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South Korea's Economic Prospects

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Summary

As South Korea has completed a full year of restructuring under an International Monetary Fund (IMF) imposed program, the prospects for a sustained economic recovery are mixed. While the financial crisis that broke out in October 1997 has been alleviated, the contraction of South Korea's economy intensified in 1998. A significant drop in Gross National Product, as well as a rapid increase in unemployment, has precipitated Seoul's most serious economic and social crisis since the end of the Korean War. To return the economy to a healthy growth trajectory, the government is attempting to reform the financial and corporate sectors, as well as to create more flexibility in labor markets. Analysts now predict that the South Korean economy might resume growth in the last quarter of 1999. South Korea's economic crisis, in turn, is having both short and long term consequences for U.S. economic interests. Short term, the United States is experiencing a rising trade deficit with South Korea, as well as increased conflict on a number of sectoral trade issues. Longer term, however, the reforms that Seoul is implementing have the potential to make it a much more open, important, and stable trade partner. This report will be updated periodically. A related CRS report is *Korea: U.S.-South Korean Relations--Issues for Congress*, CRS Issue Brief 98045.

Background¹

By the close of 1997, South Korea was in the midst of a serious financial crisis. Due in large part to a sharp increase in repayments required on short-term external debt, the country's foreign currency reserves dropped precipitously to a precariously low \$4 billion level. This undermined investor confidence and capital fled the country. The Korean *won* lost half its value, going from 800 *won* to 1,600 *won* to the dollar, within a few days. At the same time, some major industrial conglomerates (*chaebol*) declared bankruptcy, and the value of the Korean stock market plummeted. To deal with the crisis, the government agreed in late December 1997 to the terms of a \$57 billion support package put together

¹ Sources of information include various reports of the International Monetary Fund, the Korean Economic Institute of America, and the Economist Intelligence Unit Country Reports.

by the International Monetary Fund (IMF), and engaged in a U.S.-backed negotiation on debt-payment moratorium and rescheduling.²

As a quid pro quo for the IMF emergency loans, South Korea agreed to pursue tight monetary and fiscal policies, to refinance and restructure the banking system through direct government assistance, and to enact wider policy reforms aimed primarily at making large conglomerates and labor markets more efficient. Buttressed by laws passed in early 1998 to toughen financial oversight and agreement by international banks to reschedule foreign debts, Korea's financial crisis began to stabilize. By year-end 1998, Korea was experiencing major improvements in its financial position with foreign exchange reserves approaching \$50 billion and with an annualized current account surplus of about \$40 billion. In January 1999, Korea began paying back its IMF loan, and international credit agencies began upgrading its sovereign risk rating from junk bond to investment grade status.³

Despite the improvement in Korea's financial position, its real economy continues to suffer. The overall economy contracted by 6% and unemployment rose to about 8% in 1998. No growth is predicted until the last quarter of 1999, and unemployment is expected to continue to rise as thousands of small and medium sized companies go bankrupt every month. Behind these numbers are painful adjustments for millions of ordinary Koreans, particularly in terms of job losses and a dramatic decline in living standards.

Restoring Economic Growth

Restoration of economic growth depends on both improvements in the global economy and implementation of internal reforms. Improvements in the health of the global economy, particularly the Asian economy, would do much to boost Korean growth. Nearly 50% of Korean exports now go to Asia, and the export sector has been hard hit by economic declines there.

While South Korea has limited influence on improving the global economy, it can work to restore its own economic growth by enacting structural reforms more vigorously. According to a number of analysts, the fundamental cause of Korea's economic plight is that capital and labor productivity in most industries are less than 50% of levels in the United States and Japan. Low capital productivity resulted from a banking system that provided the *chaebol* with easy credit for basically undisciplined capacity expansion in a growing number of industries. Not needing to worry about profitability, the top *chaebol* created considerable overcapacity in industries such as cars, petrochemicals, semiconductors, and steel. At the same time, under political pressure to avoid labor troubles, the *chaebol* over the past decade awarded labor a five-fold increase in wages that was not matched by increases in productivity.

² For background, see Nanto, Dick K. and Vivian C. Jones, "South Korea's Economy and 1997 Financial Crisis," CRS Report 98-13 E, December 29, 1997, 29 p.

³ WuDunn, Sheryl. "South Korea's Mood Swings From Bleak to Bullish," *New York Times*, January 24, 1999, p. A 3.

The IMF program provides external pressure to assure that productivity-enhancing reforms of the banking, corporate, and labor sectors take place. While some critics have argued that Seoul has not moved fast enough, the government has maintained that much is being done, particularly given the wider economic and social repercussions that have to be considered in the implementation process. All agree, however, that the domestic reforms are indispensable for economic recovery.

Banking Reforms. A key component of Korea's reform program is a comprehensive restructuring and recapitalization of the banking system. Korea's banks are burdened by a high level of non-performing loans and an eroded capital base. One estimate is that 20% of all bank loans are to some extent non-performing and that half of those will have to be written off.

The first step the government took to deal with this problem early in 1998 was to establish an independent, financial supervisory institution called the Financial Supervisory Commission. Next a total of 94 financial institutions, including 16 merchant banks, two securities firms, and one investment trust, were closed. Remaining banks have been ordered to clean up the number of non-performing loans to meet international capital adequacy standards. The government has also announced, and partially funded, a 64 trillion *won* (\$54 billion) fund to purchase non-performing loans and to fund bank restructuring.⁴

The government has decided to deal with the six biggest and most troubled banks through mergers or sales to foreign investors. The hope is that "super" banks will have enough leverage over the *chaebol* to begin allocating credit efficiently. In return for an infusion of new capital into the troubled banks, the government is demanding cost reductions through deep cuts in branches and staff or other efficiency measures.

Some fear that this plan could prolong the financial crisis by forcing strong banks to take on the problems of weaker banks. In June 1998, for example, the government closed five commercial banks, but had healthier banks take over the assets. While the merged banks are under orders to restructure and cut costs, no plans have been announced.

Corporate Reforms. Efforts to restructure Korea's banking sector are also intertwined with corporate sector reforms. The main problems deal with an incredibly high corporate debt level and weaknesses in corporate governance, especially in the dominant *chaebol*.

Large Korean companies rely on debt as their main source of financing with extraordinarily high debt levels. The level of corporate debt in Korea has been estimated by the IMF to be between \$500-\$600 billion, of which \$60 billion is external debt. Short term liabilities accounted for half the total, making Korean companies vulnerable to economic downturns, changes in interest rates, and changes in creditor perceptions.

The vulnerability of Korean companies to cyclical downturns is intensified by their ownership and financial structures. A non-transparent structure, combining a large number

⁴ Lee, Kyung-Tae. "Korea's Economic Transition: A New Growth Paradigm," *Korea Economic Institute of America Economic Update*, Volume 9, Number 4, November 1998, p. 2.

of affiliates with cross shareholding and debt payment guarantees, makes the failure of one or two companies a threat to the viability of the entire *chaebol*.

Top priority is being given to the reform of the five largest *chaebol* (*Hyundai, Samsung, Daewoo, Lucky-Goldstar, and Sunkyung*), given the huge role they play in the overall Korean economy. In what is called the "Big Deal," the government is pressuring the *chaebol* to swap businesses. For example, *Samsung* has agreed to hand over its car manufacturing affiliate to *Daewoo* in return for *Daewoo's* electronics unit. Also in an effort to eliminate duplication and become more specialized, the *chaebol* leaders have agreed to cut the number of their subsidiaries nearly in half. The proceeds from the sale (an estimated 20 trillion *won* or \$16 billion) of these non-core companies will be used to reduce corporate debt. The *chaebol* leaders have also reaffirmed deadlines set for preparing consolidated financial statements in 1999 and for unraveling their cross-subsidiary loan guarantees by March 2000.⁵

While President Kim Dae Jung has been taking a leading role in pushing the *chaebol* leaders to implement substantial reforms, many analysts caution that underlying problems of overcapacity and politically directed credit need to be addressed. Under this view, true restructuring involves shutting down money-losing enterprises. The closing of plants and reduction of excess capacity, of course, is vehemently resisted by both corporate captains and organized labor.

Labor Reforms. The government's efforts to liberalize the labor market by passing new labor laws or strictly enforcing labor laws with regard to strikes have faced considerable resistance. The labor market has been very rigid because of the tradition of lifetime employment. While trade unions appeared to accept an end to lifetime employment guarantees in February 1998 based on the promise that *chaebol* owners would give up some of their economic power and make themselves more accountable, efforts to push through reform have been hampered by political stalemate and the lack or inadequacy of state unemployment benefits. The opposition Grand National Party, with close links to big business, has attempted to weaken a number of labor reform proposals.

In order to maintain social stability during the reform process, the government has been broadening unemployment benefits. As of October 1, 1998, unemployment insurance was expanded from coverage of only those displaced workers who lost their jobs at large corporations to coverage of all displaced workers. In addition, the government has budgeted an excess of 10 trillion *won* (\$8.5 billion) for social welfare purposes. If the *chaebol* begin shutting inefficient plants and laying off workers on a significant scale, demand for social services and unemployment benefits could soar.

U.S. Economic Interests

South Korea's economic crisis will have both short term and long term consequences for U.S. economic interests. On balance, the effects are likely to be mostly adverse in the short term, but more favorable over time.

⁵ Lee, Charles S. "Chaebols Again Promise Kim They Will Reform," *Far Eastern Economic Review*, p. 52.

Korea's economic crisis will have the most immediate effect on U.S. exports and imports. Contraction of the Korean economy and depreciation of the *won* reduced demand for U.S. exports in the first 10 months of 1998 by 41%, dropping U.S. exports from \$21.6 billion in 1997 to \$12.6 billion in 1998. All major U.S. export sectors - capital goods, consumer goods, and agricultural products - were affected. South Korea dropped from being the fifth largest country market for U.S. exports in 1997 to being the 10th largest market in 1998.

At the same time, U.S. imports from South Korea continued at 1997 levels (\$19.7 billion in exports through the first 10 months of 1998 compared to \$19.3 billion during the same period of 1997). U.S. imports from South Korea are concentrated in steel, computers, cars, and video equipment. Among these sectors, steel imports surged by more than 125% over 1997 levels.

As a result mostly of the steep drop in U.S. exports to South Korea, the U.S. trade surplus with Korea, which totaled \$1.9 billion in 1997, moved to a deficit position of about \$7 billion in 1998. This reversal came after a sustained upward trend over the past few years.

South Korea's trade surplus with the United States can be expected to grow in 1999. On the one hand, Korean demand for U.S. exports of machinery and industrial inputs is likely to remain depressed as the Korean economy remains in recession for most of the year. On the other hand, U.S. demand for Korean goods is likely to grow due to continued U.S. economic growth and the increased price competitiveness of Korean exports. The rising trade deficit, in turn, is likely to lead to increased political pressures to limit Korean export surges in particular sectors, as well efforts to improve market access for U.S. exports to Korea.

Political pressures to limit Korean exports are being felt in the steel sector. A number of U.S. steelmakers and unions are pressing the Clinton Administration to impose quotas of steel imports, which grew overall by 30% in the first 10 months of 1998. Korean exports have been singled out by U.S. steel interests due to their 86% increase in 1998 and long-standing allegations that Korean steel producers have benefitted from low-interest loans and subsidies from the Korean government.⁶

U.S. steelmakers and workers have also alleged that unfair subsidies were provided to Hanbo Steel, Korea's second largest steel producer. According to industry sources, Hanbo's access to credit on preferential terms enabled it to undertake construction of one of the largest integrated steel mills in the world. Hanbo collapsed in January 1997, but the South Korean government allegedly continued to provide grants so that Hanbo could continue its operations. The U.S. steel industry and congressional steel caucuses have repeatedly pressed the Clinton Administration to address these concerns of unfair competition. In the omnibus spending bill passed in October 1998 (P.L. 105-277), Congress directed (section 621) that the Office of the United States Trade Representative report to Congress within 60 days on the Korean government's support for Hanbo and its steel industry.

⁶ Burton John. "Koreans Cut Steel Exports To Stave Off Clash With US," *Financial Times*, January 12, 1999, p. 7.

Administration trade officials historically try to deflect pressures to limit import penetration in key sectors by increasing efforts to open up markets to U.S. exports. Better market access conditions for U.S. exports is viewed as a way of minimizing the political fall-out from a rising bilateral trade deficit. Efforts along these lines in certain sectors, particularly automobiles, could prove difficult. Even though the Korean government has recently pledged to lower tariffs, and eliminate other discriminatory barriers, the drop in projected demand for automobiles in Korea means that trade in this sector will remain sensitive. In 1997, for example, U.S. automobile exports to Korea totaled \$83 million, while Korean automobile exports to the United States totaled \$1.9 billion, for a \$1.8 billion deficit.

Longer term, assuming Korea returns to a position of sustained growth, U.S. economic interests should be substantially enhanced. A major reason is that the kinds of changes that Korea is being required to undertake under the IMF program are basically congruent with longstanding U.S. trade and investment liberalization objectives. These entail a much more open market, including elimination of trade-related subsidies, and restrictive import licenses. They also include greater transparency in both Korean corporate and governmental decision-making, wider participation by U.S. companies in the Korean economy, and less policy-driven bank lending which in the past had given rise to overcapacity in industries such as steel, automobiles, semiconductors, and shipbuilding.

Perhaps the most promising changes have occurred in the area of foreign direct investment. In an effort to attract more foreign direct investment as a way of fueling Korea's economic recovery, the Kim Administration has enacted sweeping changes in its foreign direct investment regime. Buttressed by an "attract foreign capital" motto, all limits on foreign investment in the local bond and money markets have been lifted, and the ceiling on foreign investment in the stock market has been eliminated. Foreign banks and securities companies have gained the right to establish local subsidiaries. In June 1998, the Korean government allowed hostile takeovers of Korean corporations by foreigners to take place without any reservations. Restrictions on foreign ownership of land have also been eliminated.⁷

Combined with cheaper asset prices, the liberalized environment contributed to a record amount of foreign direct investment in 1998. The nearly \$9 billion invested by foreigners in Korea during 1998 was more than one-third the entire amount invested in Korea since the mid-1960s. While the U.S. share of foreign direct investment in Korea remains around one-third, South Korea's growing receptivity to foreign investment could lead to a much larger U.S. corporate presence in Korea over time.

⁷ Lee, Charles S. and Michael Vatkotis, "South Korea Warms Towards Foreign Investors," *Far Eastern Economic Review*, December 24, 1998, p. 51.