

Korea's Economy 2010

Korea's Economic Prospects and Challenges

Korea's Economic Stability and Resilience in Time of Crisis

The Republic of Korea and the North Pacific Economy: After the Great Panic of 2008

Housing Policy, Mortgage Markets, and Housing Outcomes in Korea

Financial Crises and East Asia's Financial Cooperation

U.S.-Korea Economic Relations: A (Historical) View From Seoul

U.S.-Korea Economic Relations: A Washington Perspective

The Rocky Road for Modernizing the North Korean Economy

How Available are DPRK Statistics?

a publication of
the Korea Economic
Institute and the
Korea Institute for
International
Economic Policy

Volume 26

CONTENTS

Part I: Overview and Macroeconomic Issues

- Korea's Economic Prospects and Challenges**
Subir Lall 1
- Korea's Economic Stability and Resilience in Time of Crisis**
Lee Jun-kyu 8
- The Republic of Korea and the North Pacific Economy: After the Great Panic of 2008**
Jeffrey Shafer 14
- Part II: Financial Institutions and Markets**
- Housing Policy, Mortgage Markets, and Housing Outcomes in Korea**
Kim Kyung-hwan and Cho Man 19
- Financial Crises and East Asia's Financial Cooperation**
Park Young-joon 28

Part III: External Issues

- U.S.-Korea Economic Relations:**
A (Historical) View from Seoul
Kim Wonkyong 35
- A Washington Perspective**
Deena Magnall 41
- Part IV: North Korea's Economic Development and External Relations**
- The Rocky Road for Modernizing the North Korean Economy**
Bradley Babson 45
- How Available are DPRK Statistics?**
Lee Suk 52

EXTERNAL ISSUES

U.S.-KOREA ECONOMIC RELATIONS: A (HISTORICAL) VIEW FROM SEOUL

By Kim Wonkyong

When the Korea Economic Institute (KEI) asked me to write an article for *Korea's Economy 2010* and told me they assumed the title would be "U.S.-Korea Economic Relations: A View from Seoul," I paused for a while. Traditionally, the economic counselors at the ROK embassy have written these annual articles. They usually listed major outstanding trade issues of the time, mostly sectoral disputes over perceived trade barriers in the Korean market; evaluated the state of our economic relations by the measure of the seriousness and frequency of those trade disputes; and ended with an expression of hope for a more peaceful trade relationship in the year to come. These articles have been useful during periods of frequent and fierce trade conflicts, particularly in the 1990s, and have helped educate U.S. audiences about Korea's positions on current trade issues. In the opinion of Korean policymakers, Washington policymakers' level of understanding of the Korean economy has been rudimentary. If the facts were better known to them, it has been thought, Seoul would have fewer trade conflicts with Washington. In fact, this was one of the reasons why KEI was established in Washington, D.C., in the first place, in 1982. My question is: Is this philosophy valid today?

I believe we have moved beyond that stage. A lot has changed since the last full-scale trade conflict erupted between Korea and the United States in 1998, over perceived market access barriers to Korea's automobile market. The introduction of a rules-based international trading system under the jurisdiction of the World Trade Organization (WTO) in 1995 has virtually transformed the world's trading landscape and prohibited unilateral retaliatory measures, such as those mandated by Section 301. The past decade has also observed dramatic changes in the structure of the world's economic governance. A prominent change is the rise of China's economy and China's influence in the economic affairs of the world; another change is

the creation of the Group of 20 (G-20) summit as the premier forum for the world economy.

What corresponding changes are being made to the Korea-U.S. economic and trade relationship? If, through the changes of the last decade, our trade relationship has evolved from one narrowly focused on outstanding trade issues to a broader and more strategic relationship, as I will argue in the following section, what are the challenges and opportunities that lie ahead of us? This year, instead of writing a traditional article focused on the trade issues of the moment, I approach the topic from a historical perspective, which may help policymakers view one of the most important and dynamic relationships on Earth in an appropriate light.

Changes in Korea-U.S. Economic Relations: A Historical Perspective

In my view, the Korea-U.S. economic relationship has evolved through three stages since Korea embarked on its ambitious trade liberalization programs in the mid-1980s. It started with a period of burgeoning trade disputes between the two countries. As Korea rapidly liberalized its economy and envisioned itself as an open trading nation by the late 1990s, the relationship improved. Now we see the development of an economic relationship as strategic partners. The following is a brief account of that evolution from the perspective of a student of Korea-U.S. trade relations from Seoul.

Mid-1980s to 1994: Bilateral Trade Disputes Begin

Although Korea joined the General Agreement on Tariffs and Trade (GATT) in 1967, until the mid-1980s it maintained a long list of products whose importation required government approval. In the early 1980s, the proportion of liberally traded products was around 65 percent of all traded products. Despite strong national-

istic sentiments and demands for the protection of so-called infant industries, a certain group of liberal policymakers and economists believed trade liberalization was key to improving the long-term competitiveness of Korean industries. These people often had economics degrees from U.S. universities, worked in the Korean government's Economic Planning Board (EPB), and were armed with liberal economic theories and a vision for Korea as an open trading nation. They prevailed in the fierce intragovernment debates on Korea's future economic policy, and in 1984 the Korean government embarked on voluntary trade liberalization programs. In 1985, the Korean government created a special organization, the Overseas Cooperation Committee, which oversaw the liberalization programs and trade negotiations with foreign countries. This was the first time that the Korean government created an institution specifically focused on trade relations with foreign countries. Its functions and philosophy were inherited by the current Office of the Minister for Trade.

As Korea was moving forward with its liberalization programs, market-opening pressures from the United States were also picking up. From approximately 1982, when Korea started to record a trade surplus with the United States, Washington began to view Korea as another Japan, a mercantilist nation that protected its industries by encouraging exports and discouraging imports through the use of trade barriers and subsidies. The U.S. government decided to apply serious market-opening pressures. At that time, the U.S. government was suffering from the so-called twin deficits—budget and trade—and Washington was inundated with protectionist sentiment. The pressure led to aggressive Section 301 investigations under the Trade Act of 1974. Section 301 allows the U.S. government “to impose trade sanctions against foreign countries that maintain acts, policies and practices that violate, or deny U.S. rights or benefits under, trade agreements, or are unjustifiable, unreasonable or discriminatory and burden or restrict U.S. commerce.” With regard to Korea, Section 301 had been first used to open the insurance market but later was applied more broadly to other sectors.

Section 301 was not the only weapon used in trade conflicts. Anti-dumping investigations were frequently conducted, often resulting in the devastation of the relevant Korean industries. One incident that left a huge mark in Korean people's minds was the imposi-

tion of anti-dumping duties at a shocking rate of 65 percent on Korean photo albums in 1985. Because the manufacturers of these albums were small businesses, most of them went bankrupt and thousands of workers lost their jobs immediately. A lot of them had to go out to the streets to sell the remaining albums to passers-by, appealing to their patriotism. This eventually led to a nationwide campaign that asked every Korean family to buy one album. This was a rude awakening for the Korean people. They realized that the United States could be a ruthless competitor, contrary to the image of the generous big brother many Koreans held in their minds.

Trade disputes were so frequent that it became a part of our daily lives throughout this period, with the two governments engaging in negotiations on diverse sectoral issues, including tobacco, beef, financial services, and telecommunication services. These bilateral disputes were still limited in terms of scale and sectors, however, partly because from the early 1990s the biggest controversies were taking place in, and most attention paid to, the multilateral front. The whole country was in turmoil over the issue of its rice market liberalization under the Uruguay Round negotiations; however, the biggest trade disputes in our relationship were lurking just around the corner.

1995 to 2005: Transition Period

This period saw trade conflicts between our two countries reach their peak, then a gradual transition toward a more harmonious trade relationship. At first, issues that had caused relatively minor disputes in the previous decade now led to huge trade conflicts. In the mid- to late 1990s, Super 301 reviews and investigations of Korea's automobile market dominated the Korea-U.S. trade agenda. Super 301 refers to a provision Congress adopted in 1988, and was later extended by executive order of the president, requiring the U.S. Trade Representative (USTR) to identify and designate priority foreign-country practices that had the greatest effect on restricting U.S. exports. The USTR then would initiate a Section 301 investigation against the priority countries to obtain elimination of the practices that impeded U.S. exports under the threat of a mandatory retaliation.

After a painful but successful round of negotiations on automobiles in 1995, held under the threat of a Super

301 designation, the U.S. government eventually used its Super 301 authority and on 20 October 1997 designated Korea's automobile market a priority foreign-country practice. This allowed both governments to engage in negotiations for one year. If the negotiations did not produce a satisfactory outcome before the deadline, U.S. law required retaliation. This second round of automobile negotiations drew a huge amount of attention and caused grave worry among Koreans because Korea was mired in the Asian financial crisis and was thought to be in danger of bankruptcy if retaliatory tariffs were imposed on its exports to the United States. Eventually, the two governments were able to reach an agreement about when the time for negotiations under Super 301 procedures expired.

The 1998 automobile negotiations marked a turning point. If a typical scene in the Korea-U.S. trade relationship in previous periods showed the United States applying market-opening pressures on Korea, and Korea reluctantly and half-heartedly giving in to them, from 1998 onward the Korean government decided to dramatically liberalize its economy and aggressively pursue market-opening negotiations with its trading partners. The first of these efforts was the initiation of a bilateral investment treaty (BIT) negotiation with the United States. BITs concluded by the U.S. government provide a high level of foreign investment and investor protection and require that the other party take serious liberalization measures. If this negotiation had been initiated by the U.S. government, it would have meant yet another wave of pressure from Washington. But, amazing even some policymakers within the Korean government at that time, it was initiated by the Korean side. What led to this sea change in the Korean government's policy deliberations?

First, in its efforts to survive the Asian financial crisis, the Korean government accepted the responsibility for taking drastic liberalization measures as a condition of receiving bailout funds from the International Monetary Fund. Subsequently, the government overhauled the Foreign Exchange Control Act and renamed it the Foreign Exchange Transaction Act. Change was not limited to its name. It also eliminated the government approval requirement for most capital transactions involving foreign currencies. Another example is the enactment of the Foreign Investment Promotion Act (FIPA), which replaced the Act on Foreign Investment and Foreign Capital (AFIFC). The FIPA dramatically

eliminated AFIFC's regulatory limitations on the introduction of foreign direct investment (FDI). With these and other liberalization measures, the Korean economy became a liberal market economy to an extent it had never experienced before, and it was ready to make dramatic changes in its trade policies.

There was another important change behind the scenes. By this time the Korean people started to suspect that Korea's miraculous economic growth had topped out. They also felt that their economy was stuck in a "nutcracker," with advanced Japan on one side and China, rapidly catching up, on the other. The call for a more aggressive trade policy began to appeal to a broader base. Furthermore, the creation of the Office of the Minister for Trade in 1998 gave a new impetus to the pursuit of an aggressive trade policy. Before its creation, the Korean government's primary agency for trade policy was the Ministry of Trade and Industries (MTI). As its name implies, the MTI sometimes had self-conflicting missions of promoting domestic industries and international trade. The new Office of the Minister for Trade was less vulnerable to pressure from industries seeking protection and was ready to make dramatic changes to our trade policy.

Korea's first trade minister, Han Duk-soo, immediately embarked on ambitious trade negotiations designed to upgrade the domestic economic system to fit international standards and to open overseas markets. It included a BIT with the United States; a BIT with Japan; and a free trade agreement (FTA) with Chile, Korea's first-ever FTA endeavor. Chile was chosen as the first FTA partner because it was believed to have the fewest implications for Korea's agricultural sector. Chile's harvest period is during the agricultural off-season in Korea. Also, Trade Ministry officials thought that they needed more experience and understanding of FTAs before they could engage in negotiations with major trading partners. At the moment, they thought, all Korea could offer to major trading partners such as the United States and Japan was a BIT. While the BIT with Japan and the FTA with Chile were successfully concluded in 2001 and 2003, respectively, the BIT with the United States was never finalized. It was under negotiation until 2000, when it lost its political momentum and faded into oblivion. It had to wait until political momentum built up for a bigger relationship, the Korea-U.S. FTA.

2006 to Present: Toward a Strategic Partnership

Building upon the accomplishments of the previous period, Korea was now in a position to pursue a strategic economic partnership with its most important ally, the United States. However, when the Korean government proposed to initiate FTA negotiations with the United States in 2005, the U.S. government did not show enthusiasm right away. U.S. policymakers expressed doubts about whether Korea could accept the high-level liberalization measures an FTA with the United States would require and make the necessary changes to its economic system. Specific concerns revolved around Korea's ability to liberalize its heavily protected agricultural markets.

Koreans had doubts of their own. When the launch of the negotiations was announced in January 2006, protesters flooded the streets of Seoul to rail against the proposed FTA. They argued that the brutal capitalism of the United States would devastate Korea's infant economy, the agreement would destroy Korea's weak agricultural sector, and mighty U.S. negotiators would crush the incompetent Korean trade officials.

A core question here is why the Korean and the U.S. governments decided to jump into this venture given the level of skepticism, concern, opposition, and political constraints they faced. From the beginning, it was widely held that the agreement would be possible only with the direct involvement of the highest political authorities in both countries—involvement based on strategic as well as economic considerations. Faced with such daunting challenges, what were these strategic considerations that prompted policymakers to pursue the KORUS FTA? The answer to that question elucidates the defining characteristics of our current economic relationship as well as the challenges and opportunities that lie ahead.

New Challenges and Opportunities for the Korea-U.S. Economic Relationship

There are three prominent challenges the Korea-U.S. partnership faces today, which distinguishes the present from the past. First is the rise of China. The stunning growth of the Chinese economy has brought us to an era in which people talk about a "G-2"—the United States and China. Niall Ferguson, a Harvard history professor and the author of *The Ascent of Money*, wrote

in a *Financial Times* article entitled "The Decade the World Tilted East" that "we are living through the end of 500 years of western ascendancy." The notion that China has become a power to rival the United States is probably an exaggeration. But it is true that we now see and will continue to see an increasingly assertive China with regard to its rightful place in world affairs. Concerns are rising in the region about whether East Asia could transform its relations among member states in a peaceful and managed way. Accordingly, the U.S. role as counterweight and honest broker has become ever more important.

Another challenge, also related to the rise of China, is the decreasing market share of the United States and its lessening influence in the Korean market, and in Asian markets in general. Until 2003, the United States logged in year after year as Korea's largest trading partner. But it lost that distinction in 2004 and now is in fourth place, after China, the European Union, and Japan. Although trading volume with the United States has increased steadily during the past several years, it has not been able to match the exploding increases in Korea's trade with China or its rapidly expanding trade with the European Union and Japan. The United States has been lagging behind in the race to dominate fast-growing Asian markets. While Koreans welcome the economic opportunity China's vast market provides, growing dependence on China is a source of concern as dependence often comes with vulnerability.

Last, a more intriguing challenge has appeared on the Korean political horizon. For most of the past 60 years, it was inconceivable to Koreans that Korea's alliance with the United States was an option that they could take or leave. Our alliance with the United States was always at the epicenter of Korea's national strategy. But, more recently, what had long been inconceivable became conceivable, at least conceptually. Political groups espousing anti-Americanism were no longer hiding behind the scenes. They wanted to explore ways to pursue a future without relying on the United States as the linchpin for Korea's security and prosperity. In reaction, an increasing number of Americans started to view Korea as a country that may eventually fall into the Chinese orbit.

Policymakers in Seoul and Washington recognized these challenges and seized upon an opportunity to turn these trends around in one big swoop: the Korea-U.S.

Free Trade Agreement or KORUS FTA. Its conclusion would facilitate a mutually beneficial transformation of Korea's economic and trade relationship with the United States into a strategic partnership. It would also provide a foundation from which we could keep pace with Chinese ascendancy by strengthening strategic alliances among our businesses, dramatically improving those businesses' fortunes in each other's markets and reinforcing the Korea-U.S. security alliance by adding another rope to those tying the two countries together. After difficult negotiations that lasted from June 2006 to March 2007, both countries successfully signed the agreement on 30 June 2007. As of this writing, however, the agreement has not been approved by either country's legislature.

Where do we go from here? Some in the U.S. Congress would like to go back to the old days of trade conflicts and serving the parochial interests of their local industries and labor forces at the expense of the greater good. Korean politicians are not universally enthusiastic about the KORUS FTA, either. Opposition to it is still strong and vivid. Many National Assembly members would be happy if it were scrapped. With antitrade sentiments on the rise because of the global economic crisis, we may well go back to the bad old days. Alternatively, we can ratify the KORUS FTA and transform our economic relationship into a true strategic partnership that will enable us to be equal to the challenges of the next several decades. The choice is ours.

To the Korean people, the choice is clear. When the negotiations began in February 2006, 60 percent of Koreans opposed the KORUS FTA, and only 30 percent supported it. Ceaseless and impassioned public education efforts turned those numbers around. When the negotiations ended in April 2007, 60 percent of Koreans supported, and 30 percent opposed, the FTA. What accounts for this turnaround? Koreans have come to understand that, for them, the KORUS FTA is larger than the sum of its parts. Some of them still have doubts about its fairness, but they generally believe that its strategic benefits, which are not mentioned in any of the FTA's 270 articles of the 24 chapters, outweigh any shortcomings it might have.

The majority of Korean people believe that a strong alliance with the United States, a benign superpower without territorial ambitions, is the surest way of

keeping peace and of securing Korea's place in East Asia. That is a lesson we learned from our history and experience. When China was strong, or when it was dominated by a new ruler—say, the Mongolians in the 13th century or the Manchurians in the 17th century—Korea became a victim of their conquests. When Japan became strong or when it needed a cause to unify its constantly fighting warlords, it invaded Korea. In the late 19th century, when East Asia did not have a stable status quo power and Korea's future was precarious, a renowned Chinese scholar named Huang Zunxian wrote a book entitled *Choseon Chekryak* [Strategies for Korea]. It advised Korea to strengthen itself through reform and by “keeping close to China, creating ties with Japan, and allying with the United States.” Although the book's purpose was to prepare Koreans for Russia's southward march, some of its insights are still valid today, as Korea's external environment has not changed much.

Considering the state of international relations in East Asia today, many Koreans believe stability in the region can be best preserved when Korea and the United States maintain a strong political and economic relationship. Without an active role for the United States as a counterweight, it would be difficult to stifle flammable nationalism in China, Japan, and even Korea. To maintain this precious relationship, the Korean government has been truly faithful to our alliance. Recently, Korea decided to dispatch forces and a provincial reconstruction team to Afghanistan and is collaborating with the United States on a range of major global issues.

Furthermore, a growing number of Korean intellectuals maintain the view that Korea should open its own economy and lead economic integration in East Asia so that our neighbors may become greater stakeholders in Korea and have vested interests in peace. As the liberal peace theory suggests, economically interdependent countries become reluctant to disrupt otherwise profitable relationships. They will have stronger incentives to maintain their trading network as well as peace. Accordingly, in their domestic politics, there will appear stronger business and political groups with vested interests in preserving amicable relations with their trading partners. This scenario is more likely to become reality if economic integration in East Asia is not limited to our immediate neighbors. Korea should invite Americans and Europeans to come to Korea and

to make a profit as well as Japan and China, raising the stakes in peace.

Korea's strategies outlined above are perfectly consistent with U.S. interests. Through a solid strategic partnership with Korea, the United States will be able to maintain stability in East Asia and secure the U.S. share in the most dynamic and fastest-growing area in the world economy. From these perspectives, I believe Korea can work as an "anchor of peace and prosperity" in East Asia. Korea cannot be a "balancer" as in 19th-century European politics. That would lead to ruthless power politics being played in an East Asian setting and to instability in the region. But through Korea, the other players in East Asia can invest in peace and economic dynamism. Neither China nor Japan can play that role. Korea is a relatively smaller country in East Asia compared with its giant neighbors; however, because of that status, it may also be the only country with the potential to gain trust from all players in the region and play a reconciliatory role. But that is only possible when Korea is aligned with a strong outside power.

Prospects for 2010

Approval of the KORUS FTA is still the dominant issue in our relationship and the last test before we enter the next level of our alliance. After years in the doldrums, we are now seeing signs of positive changes. In November 2009, President Obama met with President Lee Myung-bak, and the two leaders completely agreed on the importance of the KORUS FTA and on their desire to move it forward. In his State of the Union address in January 2010, Obama outlined his plan to double U.S. exports within five years and said he wanted to strengthen America's trade relationship with Korea. Finally, the Obama administration has begun to see trade expansion as part of the solution, not part of the problem. As the ROK government has argued all along, implementation of the KORUS FTA is a way to create jobs and expedite economic recovery without a single tax increase. The ROK embassy will be working hard throughout this year to disseminate this message throughout the United States in coordination with U.S. businesses and workers.

There are still some outstanding trade issues between us, but none so contentious as those that marked our relationship in the 1980s and 1990s. Current issues

tend to concentrate on two areas: technical barriers to trade and sanitary and phytosanitary measures. Issues discussed in 2009 included allowing non-Korean labs to test lithium ion batteries for conformity with Korea's safety regulations; eliminating the home-country approval requirement for medical devices; and lifting the ban on U.S. live swine exports, which had been imposed following the occurrence of the H1N1 in the United States. In addition, as both of our governments drive policies to raise energy efficiency and reduce energy use, new measures are introduced, making changes to relevant regulatory systems. Businesses might have a hard time adapting to the changes, sometimes creating trade issues handled at the government level; however, through intensive contacts between the two governments including the bilateral trade consultations, both our governments have handled these issues remarkably well and are expected to do so again this year.

These opportunities and the spirit of cooperation may be spoiled if the economic crisis worsens and protectionism ensues. Again, the choice is ours. It will depend on whether we can look beyond the immediate temptations of protectionism and fashion a more constructive future—a future all of us may cherish and depend on for a long time.

Mr. Kim is Counselor for Economic Affairs at the Embassy of the Republic of Korea in Washington, D.C. Views expressed here are those of the author and do not necessarily represent positions of the ROK Embassy or the ROK Government.