SOC borrowing</td>
</tr>
<tr>
<td></td>
<td>• Special incentives to use farm land and mountain sites for SOC projects</td>
</tr>
<tr>
<td>Other:</td>
<td>• Permission to build on government-owned property</td>
</tr>
<tr>
<td></td>
<td>• Exemption from certain Fair Trade Practices Act restrictions</td>
</tr>
</tbody>
</table>

Source: National Trade Data Bank, Market Research Report IS9506.359.

The last item in the table is especially attractive to the chaebol, because it opens a yawning loophole in the Fair Trade Practices Act, which had been intended to slow the chaebol’s seemingly never-ending drive to diversify. Consequently, group members from most of the major conglomerates are planning to participate in SOC projects (see exhibit V.3).
Table V.3
Selected SOC Infrastructure Projects Using Private Capital
Their Estimated Cost

<table>
<thead>
<tr>
<th>Contractors</th>
<th>Project</th>
<th>Estimated Cost ($billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hyundai</td>
<td>Yongjong Intl. Airport in Seoul</td>
<td>1.50</td>
</tr>
<tr>
<td>Hyundai and Daewoo</td>
<td>Kyungin Canal between Seoul and Incheon</td>
<td>1.65</td>
</tr>
<tr>
<td>Hyundai and LG</td>
<td>Light Railway between Pusan and Kimhae</td>
<td>0.67</td>
</tr>
<tr>
<td>Hyundai</td>
<td>Light Railway between Seoul and Kimhae</td>
<td>0.41</td>
</tr>
<tr>
<td>Hyundai</td>
<td>Development of Nanji-do area</td>
<td>4.50</td>
</tr>
<tr>
<td>Hyundai</td>
<td>LNG combined cycle power plant</td>
<td>0.40</td>
</tr>
<tr>
<td>Hyundai</td>
<td>Yulchon LNG combined cycle power plant</td>
<td>0.35</td>
</tr>
<tr>
<td>Hyundai</td>
<td>Yulchon LNG receiving terminal</td>
<td>0.75</td>
</tr>
<tr>
<td>LG</td>
<td>Kadok Island port facility</td>
<td>0.30</td>
</tr>
<tr>
<td>LG</td>
<td>Road surrounding new Seoul Intl. Airport</td>
<td>0.22</td>
</tr>
<tr>
<td>LG</td>
<td>High-speed railway between Seoul and Kangnung</td>
<td>0.50</td>
</tr>
<tr>
<td>LG</td>
<td>Railway station on Seoul-to-Pusan line</td>
<td>0.08</td>
</tr>
<tr>
<td>LG</td>
<td>Co-generation power plant</td>
<td>0.08</td>
</tr>
<tr>
<td>Daewoo</td>
<td>Chunan-Nonsan Expressway</td>
<td>1.52</td>
</tr>
<tr>
<td>Daewoo</td>
<td>Gaduk Bridge</td>
<td>0.96</td>
</tr>
</tbody>
</table>

Source: National Trade Data Bank, Market Research Reports 950323.006, 950705.015, and 950316.039.

Given what is known about financing in Korea, the SOC financing scheme could foster more of the abuses that have already prompted concern in Korea’s central government and among Korea’s trading partners.

First, the project will generate substantial cash flow for investing companies well into the future, but, absent changes in other incentives, increased cash flow will only encourage the chaebol to increase their borrowing. After all, a ten percent return on the twelve-trillion-won private investment amounts to about $1.5 billion dollars per year for thirty years. These revenues will also encourage cross-subsidization and in-group loan guarantees, practices that the government says it wishes to discourage. The extra profits and visibility of chaebol firms taking part in the project will reinforce the feeling among Koreans that the government is not serious about reducing the chaebol’s economic dominance.

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Second, the massive revenues resulting from SOC projects will also have implications for international competitiveness. If past practice is any guide, these profits will result in over-investment in Korea and increased FDI by the chaebol. The former, as always, could result in dumping or disruptive oversupply conditions similar to what occurred in the DRAM market during 1996. The latter seems especially unfair, given that foreign direct and portfolio investors still lack unfettered access to the Korean market, and that foreign participation in SOC projects is limited.

Additional WTO-related problems could also arise if the government encourages primary SOC contractors and subcontractors to purchase domestically produced equipment.

**Deregulation with Protection**

The SOC projects will stimulate demand for electricity and, thus, for electric power generating machinery. The Korean government, however, like many other governments, has traditionally not allowed market forces to determine the supply and demand of electricity; and the Korean Electrical Power Corporation (KEPCO) has been the monopoly supplier. In addition, unlike many other advanced countries, Korea provided a single company, Hanjung, with de facto monopoly status for the domestic production of thermal power generating equipment, and required that about eighty percent of thermal plant demand must be met by producers in Korea.105

Over the past three years, the government broke with past policy and announced market-oriented measures to increase competitiveness in both the electricity producing and the power generating equipment industries. KEPCO’s monopoly

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105 National Trade Data Bank, Market Research Reports, IS960226.070.
status was terminated in 1995, with the introduction of the Independent Power Producer (IPP) program, which essentially allows private companies to build their own power plants. The government also broke Hanjung’s monopoly by allowing other domestic firms to produce power generating equipment.

Though these new policies are market-oriented in the sense that the government is deregulating a formerly monopolized industry, they have not created a truly free market. With an eye toward bolstering the global competitiveness of domestic producers, Seoul is increasing the localization ratio to almost ninety percent by 1998. Consequently, foreign companies will probably sell more equipment, due to growing Korean demand, but their share of the market will effectively be limited by government edict. To participate in the Korean market, foreign producers have had to license technology to future competitors, form joint ventures, or establish local subsidiaries (see exhibit V.4).
Table V.4
Technical Tie-ups between Korean and Foreign Manufacturers
Electric Power Generating Equipment

<table>
<thead>
<tr>
<th>Korean Firm</th>
<th>Technology Supplier</th>
<th>Home Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hanjung</td>
<td>General Electric</td>
<td>United States</td>
</tr>
<tr>
<td>Hanjung</td>
<td>ABB-CE</td>
<td>United States</td>
</tr>
<tr>
<td>Daewoo Heavy Industries</td>
<td>GEC-Ahlstrom</td>
<td>United Kingdom, France</td>
</tr>
<tr>
<td>Daewoo Heavy Industries</td>
<td>EVT</td>
<td>Germany</td>
</tr>
<tr>
<td>Daewoo Heavy Industries</td>
<td>Gasturbo</td>
<td>France</td>
</tr>
<tr>
<td>Samsung Heavy Industries</td>
<td>Foster-Wheeler</td>
<td>United States</td>
</tr>
<tr>
<td>Samsung Heavy Industries</td>
<td>IHI</td>
<td>Japan</td>
</tr>
</tbody>
</table>

Source: National Trade Data Bank, Market Research Report, IT Market IS960226.070.

This new policy also works against Seoul’s stated goal of limiting chaebol power and diversification. The number of domestic firms producing power generating machinery has jumped significantly in recent years, and among those that will benefit from the government’s localization program are affiliates of Hyundai, Samsung, Daewoo, Ssangyong, Halla, and LG.

Selective Liberalization

It is not that Seoul fails to recognize the potential benefits generated by market mechanisms, in terms of higher quality and increased choice. In Korea, as in Japan, there appears to be a different mindset toward deregulation and liberalization than there is in the United States. In the United States, deregulation is viewed, in many instances, as the desired end that will produce welfare gains for the country as a whole, primarily by improving the lot of consumers. In Korea, deregulation and liberalization are viewed as the means, to be used by the government in the pursuit of some desired end.

The Korean government is using market mechanisms selectively as the preferred means to achieve its desired end – namely, to improve its economy. Seoul’s policy toward engineering and construction services, for instance, contrasts sharply with the halting liberalization in other sectors. Market opening began in
earnest during the second half of 1995, when Seoul uncharacteristically accelerated liberalization measures for construction supervision activities. Foreign firms gained access to the private sector at the beginning of 1996 and, as a result of Korea’s Uruguay Round commitments, will gain access to the public-sector market in 1997.106

Behind this uncharacteristic fervor lie a series of high-profile, infrastructure disasters. In October 1994, Seoul’s Songsu Bridge collapsed.107 Eight months later, the capital’s Sampoong department store collapsed as well, killing hundreds.108 The subsequent, public outcry against shoddy construction practices had an immediate impact. Hoping to improve building quality and safety by encouraging the transfer of foreign technology and management practices, the government has since steered contracts toward Korean firms with consulting relationships to foreign firms. Seoul’s municipal government has contracted two British firms to supervise construction of the new Sampoong bridge, and Samsung Engineering has hired Taywood Engineering to inspect a decade-and-a-half’s worth of Samsung-engineered buildings.

It is unfortunate that liberalization in this particular sector occurred too late to prevent the loss of human life. The stakes of maintaining protection in other sectors are not as high, however, so it is unlikely that the liberalization measures implemented in the engineering services sector herald the onset of broad-based reform in Korea.

Meanwhile, studies indicate that a more open, less regulated Korean economy would increase national welfare. Korea’s Economy 1996, published by the Korean Economic Institute of America, included an article by Robert A. Rogowsky, who

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106 National Trade Data Bank, Market Research Reports, IS9509.667.
provided an estimate of the potential gains that could be expected of Korean liberalization.\textsuperscript{109} Using the Global Trade Analysis Project CGE model and database, Rogowsky concluded that domestic reform measures embodied in Korea’s then-current economic plan, if fully implemented, could translate into $6 billion of additional GDP for Korea. Further liberalization, in the form of a free-trade agreement with the United States, could result in an additional $12 billion in benefits, according to the study.\textsuperscript{110} Yet another analysis, by Namdoo Kim, concluded that, in 1992, tariffs and quotas in forty-nine products created a welfare loss in the range of 0.3 percent to one percent of 1992 GNP.\textsuperscript{111}

Nevertheless, if the industrial policies discussed in this chapter are indicative of the government’s intentions, even the potential gains estimated by Rogowsky and Kim will be too negligible to spark any major change in the way Korea does business. In the absence of foreign pressure to accelerate the pace of reform, Seoul will probably continue prescribing liberalization only in small doses, and only as a last resort.

\textsuperscript{110} Rogowsky, 19-20. These experiments used 1992 as the base year for projections.
Chapter VI: The Korean Auto Industry

In many ways, recent developments in the Korean auto industry mirror the reform process in Korea. Government has identified that particular industry as strategic, so its development has been shaped by government policies, not just by market forces. Reluctant to expose the industry completely to foreign competition, the government is liberalizing, but only slowly, and it continues to pursue auto-related industrial policies.

Korea’s auto makers, for their part, continue to operate in an economic environment that bears the mark of past market distortions, consequently responding to incentives that differ from those pursued by their competitors in Europe, the United States and, increasingly, Japan. The potential domestic and international consequences of these continuing market distortions in Korea underscore how high are the stakes of successful reform, not only for Koreans, but for foreigners as well.

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Korean Industrial Policy and the Rise of Korea’s Auto Industry

As with most of the economic challenges facing Korean companies and their government today, the roots of economic distortions can be found in the early 1960s. Seoul’s first five-year development plan (1962-1967) included plans to develop the auto industry. Trade associations for vehicles and parts were created at that time, in order to ensure that manufacturers hewed to the government’s goals.\footnote{113}

The development plan for the industry was pure import substitution. The government banned imports of finished autos and provided duty-free status to parts imports for domestic assembly. To no one’s surprise, there emerged an industry that specialized in assembling semi-knocked-down kits, and then completely knocked-down kits, that were imported from the United States and Japan. With the industry’s local content rising only slowly, the government established a localization schedule in 1966 and encouraged parts production by allocating foreign exchange to parts producers. By 1972, the local-content ratio had reached sixty percent, but costs were high and quality low, and the major parts, components, and systems were still produced abroad.\footnote{114}

As part of the HCI drive in the early 1970s, Seoul announced a long-term promotion plan for the auto industry. To reach the plan’s targets of 75,000 exports by 1981, and eighty percent local content, the government limited the number of manufacturers to four and encouraged them to increase production capacity drastically, even though high auto-related taxes were depressing domestic demand for the cars these bigger plants would someday produce. The


\footnote{114} Stern, et. al., 154-155.
government also protected the parts industry by giving its industry association the power to veto the imports of parts that were domestically available. This measure had the effect of compelling foreign companies to transfer parts technology to Korean manufacturers.115

Though profits were low and corporate debt was high near the end of the 1970s, local content had surpassed ninety percent, quality had improved, and production levels had risen fivefold since 1975. The recession in the early 1980s halved domestic vehicle demand, however, and left producers with low capacity utilization and high levels of debt.

Although Seoul began jettisoning the more excessive and expensive features of the HCI drive during the early 1980s, it did not abandon industrial policy toward the automotive sector. Quite the opposite, the government attempted to rationalize the domestic industry and designated it a strategic export industry.116 Hyundai, and Daewoo Motors, which was jointly owned by General Motors (GM), were designated Korea’s only producers of passenger vehicles, while Kia, forced out of automobile production by the government, was compensated with monopoly rights to manufacture light commercial vehicles.117

The five years following Korea’s economic recovery in late 1982 were glory years for the industry (see exhibit VI.1). From 1983 to 1987, vehicle production expanded at a forty-four percent annual rate, driven by a recovery of domestic demand and by rapidly rising exports to the United States. Parts exports

115 Stern, et. al., 155-156, 158-159.
116 Stern, et. al., 159-160. The plan was aborted due to a disagreement over the appropriate share for General Motors, Daewoo Motor company’s joint venture partner, in the proposed Hyundai-Daewoo merger.

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increased tenfold, and vehicle exports in 1987 totaled half a million.\textsuperscript{118} From 1986 to 1988, vehicle exports exceeded domestic sales.

**Exhibit VI.1**

**Domestic Sales and Exports of Korean Automobiles, 1983-1996**

The industry experienced a second series of setbacks beginning in 1988, the year, coincidentally, when the government’s rationalization scheme was discontinued. The Japanese yen, which had been appreciating since 1985, reversed course, thereby erasing some of the Korean car makers’ price advantages in the United States between 1985 and 1987. Japanese makers began dropping prices on their smaller vehicles that competed with Korean exports in the U.S. market. Korea’s car makers were also beset by bitter disputes with labor, which demanded, and ultimately received, better pay. Between 1989 and 1991, labor costs nearly doubled. Finally, slow product development, and the relatively poor quality of Korean car exports when compared to Japanese quality, dampened North American interest in Korean vehicles.\textsuperscript{119}

\textsuperscript{118} Stern, et. al., 161.

\textsuperscript{119} Leslie Helm, “A Bumpier Road Ahead,” Los Angeles Times (18 March 1991), D-1.
Exhibit VI.2
U.S. Motor Vehicle and Parts Imports from Korea, 1982-1992
Value, and as a Share of Total U.S. Imports from Korea

Bureau of the Census

Exports dropped precipitously in 1989, and the levels attained in 1988 were not surpassed until 1993. By 1992, U.S. imports of Korean vehicles and parts had dropped sixty-seven percent, and their share of total U.S. imports from Korea declined precipitously as well (see figure VI.2). Exports, as a share of domestic sales, also plummeted, and they have yet to approach their 1987 peak (see exhibit VI.3). Rapid growth in domestic demand for vehicles, however, helped to cushion the blow on the Korean auto makers.
The auto industry’s troubles notwithstanding, Korean planners have persisted in their undiminished enthusiasm for industrial policy. In 1992, as part of the G-7 initiative, Seoul launched the so-called X-5 project to promote the mid- and long-term development of the country’s automobile industry. In December 1994, the government announced the XC-5 plan, which was intended to strengthen Korea’s parts and components industry sufficiently to compete with industries in Europe, Japan and the United States. The comprehensive plan includes provisions affecting investment, factory location, manpower, the supply base, quality, independent technology development, standardization of parts and components, and restructuring.\(^{120}\)

**Efforts to Liberalize the Korean Auto Industry**

The end of the boom years roughly coincided with Seoul’s shift toward a policy of controlled liberalization in the automobile sector. In 1986, the government ended its 25-year import ban on finished vehicles by allowing the import of specialty vehicles, but it limited imports by imposing a sixty percent tariff, and it

\(^{120}\) Rhee, 58-59.
continued to prohibit imports from Japan. On the domestic front, the government decided to allow new entrants into the vehicles market, but continued to bar Samsung from vehicle production.

As with previous liberalization schemes, this one did not herald the transformation of Korean planners into rabid free-marketers. To the contrary, taking a page out of Japan’s play book, Seoul has implemented liberalization countermeasures in the automotive sector that have effectively blocked significant foreign penetration into Korea’s domestic auto market. In fact, Korea’s market is even more closed than Japan’s market (see exhibit VI.4).

**Exhibit VI.4**
Import Penetration in Korea and Other Major Auto Markets, 1996

[Diagram showing import penetration percentages for Germany, NAFTA, Japan, and Korea, with Germany at 32%, NAFTA at 13%, Japan at 6%, and Korea at 1%]

U.S. Department of Commerce

*The figure for Germany, which is based on nameplate data, counts imports of Ford and GM as German made, and therefore understates the true level of import penetration the German auto market.

The Korean government has succeeded in excluding imports by using a variety of nontariff measures. Perhaps the most notorious barrier has been the threat of

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121 Rhee, 59-60. The tariff was reduced to fifty percent in 1988, twenty-five percent in 1989, twenty percent in 1990, seventeen percent in 1992, fifteen percent in 1993, ten percent in 1994, and eight percent in 1995.


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automatic tax audits against Koreans who purchase foreign vehicles.\textsuperscript{123} Official limits on foreign-owned finance companies and offshore borrowing; an overly complex, nontransparent, homologation system; restrictions on advertising; and a cascading taxation system based on engine displacement have crimped both European and North American exports to Korea, even as tariffs were coming down.

The tax system has proved especially onerous. There are up to twelve kinds of levies affecting locally manufactured cars, and up to fourteen on imports. Since the tax base for imports includes the tariff and an import value-added tax, imports are saddled with a large price disadvantage, compared to domestically produced cars. According to estimates by the American Chamber of Commerce in Korea, these levies give Korean makers a sixteen percent price advantage on cars with an engine displacement less than 2000 cubic centiliters, and a nineteen percent advantage on cars with larger engines.\textsuperscript{124}

It became clear to the U.S. government and industry during the late 1980s that Korea’s high levels of protection in the automotive sector were inappropriate, especially given the competitiveness of Korean cars, the size of Korea’s vehicle market, and Korea’s reliance on export markets. Smarting from record-high U.S. trade deficits, and from the consequences of allowing Japan to maintain its sanctuary market in several industries, Washington began working to ensure that Korea would not become another Japan.

\textsuperscript{123} This policy occasionally backfired. Harassment of owners of Ford vehicles by government officials in Korea got so bad that Ford reduced its purchases of Kia-made Festivas. See Helm, D-1.

\textsuperscript{124} Korea: U.S. Trade and Investment Issues (Seoul, Korea: American Chamber of Commerce in Korea, 1995), 73. The price advantage for Korean cars is even more pronounced in Seoul and Pusan, where a subway bond tax is also in effect. See Korea - Automobiles - ISA9507, U.S. Department of Commerce, International Trade Administration (21 September 1995).
Progress was slow. During the Spring of 1987, the International Trade Commission sent word that it was sending two representatives to Korea to survey the country’s auto industry, and U.S. Secretary of Commerce Malcolm Baldridge scheduled a trip to Seoul. Occurring on the heels of U.S. sanctions against Japan for its failure to live up to the Semiconductor Agreement of 1986, these small steps produced a more open Korean market. In early April, both Daewoo and Hyundai announced plans to purchase more U.S. parts. During Baldridge’s visit, Korea agreed to implement some market opening measures affecting parts imports.125

With the U.S. global trade deficit, and the bilateral deficit with Korea, declining, U.S. efforts to improve access for foreign automobiles in Korea slowed between 1988 and 1989.126 Indeed, Korea was omitted from the Super 301 list of countries deemed unfair traders in 1989.

All of that changed after Korea’s trade surplus began to contract. In May 1990, Seoul began an offensive aimed at rolling back the gains made by foreign producers in the Korean market. Couched as a paternalistic attempt to encourage frugality, the new policy forced many retailers to take U.S.-made products off their shelves and threatened buyers of imported luxury goods with tax audits.127 Foreign autos were hit especially hard. Sales of the Mercury Sable, for example – Korea’s best selling import since 1989 – were cruising at 250-to-300 per month, but they plummeted more than sixty percent when the merchandise suddenly

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125 Baldridge also promised that Korean access to U.S. markets for cars, semiconductors, and machine tools would remain unhindered as long as Korea improves market access for U.S. products. Seoul also promised to end “buy Korean” policies that were impeding sales of foreign computers to government agencies. See, for example, “Korea to Lift Barriers to Trade,” The Seattle Times (21 April 1987), D1.
126 The only major threat to Korean auto producers in 1988 came from Canada, where Korean auto makers were accused of dumping. Duties of 26 percent were assessed in November 1987, but were removed several months later, after Canadian authorities decided that the dumping was not causing material injury to Canadian producers.
began disappearing from showroom floors.\textsuperscript{128} By contrast, sales of the Hyundai Grandeur, Korea’s best-selling domestic luxury car, continued to be brisk, thereby undercutting the government’s claim that its measures were aimed at luxury cars in general, and not just at imports. Chrysler, anxious to penetrate the Korean market, found itself unable to secure a local partner.\textsuperscript{129}

The anti-import campaign eventually fizzled, partly because of the weight of foreign pressure and partly because Korea’s trade deficit declined in 1992 and 1993. Yet, the damage that had been inflicted was difficult to reverse, despite the long overdue public statement by the Office of National Tax Administration, in February 1994, that foreign-car ownership would no longer be a selection criteria for tax audits.\textsuperscript{130} By 1994, foreign market share in Korea remained far below what would have been expected in an open market.

Eventually, consultations with the United States in 1994 produced agreements to reduce tariffs to eight percent, eliminate restrictions on floor space and showrooms, liberalize advertising and financing activities, and simplify Korea’s product approval process.\textsuperscript{131} In 1995, yet another bilateral agreement was brokered under the auspices of the Super 301 process. The memo of understanding (MOU) signed in September 1995 focused exclusively on the removal of nontariff barriers, such as unreasonable standards and certification procedures, limits on advertising time, and restrictions on foreign ownership of retail financing outlets. The Clinton administration, evaluating that agreement in

\textsuperscript{127} Tax audits in Korea are especially feared because many people maintain a number of accounts in false names in order to reduce their tax bills. After years of trying to outlaw this practice, the government finally succeeded in 1995.


\textsuperscript{130} \textit{1994 National Trade Estimate Report on Foreign Trade Barriers} (Washington, DC: United States Trade Representative, 1995), 221. (hereafter \textit{NTE1994})
June 1996, concluded that Seoul had implemented the MOU faithfully, but that foreign sales were rising only slowly (see exhibit VI.5 and exhibit VI.6).\(^{132}\)

**Exhibit VI.5**

Import Sales Trends in the Korean Automobile Market, 1987-1996

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\(^{131}\) NTE1994, 221.

Exhibit VI.6
Import Sales, and Total Sales, of Passenger Cars in Korea, 1990-1995
Units

<table>
<thead>
<tr>
<th></th>
<th>United States</th>
<th>Europe</th>
<th>Total Import Sales</th>
<th>Total Sales</th>
<th>Import Share of Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>1,678</td>
<td>758</td>
<td>2,436</td>
<td>954,277</td>
<td>0.26%</td>
</tr>
<tr>
<td>1991</td>
<td>958</td>
<td>833</td>
<td>1,791</td>
<td>1,104,184</td>
<td>0.16%</td>
</tr>
<tr>
<td>1992</td>
<td>1,026</td>
<td>802</td>
<td>1,828</td>
<td>1,268,374</td>
<td>0.14%</td>
</tr>
<tr>
<td>1993</td>
<td>1,456</td>
<td>496</td>
<td>1,952</td>
<td>1,435,967</td>
<td>0.14%</td>
</tr>
<tr>
<td>1994</td>
<td>1,893</td>
<td>1,946</td>
<td>3,839</td>
<td>1,555,602</td>
<td>0.25%</td>
</tr>
<tr>
<td>1995</td>
<td>2,578</td>
<td>4,343</td>
<td>6,921</td>
<td>1,556,339</td>
<td>0.44%</td>
</tr>
</tbody>
</table>

Sources: Korean Automobile Manufacturers Association and U.S. company sources.

Since then, foreign makers have suffered a major setback. As Korea’s trade
deficit continued to mount in late 1996, Korean officials began a highly
publicized harassment campaign aimed at foreign car owners and lease holders.
Korea’s tax agency, for example, has twice requested lists of individuals leasing
cars – a surefire way to track imports because leasing is rare for domestic
vehicles.133

While U.S. market opening efforts in 1994 and 1995 have not been totally
without effect, much more work remains. High auto-related taxes, the eight
percent tariff, past discrimination, and overregulation in the financial sector – as
well as the government’s tendency to encourage frugality whenever it becomes
uncomfortable with its trade deficit – continue to hamper efforts of foreign
companies to establish anything more than a toehold in the Korean market.
Korean firms still hold about 99 percent of the Korean automobile market, and, if

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133 “U.S., Korea at Odds over Minimal Auto Market Access Improvements,” Inside U.S. Trade (16
May 1997), 10.
numbers published in recent issues of Korean magazines are to be believed, the foreign share of the Korean market by 2000 will be only 2.1 percent.  

A Job Half Done

Korea’s closed domestic market is not the only legacy of past industrial policies. The country’s inward orientation has created a competitive dynamic that differs starkly from what occurs in the United States and Europe. In fact, today’s Korean auto industry is reminiscent of a host of Japanese industries that were criticized in the past for investing to capture market share. In most cases, Japan successfully closed domestic markets, allowing domestic companies to achieve economies of scale. Excess Japanese production was subsequently sold abroad without regard to profit, and Japan’s foreign competitors hemorrhaged both red ink and market share.

The economic environment faced by today’s Korean producers exhibits some differences, however, from what the Japanese faced two decades ago. To begin with, foreign firms have learned from past mistakes: U.S. and European firms are much quicker to call for market opening than they were in the past. In addition, competitive dynamics in the global industry are different. U.S. and European car makers, for example, are more competitive and have fewer holes in their product lines than was the case previously. Along with their Japanese counterparts, they are also pursuing market share in developing countries. Finally, the new global trade watchdog, the WTO, has more teeth than the old GATT, and that could hamper Seoul’s ability to erect new barriers in the auto sector.

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134 For estimates of domestic demand, see Business Korea (January 1996), 38; for estimates of import sales, see “Another Good Year Expected for Foreign Car Sales in Korea,” Korean Trade & Investment (January-February 1996), 14.
That being said, it is disturbing to observe the fondness of Korean producers for investing in capacity levels that do not make sense. (In fact, GM parted ways with Daewoo in 1992 out of distaste for its Korean partner’s propensity to favor sales increases over profitability.) Many believe that these investments, which are occurring both at home and abroad, are not justified by economic fundamentals, and could lead to problems for Korean and foreign firms alike.

Korean auto makers currently produce almost twice as much as they export, but that is bound to change if their current plans are carried out. Based on announcements by Daewoo, Hyundai, and Kia – the country’s big three – domestic capacity will double between 1995 and 2000, reaching the 5-million-unit mark by the turn of the century. Domestic demand is expected, at most, to be 2.3 million units, while export demand is expected to be at least 2.8 million, meaning that Korea’s big three are expecting demand for their exports to expand at a nineteen percent clip. Add the extra million vehicles planned by Ssangyong and Samsung and it becomes clear that the Korean market will be bursting with overcapacity by the turn of the century.

Unless Korean companies achieve remarkable export expansion, they could be left with levels of capacity utilization matching those of the early 1980s. Such a circumstance could result in massive dumping, thus spreading Korea’s problems not only to industries in traditional auto markets, but also into developing countries trying to nurture indigenous car makers.

At the same time they have been boosting their domestic capacity, Korean companies have also been expanding aggressively overseas. Although Korea has

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137 “…,” 38. For even higher estimates of capacity expansion, see Emily Thorton, “Do or Die,” *Far Eastern Economic Review* (13 June 1996), 55, which pegs year-2000 capacity at 5.86 million units.
made auto-related investments in industrialized countries before – such as the ill-fated investment in Canada that was temporarily shuttered in the late 1980s – Korean firms are currently investing in markets with high growth potential, including Eastern Europe, Africa, the Middle East, South Asia, Southeast Asia, and China. Current plans call for expanding production in Southeast Asia alone to 712,000 units by the turn of the century.\textsuperscript{138}

There is nothing wrong with risky investments per se. If one Korean firm was going out on a limb, few would find its investments newsworthy. However, Korean companies appear to be marching lockstep to the tune of the same drummer. Moreover, these domestic and foreign investments have come on the heels of a remarkably poor financial performance by Korean makers during the 1990s, even as domestic demand was humming along at a fifteen percent clip and foreign competition was virtually nonexistent.\textsuperscript{139} The government’s decision allowing Samsung to enter the auto business, as well as recent liberalization measures, can only increase competition in the domestic market, which should have the predictable effects of lowering the profit margins of existing Korean makers and encouraging more overseas forays.

Worse, the days of sustained double-digit growth in the domestic market may be drawing to a close, especially if the government insists on maintaining high vehicle taxes. In 1995, domestic demand for passenger vehicles grew by only 0.3 percent, and 1996 has yet to see a major rebound. Some analysts have already opined that the domestic market will increasingly be driven by replacement sales, not by the first-time buyers who drove previous years’ demand growth.\textsuperscript{140}

\textsuperscript{138} Thorton, 54.
\textsuperscript{139} 1995 was the first year in the 1990s that all three major Korean auto makers reported full-year profits. See Burton, 24.
\textsuperscript{140} Burton, 24.
Unfortunately, this slowdown has been cited as the raison d’être for Korean vehicle makers’ massive forays overseas. This line of reasoning might make sense if Korean makers were not planning to double domestic capacity by the year 2000 and to triple exports from 1995 levels. Given the high Korean wage levels bemoaned by the chaebol and the desire of other developing countries to create their own auto industries, the entire scenario seems unreasonable.

Granted, Korean makers are taking steps to ensure that overseas demand for their vehicles is sufficient, but it is unclear whether their strategies are sustainable. Many overseas facilities will be reassembling completely knocked-down and semi-knocked-down vehicles, which will serve to increase demand from facilities in Korea. However, these arrangements will increasingly come under fire from governments intent on increasing local content.

A complementary strategy has been to strike deals that essentially give Korean makers preferential access to particular markets. For instance, in 1995, Daewoo struck two deals with the Polish government to produce cars, van engines, and gear boxes. In 1996, Kia Motors became the main beneficiary of Indonesia’s decision to create a “national car company.” Kia will be allowed to import nearly completed vehicles to a company owned by President Suharto’s son. The deal clearly violates WTO rules. Japan and the European Union have already requested separate WTO dispute settlement panels to deal with the practice.

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142 Christopher Bobinski and Kevin Done, “Daewoo Overtakes GM in Race for Polish Carmaker,” *Financial Times* (28 August 1995), 2. General Motors’ proposal stipulated that the state-owned firm undergo a massive restructuring to promote profitability. The Daewoo deal included no such restructuring, virtually ensuring profitability problems. This investment would only make sense if Daewoo were expecting Polish government intervention if the investment turned out poorly.

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Given the low profitability of Korea’s auto industry, the scope of current facility expansion plans are nothing short of remarkable, and beg the question about how these expansion plans will be financed.

The answer, discussed in chapter IV, lies in the unique nature of Korea’s economic and financial system. Korea’s auto companies have passive shareholders, and thus are not hindered by shareholder demands for higher dividends. Other sources of capital in Korea are patient as well, in part because the large firms in Korea have come to control many of the sources from which they borrow. Moreover, the vehicle producers belonging to the Samsung, Hyundai, and Daewoo, and Ssangyong chaebol have ready sources of low interest short term loans and loan guarantees from profitable group members.

Auto makers’ current and future reliance on these cross subsidies cannot be under estimated. Reports have already surfaced that Samsung Motor Company’s ambitious investment plans have been jeopardized by the current slump in DRAM prices, which are expected to reduce Samsung Electric’s semiconductor prices by 60 percent.\(^{144}\) Korean auto makers, their credit-worthiness bolstered by the government’s implicit guarantee and the balance sheets of healthy group members, also have been to borrow on international capital markets at interest rates normally unavailable to steadily unprofitable companies. Daewoo and Hyundai each have major construction arms and have scored large government contracts and a steady stream of revenue for up to 30 years. (see chapter V) If funds generated by official construction projects find their way to auto producers, Korea could be violating WTO subsidy provisions.


The government’s decision to pursue industrial policies for the automobile and parts industries also bears watching. WTO rules do allow R&D subsidies, with certain restrictions, on pre-competitive development activity, but it would probably be left up to the trade watchdog’s Permanent Group of Experts to decide whether or not Korea’s car and parts industries can be designated pre-competitive.

The parts policy, if successful, could be damaging to U.S. and other foreign companies. Frustrated in their attempt to penetrate Korea’s vehicle market, U.S firms have by default focused on selling parts. Because Korea’s parts industry remains fragmented and underdeveloped, Ford and GM continue to record impressive sales of parts and technology to Korean firms.145 Yet these sales are by no means a sure bet: the government’s XC-5 project, which focuses on developing indigenous technology and on restructuring appears aimed at reducing these sales significantly. The government has set a target of $33 billion for domestic parts production by 2000, $3 billion of which will be exported.146

In short, industrial policy remains alive and well in the Korean automotive sector, as it does in the Korean economy as a whole. Though Seoul has committed itself to liberalization, it has also committed itself to developing further its already developed auto industry, and to obstructing the penetration of imported vehicles. The country’s auto companies have responded to this protection and promotion with large investments in Korea and abroad.

Despite the improvements in the WTO, its ability to minimize market distortions caused by Korean industrial policies is limited on two fronts. Korea’s bound tariff rate on autos, the rate negotiated during the Uruguay Round which Korean tariffs can not exceed, is high for a major exporter, but WTO rules do not

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145 Weinberg, 48-49.
146 Rhee, 59.
mandate further reductions. Just as important, the WTO’s ability to deal with anti-competitive practices is still limited. Thus, further market opening will probably require further efforts by foreign governments.
Chapter VII: Conclusions

Korea’s economic performance over the past thirty-five years has lifted the country from abject poverty to prosperity. Part of the secret of that growth is that government “got the fundamentals right.” The government has followed policies that reduced unemployment, reduced inflation, raised rates of saving and investment, kept public expenditures at moderate levels, and rectified the country’s current account imbalance. The *sine qua non* of this success, and the most important “fundamental,” has been an industrial policy aimed at economic development.

Simply put, Korea’s spectacular growth, low unemployment, high saving rates, and massive investments in industry did not come from following free-market-oriented policies. Through the period of rapid growth, Seoul wore several hats. The government was simultaneously an owner, a financier, a nag, a trader, a cheerleader, and a strategic planner. Seoul’s policy threads were such an important part of the country’s economic fabric that one cannot credibly argue, as some have tried to do in the case of Japan, that Korea’s economy has expanded and prospered in spite of government intervention. The results of Korean industrial policies – sustained rapid economic growth, OECD status, and a stable of corporate powerhouses – speak for themselves.
At the same time, Seoul’s industrial policies have spun some problems. Government policies and incentives have created large conglomerates that cast massive and, at times, menacing shadows over the country’s economic landscape. Although the government has enacted laws and policies to correct some of the excesses associated with conglomeration, it has been held restrained by the perception that anything bad for the chaebol is bad for Korea.

South Korean worship at the alter of manufacturing competitiveness has also led to the slighting of other aspects of economic and social well-being. The country’s capital markets are underdeveloped, and its banking sector is weighed down by bad loans. Korea’s transportation infrastructure is on the verge of being overwhelmed and has become a drag on Korean competitiveness and living standards. The small business sector is, in general, heavily protected, noncompetitive, or both. Some economists have even argued that Korean productivity growth – the ultimate determinate of increases in living standards – has been unaffected, or even hampered, by the country’s industrial policies.

In some ways, investment-led and export-led growth – and the high rates of saving such growth fosters and demands – may no longer be feasible for the Korean economy. The county’s light-industry exports, which competed on the basis of low labor costs, can not become a major source of growth so long as China’s exports of these products continue to rise. Fierce global competition, and the rapidly rising cost of resource misallocation, are complicating Korea’s strategy of investing to create economies of scale and supply world markets. In short, it is time for Korea’s planners to consider allowing their economy to settle into a new mixture of investment, exports, and consumption.

The large corporate groups, whose fortunes the government has tried to promote, are also facing some challenges. Preferential access to funds has led to high debt burdens that the government seems bent on reducing. Heavy
investment in promoted products has led to excess capacity, supply gluts, and a
dangerous reliance on the profitability of a few key products. The protection that
nurture their development is now revisiting them as they export to, and invest
in, foreign markets.

Driven in large measure by calls for mutual market access, the Korean
government has taken some strides toward liberalization. Tariffs have come
down steadily during the 1980s and early 1990s, and the government agreed to
market opening in certain sectors, as part of the Uruguay Round Agreement.
Yet, Korea’s market remains far from free, and further liberalization of tariff and
nontariff barriers is necessary if Korea is to be as open as its major trading
partners are.

Based on the evidence presented in this report, it should be clear that Korea
currently plans to continue using industrial policies that risk distortion in both
domestic and global markets. Over the past thirty years, Korean industrial
policies have led the country to economic heights only dreamed of during the
1950s. In the meantime, certain business practices, public-and-private-sector
relationships, and expectations have become ensconced. Given the situation, it
seems inconceivable that Seoul, if left to its own devices, will jettison industrial
policy altogether and embrace deregulation and liberalization.

Instead, Seoul will probably continue its halting liberalization. More specifically,
it will continue implementing a two-track program, with selected liberalization
on one track, and protection and promotion on the other. This ambivalence
toward openness and deregulation in the markets, if unchallenged, will continue
to confound those outsiders who think drastic reform is imminent, and will also
continue producing policies that contradict both Seoul’s international
agreements and its goals for domestic reform.

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Such policies are not in the best interests of Korea or the international community. For Korea, the potential costs of the status quo are high. Long-standing problems, such as chaebol dominance and shaky banks, will only get worse with time, and they could prove intractable if the country takes a breather from its rapid economic growth. The perception among its trading partners— that trade with Korea is somehow rigged and not mutually beneficial—could cause trade friction.

For the international community, the benefits of a more open Korea are clear. Obviously, foreign companies and workers would gain from better access to the Korean market, but the exposure of chaebol to market forces would be equally important. Unconstrained by market forces, the chaebol will be more likely to over-invest in production capacity, more likely to dump, and more likely to sign on to foreign government programs that blatantly violate principles enshrined in the WTO, such as national treatment.

Moreover, the reform process in Korea has even wider repercussions, because it may determine whether the costly mistakes of the past are repeated. For decades, the United States and other countries sat back and watched Japan pursue discriminatory policies that clearly ran contrary to the maintenance of a free trade environment. The dislocations spawned by these policies eventually moved these countries to action, but only after the costs of Japanese protectionism became too high to bear. Reform in Japan has not come easy, and the process of opening that country has bruised feelings on both sides of the Pacific.

Worse yet may be the lessons that other countries have learned from watching Japan. Korea is only one of many important economies that, while not copying all of Japan’s policies, certainly learned a thing or two about creating comparative advantage through the use of industrial policies. A Korea that
reforms promptly and effectively, while remaining competitive and prospering, would offer a powerful argument for liberalization, an example that other countries would undoubtedly heed. In the long term, this could be the most important reason for the United States and others to take an interest in Korean economic reform.
Chapter VIII: Recommendations

As indicated in the preceding chapters, the Korean economy is more open today than ever before, but the Korean government continues to follow policies that distort the flow of goods, services, and capital. Given the stage of its economic development, its unbalanced domestic economy, and its underdeveloped capital markets, Korea’s best interests would be served by abandoning the industrial policies of the past and accelerating down the path of liberalization and deregulation.

The Korean Government Should . . .

1) get serious about reforming the chaebol

The chaebol have become a subject of controversy both inside and outside of Korea. Korean citizens view the conglomerates’ economic dominance with suspicion and Seoul bristles at their willingness to flout government efforts at reform. Meanwhile, foreign companies are concerned that the chaebol, partly shielded from market forces at home, compete unfairly abroad.

The cure for these ills seems obvious. By opening up their market to more foreign competition, the Korean government can set in motion a process that will ultimately solve many of the country’s chaebol problems. Foreign competition across all economic sectors will force the chaebol to be more careful with their resources and encourage them to focus on their core sectors – a goal the Kim
administration has been touting for years. Greater foreign access would also increase choice, and lower prices, for domestic consumers while reducing economic concentration.

In addition to opening its markets, the government must stick to its guns when it comes to internal reforms. Several times during the past decade, the government has announced policies aimed at limiting chaebol diversification and debt, only to back off, or even to reverse course, during the implementation stage. If Seoul is serious about reform, it should formulate sensible and credible policies and then implement them.

Seoul should also strengthen its FTC. During the past year, the agency has made a number of serious proposals that, if adhered to, would go a long way toward encouraging market-based competition in the Korean market. If Korea is to rid its economy of cartels and reduce the chaebol’s economic dominance, it must have a strong FTC, with the unwavering support of the country’s political leaders.

2) *establish a timetable for liberalization*

The decision to liberalize aggressively should be made as soon as possible, so that the chaebol can begin to factor open domestic markets into their strategic plans. The government should produce a credible road map and a reasonable timetable to guide the reform process. The sooner the government makes this decision, the better. Seoul’s current two-track approach is sending mixed signals to the chaebol and to Korea’s trading partners, and is hindering developments that could erase the damaging legacies of past industrial policies.

As part of its plans, the government should consider accelerating tariff reductions in sectors where it is already competitive; implementing policies to ensure that the subsidies and monopolies created by SOC projects are not used
in an anticompetitive manner by related firms; and making a commitment to
fund only precompetitive research.

3) open its capital markets

In regard to the OECD’s financial sector liberalization codes, Korea should bring
its compliance level into line with the OECD average of ninety percent. This
would constitute a genuine “big bang,” perhaps even upstaging the recent
Japanese announcement of financial-sector liberalization. Korea should learn
from Japan’s mistakes: Tokyo’s importance as a financial sector is declining due
to overregulation; Japanese banks, like Korea’s, are weighed down by bad debt;
and financial innovations in Tokyo are few and far between.

Capital inflows could very well strengthen the won in the short term, hurting
Korea’s export competitiveness in the short run. The resulting lower interest
rates, however, could be a boon for small businesses and entrepreneurs. Koreans
might also be reluctant to allow higher levels of foreign ownership in the form of
FDI, but experience shows they have little to fear.

4) promote inward foreign direct investment

The government has taken some steps in the direction of promoting inward
foreign direct investment, but more must be done to overcome the perception
that Korea’s market is rigged and, thus, inordinately expensive to penetrate. The
benefits of increased FDI in Korea would be considerable. Although foreign-
invested firms often run trade deficits for their host economies, they generally
rely heavily on local suppliers. For instance, the U.S. content of production by
Asian affiliates of U.S. multinational corporations is about ten percent, which
means that ninety percent of the value added by these affiliates is local.147
Foreign firms would provide a substantial counterweight to the chaebol, would

147 Lawrence Chimerine, Andrew Z. Szamosszegi, and Clyde V. Prestowitz, Jr., Multinational
improve management and production processes, and would help to nurture Korea’s SME sector back to health.

5) *take its international commitments seriously*

By joining the OECD, Korea has committed itself, in effect, to behave like an advanced country in conducting its international economic affairs. That being the case, the government should cease market-distorting tactics, such as the encouragement of frugality campaigns that inevitably turn into anti-import campaigns, blatant exchange-rate management, and frequent policy loans.

**The U.S. Government Should . . .**

1) *let Seoul know that its decision on reform will color future U.S. trade policies toward Korea*

If Korea decides to pursue a two-track policy that relies heavily on market-distorting industrial policies, the United States should be vigorous in its use of the WTO, and of the remedies specified in U.S. trade law, to protect U.S. commercial interests. If, on the other hand, Korea makes credible promises of reform, provides a reasonable down payment on liberalization, and liberalizes on schedule, the U.S. policy should be more accommodating.

The United States has several policy tools it should not hesitate to use to protect U.S. commercial interests and to promote market opening in Korea. For instance, the U.S. government can:

- monitor price differentials among Korea and its trading partners. Wide variations in foreign and domestic prices are often a sign of closed markets and anticompetitive practices. Keeping close tabs on prices will enable Washington and other countries to make certain that market mechanisms in Korea are indeed working.
• self-initiate dumping cases. The U.S. government has the legal authority
to initiate dumping cases without waiting for private-sector approval.
The self-initiated dumping case against Japanese semiconductor
producers in December 1985 was key to bringing the Japanese
government to the bargaining table.
• enforce existing antitrust and tax laws that apply to Korean companies
operating in the United States, in order to ensure that they are in
compliance with U.S. laws.

2) enforce compliance with prior market-opening promises
It is often easier to reach an agreement on market opening than it is to ensure
compliance, and Washington, all too frequently, has permitted market-opening
promises to be broken. Promises not kept breed more unkept promises and,
ultimately, a lack of respect. The U.S. government should not hesitate to retaliate
if Korea breaks past promises, such as those made in the 1995 auto agreement.

3) seek out allies in third countries
U.S. companies are not the only ones that stand to lose from unfair subsidies or
closed Korean markets. The U.S. government should ally with others that feel
Korean policies are breaking WTO rules.

During the early 1980s, the U.S. government missed a golden opportunity to sign
onto a European filing, based on GATT article XXIII, charging that Japanese
policies had “nullified and impaired” the commercial benefits that should have
accrued from previous Japanese liberalization. Absent U.S. support, the
Europeans pulled their case, and European bitterness subsequently hampered
bilateral cooperation on the Japan problem. It is clearly not in the U.S. interest to
repeat the same problem in the case of Korea. The European Union is
considering WTO action targeted against Korea’s frugality campaign and tax
treatment of imported spirits. The United States should consider cooperating
with the Europeans on these and other areas where Korean government policies are blocking imports.

4) **insist on a significant increase in Korean conformity to OECD codes**

The OECD gave Korea a break by approving membership despite its closed capital markets and weak protection of worker rights. The Korean government has since broken its promise to reform labor practices by taking a secret vote that, some say, makes Korean labor law less labor-friendly than it was before. Major strikes by Korean unions were successful in altering the government’s labor policy, but the United States should encourage the OECD to make clear that it expects Korea to live up to the letter of all pledges it made when seeking OECD membership.

5) **seek allies in Korea**

An ample share of Koreans, in both public and private life, agree that their government should liberalize and deregulate the Korean economy. Any action – bilateral or multilateral – should be crafted with an eye toward securing the maximum number of allies in Korea. Liberalization has already led to safer buildings and bridges. The U.S. government should build on these and other successes.

6) **make sure that subsidies associated with Seoul’s high-tech development programs and SOC projects are not distorting international trade or causing injury**

Seoul’s new industrial policy provides billions of dollars to Korean firms for precompetitive and applied research and development. Precompetitive and basic R&D funding is exempt from countervailing duties by the GATT but, in practice, it is difficult to distinguish between different forms of funding.\(^{148}\) Moreover, Korea, a developing country when the Uruguay Round concluded, does not

have to comply with the subsidies provisions until 2010. All of this offers Korea substantial leeway to provide subsidies to the chaebol.

Washington should keep a close eye on the impact of Korea’s subsidy regime. The government’s reliance on subsidies seems odd, given Korean competitiveness in certain sectors. Further, the revenues and subsidies generated by the SOC monopolies could fund applied research activities in related companies indirectly. The U.S. government should take whatever steps are necessary to clarify the WTO subsidies language, investigate whether Seoul’s SOC monopolies are generating subsidy equivalents to HCI and high-tech industries, and use countervailing duties when subsidies are found to exist.

**Finale**

As the twenty-first century approaches, Korea and other countries will have to decide whether the momentum of trade liberalization over the past forty-five years will continue. Trade liberalization has improved global living standards at an unprecedented rate, and it will generate further gains, if permitted. The greatest threat to such continued improvement would be a broad-based shift of public opinion against free trade in the world’s major importing nations.

If, for instance, Americans were to feel that mutuality is lacking, on the whole, or even in high-profile product categories, the free-trade consensus would be difficult, if not impossible, to preserve. The best way to avoid such a shift is for the world’s major economies, including Korea, to allow mutual access to foreign goods and services. It is incumbent on Korea, therefore, to keep the free-trade momentum moving in the right direction.

Coincidentally, it is also in Korea’s self-interest.