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Implications for South Korea

For better or worse, the futures of North and South Korea are inextricably bound together. This linkage raises profound questions about the capacity of South Korea's still-maturing democratic political culture and about the economic and political issues posed by its relationship with the North and derivatively with other countries, most importantly the United States, China, and Japan. As much as the economic "miracle on the Han" is a well-deserved source of pride, it is the political evolution of the South—from military authoritarianism to managed elections to truly contested elections and empowerment of a once despised political opposition in little more than a decade—that is an even more compelling legacy.

The most difficult political issues would be created by the collapse and absorption scenario and the requirement to somehow give voice to the current residents of North Korea and incorporate them into South Korea's political culture. Presumably this would be accompanied by some kind of "lustration policy" to ban high-ranking members of the Kim Jong-il regime from holding positions of responsibility in a democratic unified Korea. Yet even the less apocalyptic scenarios of gradual integration pose their own challenges. How does a democratic polity like South Korea accommodate itself to the antithetical values represented by the North's dynastic Stalinism? Would the exigencies of engagement reflect themselves in the corruption and stifling of civil liberties as observed over the past several years? (Though to be fair, this cannot be blamed entirely on the engagement with the North—corruption and stifling of civil liberties seem to be regrettably enduring features of South Korean political culture.) How can South Korea's political leadership create a national consensus—so evidently absent today—on how to handle the North?

Likewise, while a collapse of North Korea could create dangerous international situations of great immediacy—possibly involving military forces from South Korea, the United States, China, and Japan—the more prosaic process of gradual rapprochement between Pyongyang and Seoul carries with it its own burdens. The most obvious is in terms of South Korea's relations with its alliance partner and security guarantor, the United States. Today, increasing numbers of South Koreans, accustomed to living for decades in the shadows of the North's forward-deployed artillery, do not regard the North as a serious threat. Growing prosperity and confidence in the South, in marked contrast to the North's isolation and penury, have transformed fear and loathing into pity and forbearance. Instead, it is the United States, an ocean away, that regards the North and its nuclear weapons program with alarm. As the United States has focused on the nuclear program, its ally, South Korea, has observed the North Koreans' nascent economic reforms and heard their talk of conventional forces reduction, and the gap in the two countries' respective assessments of the North Korean threat has patently widened. The divergence in threat perceptions has been reinforced by differences in attitudes toward a host of bilateral and global issues that have emerged in the post–9/11 world. (The Pew Research Center for People and the Press survey "What the World Thinks in 2002," for example, revealed that of 27 countries surveyed, the percentage of the South Korean public having a favorable image of the United States exceeded the percentage in only four other countries.) Whatever one thinks about the US military presence on the peninsula, a process of local tension de-escalation not accompanied by the elimination of the broader threat to global stability posed by the North Korean nuclear weapons and missiles programs is at a minimum a recipe for bilateral political tension between Seoul and Washington.

These are big issues and beyond the scope of this policy analysis. They will be set aside for the remainder of the chapter to concentrate on the economic policy issues. In the memorable words of that fictional San Francisco detective, "Dirty" Harry Callaghan, "A man has got to know his limitations."

The Economics of Engagement

In the five years since the 1997 crisis, South Korea has made better progress than any other country in Asia (Japan included) in addressing its economic problems (Noland 2002b). As Arthur Alexander (2003) has demonstrated, corporate leverage has fallen to less than half its precrisis level, the rate of return on capital has increased, and the share of corporate "winners" (low leverage, above average profits) has more than doubled.

In the financial sector, the share of bad loans has been driven below 3 percent to its lowest level ever from a high of more than 15 percent in March 2000, and the capital adequacy of South Korean banks exceeds 10 percent on the Bank of International Settlements (BIS) standard. The result of this successful restructuring has been continued improvements in the country's credit rating. In the past five years the country has attracted more foreign investment than in the previous 50 combined.

The world is in the midst of a technological revolution that is significantly improving productivity, organizational relationships within and among firms, and the distribution of income and wealth, and South Korea has adopted information technology faster than any other economy in Asia and leads the world in broadband access.[1] Information technology is changing the structure of the South Korean economy. Given the rigidities and uncertain futures of the *chaebol*, since the 1997–98 crisis, there has been an upsurge in start-up activity and initial public offerings in the stock market, and the government is supporting the establishment of venture capital firms to support this process.[2] Admittedly, not all these new firms were in high technology, and the creative destruction of 1997–98 may have generated a temporary surge in new incorporations, nevertheless these developments demonstrate that business does not start and end with the *chaebol*. Indeed, these new firms are changing South Korean corporate culture as well, replacing the hierarchy and secrecy that have characterized the *chaebol* with greater flexibility and openness, partly due to generational change, as the ranks of South Korean corporate management are swelled by Western-educated business school graduates.

At the same time that South Korea is emerging as a global high-tech leader, it is also becoming an increasingly important supplier of cultural products to the rest of Asia. Today, South Korean pop culture (film, music, and fashion) trends are followed throughout Asia as keenly as (if not more than) Japanese styles. South Korean firms are aware of this and are attempting to build franchise value on the back of the country's cultural cachet, both at home and abroad. Interestingly, in Arthur Alexander's analysis of returns to capital in South Korea, the entertainment industry was the only sector classified as a "winner" (i.e., high profit, low leverage) in each year of his sample.

And while Seoul is not quite yet the Swinging London of the 1960s, profound political, economic, and social changes are clearly under way,

1. For a comprehensive analysis of the "New Economy," see the *Economic Report of the President*, Washington: Council of Economic Advisers, January 2001. Although this report is oriented toward the US economy, its insights have a broad applicability to South Korea. See Yusuf and Evenett (2002) for an Asia-centric discussion of the same issues and Noland (2002b) for South Korean illustrations.

2. See Seong (2003) on the venture capital business.

and the government's attempts to turn the country into an international business hub, however quixotic they may be, will reinforce this process.

Yet, regardless of its economic progress or policy stance, South Korea remains vulnerable to the vagaries of North Korean behavior. In June 2003, Standard and Poor's (S&P), which is in the business of assessing risk on a cross-nationally comparable basis, issued a report reading in part "No rated sovereign . . . faces a more serious military threat than the menace that North Korea poses to South Korea. Among investment-grade sovereigns, the State of Israel and Taiwan face serious geopolitical risks, but the danger is less present. In the case of South Korea, the risk comes from a failed state with nuclear weapons that must extort money with military threats to prop up its regime" (Standard and Poor's 2003, 3). S&P went on to explain that this situation exerts a dampening effect on South Korean bond ratings.

Moreover, it is precisely South Korea's greater integration with the rest of the world that creates new vulnerabilities in this context. Financially, South Korea is more integrated into the world economy now than it was at the time of the 1994 nuclear crisis. Foreigners are major players in the capital markets, accounting for nearly 40 percent of stock market transactions, and South Korean residents have greater opportunities to move their funds abroad. The use by South Korean financial firms of off–balance sheet transactions and financial derivatives, which did not exist in 1994, is expanding rapidly. While it is true that the South Korean stock market actually rose during that earlier crisis, the expanded role of foreign participants and the increased complexity of the financial transactions mean that the market today is far less susceptible to political intervention than it was a decade ago.

The popular image of capital flight occurring when foreigners flee for the exits is belied by historical experience the world over—almost invariably it is the better-informed locals who are out the door first. The Bank of Korea (BOK) data reveal that during periods of uncertainty, while foreigners were net buyers in the stock market, South Koreans were net sellers. And although at present there is no indication of capital flight—enabling mechanisms that did not exist in 1994 are in place today—the South Korean population is badly split with respect to its attitudes toward the North, and older South Koreans, who evince the greatest wariness toward North Korea, are the predominant owners of the country's savings.

South Korea should do two things. First, commit to the principle that engagement should be done on efficient, transparent terms. The fundamental issue is that as long as the state maintains direct and indirect influence over specific capital allocation decisions by financial intermediaries, it will be tempted to use this influence to promote its policy toward the North. The Hyundai Asan corruption trials in which five South Korean government officials were convicted of illegally channeling funds through the Korea Development Bank to Hyundai Asan for use in the North is exhibit A in this regard.[3] Subsidization of engagement with the North can be justified from a social standpoint (it may promote evolutionary economic and political change in the North), but it should be done as neutrally as possible with respect to specific projects and firms. The simplest way of accomplishing this would be to put provisions into the tax code that would create an incentive for South Korean firms to invest in the North instead of moving operations offshore to other destinations such as China and Southeast Asia. In contrast to implicit hidden subsidies and political quid pro quos delivered through the public-sector financial institutions, this approach would be a way to capture the possible social benefits of engagement with the North on the basis of microeconomic efficient behavior of private firms. Market-compatible engagement would have the added benefit of encouraging learning on the part of the North Koreans for whom much of their interaction with the outside world has been on nonmarket terms, either through aid agencies, politically subsidized activities by South Korean firms, and fronts for intelligence-gathering activities. The notion that the road to riches is through the efficient transparent provision of services is a lesson that North Korean officials should be encouraged to learn.

Such a tax-based approach would also have the virtue of transparency. While one can argue that given the history of enmity and distrust between North and South Korea, public subsidization of Hyundai Asan's activities in the North was justifiable on the grounds that South Korea had to in effect offer a loss leader to get the process of engagement going, the illegal and nontransparent way in which the engagement policy of the Kim Dae-jung government was implemented has created a political backlash against engagement and arguably has made it more difficult to implement the policy in the long run.[4]

Second, while engaging, South Korea should prepare for the possibility of collapse. The North can be thought of as the world's largest contingent liability. The relevant policies could be thought of as those that are contingent on specific circumstances and those that are relatively invariant to the timing and specifics of an eventual North Korean collapse.

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3. Cross-debt guarantees to Hyundai Asan, the subsidiary responsible for activities in North Korea, were an issue in the disintegration of the parent Hyundai group. The Kim Dae-jung government's commitment to engagement with the North was so great that Hyundai's activities, undertaken at a time when the conglomerate was under great financial strain, were begun with the intent to create a moral hazard for the South Korean government, which would be unable to resist bailing out the *chaebol* should it encounter economic difficulties. The issue of "too big to fail" is discussed further later.

4. A similar, though smaller-scale, scandal over alleged under-the-table payments to North Korea involving the Roh Moo-hyun government erupted in October 2003. See Barbara Demick, "Sunshine from North Korea Has Its Source in Cold, Hard Cash," *Los Angeles Times*, November 17, 2003.

The specific to-do list in a collapse scenario was discussed in the previous chapter. Here the focus is on building the preparatory foundation—the policies that would be desirable whether or not North Korea existed. The specter of North Korea simply underscores the desirability of their adoption.

For the South Korean economy to continue to prosper, it must improve its mechanisms of resource mobilization, allocation, and management. The overarching goal should be to improve the functioning of markets. For this to occur, accurate information must be accessible, property rights must be enforced, and agents should be motivated by efficiency, not political considerations. So what can the government do to improve the business climate and create a stronger, more flexible economy in light of possible future contingencies?

First, markets operate on information, and better information facilitates greater efficiency in the allocation of capital. There is a general need to improve the quality of financial transparency in the South Korean economy. This requires improved accounting rules and conventions, truly independent accounting firms capable of auditing accounts, and a regulator capable of enforcing the rules with respect to corporate accounting and financial-sector firms—South Korea has made considerable progress since the 1997–98 crisis in this regard. Independent bodies have been established to rewrite South Korean accounting rules, bringing them closer to the International Accounting Standards (IAS), though additional progress would be welcome.[5] The South Koreans explicitly rejected the Generally Accepted Accounting Principles (GAAP) widely used in the United States and expressed some pride that Americans were looking into South Korea's reform experience in the wake of their own accounting scandals.[6] The production of consolidated financial statements under improved accounting rules beginning in May 2002 is another positive move. Unfortunately these positive developments have been overshadowed by a massive accounting and political influence peddling scandal involving the SK Group, South Korea's third largest *chaebol*. Additional accounting legislation has been proposed in the National Assembly but has yet to be enacted.

These improvements in practices have been backed up with heightened penalties for violators and more stringent enforcement. To cite a few examples, in September 2000, the Financial Supervisory Commission threw the book at Santong, one of Daewoo's main accounting firms, for conniving with its clients to falsify audits. In February 2001, facing

5. To cite an example: If a bank sells a nonperforming loan with a provision that if the loan does not meet certain performance rules, the selling bank will buy back the loan from the purchaser; under South Korean accounting rules, the bank is allowed to completely remove the loan from its books, despite the contingent liability associated with the buy-back provision.

6. Kim Yon-se, "US Imitates Korea's Accounting Reforms," *Korea Times*, May 12, 2003.

expiring statutes of limitation, Seoul prosecutors charged 34 Daewoo executives and accountants, including former chairman Kim Woo-choong, with fraud, though there are questions as to how serious the government is about tracking down the fugitive industrialist.[7] In March 2002, financial regulators accused seven of the largest accounting firms with malpractice involving 13 corporate clients. The Securities and Futures Commission sought criminal charges against two of the accounting firms and recommended the suspension of 26 auditors.[8] In July 2002, the Financial Supervisory Service (FSS) sent external auditors to examine the books at 100 companies suspected of irregularities, resulting in a number of indictments and convictions for financial crimes (Graham 2003). Unfortunately, although the number of professionals is increasing, the lack of trained accountants and auditors remains a constraint on the system.

With improvements in transparency, it becomes possible to impose capital-market discipline on corporate management.[9] Two institutional developments would facilitate this. The establishment of outside boards of directors would create an "inside" check on management abuse. This alone is no panacea, however: South Korea has successfully put new laws on the books regarding corporate boards, but the problem has been in implementation in a number of cases—incumbent managements have stuffed the boards with pliant cronies or even government officials.

A second desirable innovation would be the creation of independent institutional investors capable of monitoring management and fostering a market for corporate control. Related to this are the rights and treatment of "minority shareholders." As Graham (2003) points out, this appellation is a bit of a misnomer, because in some cases the "minority shareholders" actually hold bigger financial stakes in these firms than the insiders (often the company founder and associated family members). A number of shareholders rights groups, including the People's Solidarity for Participatory Democracy (PSPD) and its Center for Economic Reform and the Center for Good Corporate Governance, have had limited success in suing corporations for a variety of malpractices, but the law on class action suits has hampered this effort (Noland 2000, chapter 6). Again, legislation to facilitate

7. Thus far, the government has not referred Kim's case to Interpol and instead has merely asked South Korean embassies in countries where the fugitive industrialist is thought to be hiding. Many believe that he would implicate large parts of the South Korean political elite in the web of corruption.

8. Five of the accused firms have partnerships with the Big Five global accountancy groups, including Arthur Andersen of Enron fame. The accused clients included subsidiaries of the LG and SK groups (Andrew Ward, "South Korean Audits Under Fire," *Financial Times*, March 16, 2002). The Korea Deposit Insurance Corporation followed up by suing five of the firms for compensation for public losses resulting from "improper accounting" at the Daewoo and Kohap groups and separately sued the chairman of Kohap (Graham 2003).

9. See Cho (2003) for an overview of South Korean corporate governance issues.

class action suits by minority shareholders and to protect shareholders from false disclosure, unfaithful accounting, and stock price manipulation awaits approval in the National Assembly.

The creation of truly independent institutional investors would reinforce such activity. To the extent that such institutional investors exist in South Korea, they tend to be affiliated with the major *chaebol*. It would be desirable to separate financial and industrial groups, but this is unlikely to happen, and in fact, the October 2001 easing of restrictions on *chaebol* ownership of financial institutions goes in precisely the opposite direction.

Foreign investors now account for nearly 40 percent of trading on the South Korean stock exchange, and there have been instances of cooperation between some foreign institutional investors and the nascent shareholder rights movement exerting some beneficial effect. But the alliance with foreign investors allowed the *chaebol* to tar the good governance groups with the nationalist brush, and despite the increasing role of foreign firms in the domestic funds management business, it still appears necessary and desirable to develop independent South Korean institutional investors.[10] Regrettably, prospects on this front are inauspicious.

Another potential source of discipline on corporate behavior is the banks, and their operation and financial health have been considerably improved, despite their current problems with excessive issuance of credit cards. As mentioned previously, tremendous progress has been made with respect to nonperforming loans (NPLs), even taking into account the growing importance of household lending and increasing rates of personal bankruptcy. The recovery rate on NPLs of more than 30 percent, though lower than what was achieved by the United States in its relatively smaller savings and loan crisis, is in the same league of successful banking system rehabilitations in Finland and Chile and far higher than the comparable figure for Japan over same period (IMF 2003, box 3). This improvement in financial health has been facilitated by industry restructuring and consolidation, which despite labor-union opposition greatly reduced previously existing overstaffing.

Beyond the balance sheet issue, there is the critical requirement that financial intermediaries change their behavior and make investment decisions on economic, not political, grounds. There are multiple grounds for optimism on this score. The government, which at the height of the crisis owned three-quarters of the banking system, has largely sold its holdings and effectively denationalized the industry. The practice of pressuring private banks to participate in bond underwriting schemes and bond stabilization funds organized by the Korea Development Bank, at the center of the controversy regarding subsidies to Hynix Semiconductor, has been ended by terminating these programs.

10. See Graham (1999) for an interesting proposal to use pension fund money to create independent institutional investors.

The entry of foreign investors and firms has brought with it new management approaches and technologies. Foreign participation in the financial system has been increased both through direct investment in South Korean banks and through management contracts with South Korean–owned banks.

And some of the measures introduced in the wake of the crisis appear to be at least modestly reducing the extent of cross-company financial links among *chaebol* firms, thus permitting investors to better separate good from bad *chaebol* businesses. Improvements in management have been reinforced by improvements in prudential regulation such as the introduction of "forward-looking criteria" in asset classification standards. The replacement of blanket deposit insurance, introduced during the crisis, in favor of a limited deposit insurance scheme should encourage the reallocation of saving toward better-managed intermediaries within the financial system itself. Commercial bank capital adequacy as measured by the BIS is over 10 percent. Less progress has been made with respect to nonbank financial intermediaries. It would be desirable for the FSS to continue its policy of scrutinizing the use of financial derivatives and off–balance sheet transactions by South Korean financial entities.

Even improved decision making will still generate failures, however, and the continued existence of capital-eating "zombie" firms, which exhibit persistent financial weakness, attests to the absence of functioning exit mechanisms. As detailed by Alexander (2003), one of the notable developments in the South Korean economy over the past several years has been increased differentiation of corporate performance. One aspect is the increasing prominence of "winners"—high-profit, low-leverage firms. Yet at the same time there is clearly a class of chronically weak firms, unable to generate sufficient earnings to cover the interest on their debt, accounting for perhaps 10 to 25 percent of the corporate sector (Alexander 2003, IMF 2003). These zombies must either be restructured to achieve profitability, or, if this is not possible, they must be closed—otherwise their continued existence sucks the lifeblood away from the truly efficient firms by competing with them for scarce capital and labor on the input side and depressing prices on the output side. The problem in South Korea, as one wag puts it, is that "the bankruptcy procedures are themselves bankrupt" (Graham 2003, 168).

When the crisis hit in 1997, South Korea, which after all had been growing robustly for 35 years, did not have a well-developed system for corporate failures. There simply had not been many failures, and many of those that had occurred had historically been handled through informal extrajudicial bank-led workouts, not formal bankruptcies. Lacking both the laws and the specialized courts to handle the wave of corporate failures in 1998, the government, as the owner of three-quarters of the crumbling banking system, faced the prospect of a politicized process of negotiations with delinquent borrowers, a situation former Prime Minister

Nam Duck-woo memorably described as "akin to having some [hospital] patients assume responsibility for the treatment of other patients" (Nam 2000, 37). In response, the government effectively normalized the informal procedures through the introduction of the corporate restructuring vehicle (CRV) and prepackaged bankruptcy (PB) to at least handle the relatively less politicized cases not involving the major *chaebol* or their subsidiaries (Graham 2003, Park 2003).

In the meantime, the government took direct responsibility for workouts of the major distressed borrowers. Unfortunately, the government was hesitant, reflecting the belief that some firms were "too big to fail," and a preference for trying to organize intra–South Korean solutions over selling assets to foreigners. One prominent example was the case of Daewoo Motors.[11] In 1998, as the Daewoo conglomerate was failing, it announced that it would sell much of its stake in Daewoo Motors to GM, with which it had historical ties, but GM exhibited a lack of interest and the sale was never consummated. After the Daewoo bankruptcy, GM offered to buy Daewoo Motors, but the South Korean government refused the offer and engaged in a fruitless negotiation with Ford. In the meantime, Daewoo Motors was kept by its creditors, most notably banks under direct or indirect state control. New loans extended to Daewoo Motors in the fall of 2000 temporarily preserved 50,000 jobs, at a cost of $80,000 per job. Even with this infusion of cash, internal documents indicated that Daewoo Motors would have to shed more than one-third of its workforce (Noland 2002b).

Delay has costs beyond the obvious one cited above. Firms are more than a collection of machinery. As time passed, the value of the automaker to any prospective buyer declined. Talented staff departed the firm. New product models were not developed. The retail distribution system atrophied. GM finally purchased Daewoo Motors in 2002 for around $400 million—roughly a tenth of what it had bid two years earlier.

Daewoo Motors is not the only example of this tendency. An ongoing case is Hynix Semiconductor, formerly Hyundai Electronics, which is at the center of US and EU allegations that the South Korean government has used its influence over the financial system to prop up Hynix to the detriment of US-based Micron Technology and Germany's Infineon.[12] (The implicit subsidization of Hynix also harms Samsung Electronics, probably South Korea's premier firm, but that is an internal matter.) For a time it appeared that the dispute would be resolved by Micron's offer to take over Hynix, which was supported by Hynix's creditors but scuttled

11. See Noland (2000, 2002b) and Graham (2003) for analyses of the "too big to fail" phenomenon in general and the Daewoo Motors case in particular. D.G. Lee (2003) also contains an analysis of Daewoo restructuring.

12. In the case of Hynix, the state-run Korea Development Bank agreed to purchase hundreds of millions of dollars of otherwise unsellable bonds. For a highly informative analysis of the Hynix situation, see Manyin, Cooney, and Grimmett (2003).

by the Hynix board. In November 2002, Micron filed a countervailing duty case against Hynix alleging that the South Korean government's actions amounted to an illegal subsidy, and on April 1, 2003, the Department of Commerce announced a preliminary countervailing duty of 57 percent against Hynix's chips. In the meantime, the European Union and Taiwan are pursuing similar complaints under their respective laws, and in April 2003, the European Union imposed a 33 percent countervailing duty on Hynix chips. It follows predictably that chip prices will rise in the United States and the European Union, helping Micron and Infineon, but hurting downstream users such as in those locations. Hynix will be forced to dump its chips in Asia, primarily hurting emerging Chinese producers but lowering costs to chip users in Asia, such as electronics assemblers in China and Southeast Asia. The firm's fortunes have been boosted by the worldwide rise in semiconductor prices, which has accompanied the global revival of the electronics sector, but in the long run, it will probably lose market share as its capital-starved plants lose competitiveness.

South Korea still has not developed the procedures (and perhaps the political will) to allow corporate failures to be resolved through a transparent legal process. The mechanisms introduced in the wake of the crisis were really stop-gap measures. However, the government has moved both to expand and improve the functioning of bankruptcy courts and to improve the law, for example, by unifying the existing three-track mechanism for resolving bankruptcies (Lim 2003). A draft Bankruptcy Act was circulated for public comment in November 2002, but the legislation that would streamline and strengthen the existing bankruptcy procedures languishes in the National Assembly.

The other aspect of an efficient exit mechanism is the existence of a functioning social safety net—otherwise understandable concern about job losses will inhibit the closure of unprofitable facilities. Again, in this regard South Korea has made considerable progress since the crisis, when its social safety net was really oriented toward the proverbial widows and orphans and had only a very narrowly targeted unemployment insurance scheme. Since then the government has made considerable strides, yet more remains to be done. As pointed out by Graham (2003) and the OECD (2003), the unemployment insurance system is limited to full-time workers who make up a declining percentage of the labor force as part-time and temporary work becomes increasingly common, which in turn is a reaction to existing labor laws that make full-time workers a quasi-fixed factor of production. One consequence is that the existing unemployment insurance system covers a shrinking share of the labor force. The 2003 OECD *Economic Survey of South Korea* contains a discussion of this issue along with other recommendations for labor-market reform.

The situation with regard to foreign investment is illustrative of these themes.[13] South Korea experienced a substantial increase in foreign direct investment (FDI) after the financial crisis, but this appears to have been in large part the result of minority-stake foreign investors buying out their cash-strapped South Korean partners—not new, greenfield investors or new mergers and acquisitions. (South Korea's historical inhospitality to foreign investment encouraged the development of minority-stake joint ventures as the primary form of investment—given the opacity of South Korean accounting at the time, these incumbent inside investors were the only foreigners who knew the true value of the assets that they were buying.) Once this one-time process of minority stakeholders buying out their South Korean partners was completed, the flow of foreign investment began to dry up, and it has fallen steadily since 2000.[14] As of that year, South Korea ranked 23rd out of 25 OECD member countries in stock of inward FDI as a share of GDP, besting only Japan and Iceland. And although some will rightly point out that there has been a slackening in cross-border investment worldwide, the decline in South Korea appears to be particularly pronounced. Why do foreign investors appear to be relatively uninterested in South Korea, despite the government's goal of turning the country into a regional economic hub?

They typically identify three barriers to investment in South Korea (two of which apply equally to domestic investors as well). Labor-market problems are the most widely cited impediments to investment in both surveys of US and Japanese investors and formal grievances filed with the South Korean government. This is ironic inasmuch as labor unrest is at least partly a product of the government's interventions in labor disputes and its financial-sector policies that ironically encourage labor militancy. The unwillingness of creditors (often ultimately the government) to impose hard budget constraints on management obviates any incentive for union leaders to compromise in negotiations—as long as the government is willing to bail out management, any union leader who compromised would be, in American parlance, a chump.

The stated goal of the incoming Roh Moo-hyun government to revitalize President Kim Dae-jung's Tripartite (business, labor, government) Commission has further raised concerns that South Korea may be headed toward a corporatist labor-market model along continental European lines. Policies and institutions matter: Although South Korea, the United States, and France all have similar unionization rates (South Korea's is actually the lowest at 11 percent), labor-market practices differ significantly be-

13. To be clear, the issue of foreign investment is used here for heuristic purposes—I do not believe that lack of foreign investment is the most important issue facing South Korea, just that it nicely illustrates some underlying issues.

14. The data on foreign investment in South Korea, while not in North Korea's league of unreliability, are problematic. See Noland (2003b) and Yun (2003) for more extensive discussions.

tween the United States and France.[15] Foreign investors have expressed concerns regarding issues such as restrictions on redundancies, mandatory severance pay, and the potential criminal liability of expatriate managers for a broad range of infractions.

The second impediment to investment is a lack of transparency in financial accounting. Its impact on FDI is particularly acute. In the 2002 A.T. Kearney annual survey of corporate executives, South Korea placed 21st in the FDI confidence index, lagging such countries as India, Poland, and Thailand. The consulting firm PricewaterhouseCoopers actually calculates an opacity index. South Korea ranked 31st out of 34, beating Russia, Turkey, and Indonesia but trailing countries such as Egypt and Romania. According to PwC's econometric model, if South Korea could achieve the average transparency level of the United States, Chile, the United Kingdom, and Singapore (the least opaque economies in North America, South America, Europe, and Asia, respectively)—admittedly a tall order—it would triple its FDI inflow. This is more than just theory or an econometric exercise. For example, at least one large institutional investor places South Korea in its "tier three/semi-transparent" category and imputes a significant "transparency risk premium" in its calculations of hurdle rates for investment in the South Korean economy.

The third barrier to foreign investment consists of financial, tax, and other regulatory problems that, for example, impede the repatriation of revenues by multinational firms to their home offices. Other impediments to foreign investment include "borrowed technology" (South Korean firms license technology extensively, and these licenses typically contain provisions that the license lapses if ownership of the licensee firm changes), and locational restrictions that primarily relate to measures undertaken to discourage geographical concentration in the area around Seoul.

It is important to recognize that these reforms are self-reinforcing: Reforms in the financial sector will encourage better results with respect to corporate decision making and labor-market outcomes, for example. Corporate bailouts through concessional loans by public-sector financial institutions discourage compromise on the part of unions. Situations in which managements do not face hard budget constraints encourage labor militancy. Likewise it is important that the Tripartite Commission not become the locus of efficiency-reducing corporatism as similar bodies have become in continental Europe.

Final Thoughts

The existence of North Korea and uncertainty about its future raise fundamental issues for South Korea. In many respects, South Korea will

15. See C.S. Lee (2003) for a survey of empirical work on labor practices and FDI inflows.

remain vulnerable to Kim Jong-il's whims, whatever it does. Yet regardless of what path North Korea follows, whether it experiences evolutionary or discontinuous political change, economic integration between North and South Korea is in the cards—the only deep uncertainty is whether it occurs abruptly or gradually.

Throughout the world, political leaders are asked to undertake actions that, at least in the short run, will increase economic distress in their societies. While the experts assure them that in the long run the policy castor oil will contribute to their economies' rejuvenation, political leaders are asked to make big decisions on the basis of essentially theoretical (if not theological) arguments about the behavior of markets. No politician could be expected to take on the painful task of economic restructuring with much enthusiasm, and it is not surprising that market participants are always on the lookout for backsliding. Perhaps the July 2002 economic policy changes in North Korea are the start of such a process there. These reforms differ fundamentally from the highly touted diplomatic openings of the last several years. Unlike the diplomatic initiatives, which really only affected a small number of elites, the economic policy changes affect everyone in the society. Make no mistake about it: North Korea has crossed the Rubicon from the realm of the elite to the realm of mass politics. Whether Kim Jong-il or his successors will be successful in either rejuvenating the economy or maintaining their political control in the face of profound changes at the grassroots level is an open question.

South Korean leaders face a set of choices that paradoxically at once put both more and less at risk than the decisions confronting their counterparts in the North. The South possesses both a stronger economy and a stronger polity (though sometimes reading the newspaper might lead one to believe otherwise). The decisions that the South's leadership must make are not the life and death decisions about personal and regime survival confronting the North. They are nevertheless profoundly critical decisions about how to preserve the elusive personal and national virtues of liberty, democracy, and self-determination while pursuing national reconciliation. As the late Muddy Waters sang, "You can't lose what you never had."

Yet the immediacy of the issues confronting South Korea's leaders in an odd way conveys its own advantages. Unlike their counterparts elsewhere, for South Koreans, envisioning the returns to careful preparation and reform need not be an act of faith or an exercise in imagination—they need only look across the demilitarized zone to see their once and future partners.