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The Strategic Importance of US-Korea Economic Relations

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Introduction

Despite the passage of 50 years since an armistice ended military hostilities, the Korean peninsula remains divided, a Cold War vestige that seemingly has been unaffected by the evolution that has occurred elsewhere. If anything, US confrontation with North Korea—a charter member of its "axis of evil"—has intensified in recent years. Yet 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 widened dangerously, threatening to undermine their alliance.

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The divergence in threat perceptions has been reinforced by differences in attitudes toward a host of issues that have emerged in the post-9/11 world. Within South Korea, long-standing resentments, alleged American arrogance, unilateralism, racism, and recent specific irritants—including the perceived denigration of the "Sunshine Policy" and President Kim Dae-jung by the Bush administration during the March 2001 summit, and the deaths of two South Korean schoolgirls in a military training accident and the subsequent acquittals of the US service personnel involved—contributed to massive anti-American demonstrations in November and December 2002. With respect to issues beyond the peninsula, research on public opinion in South Korea indicates a growing favorable interest in China, a general lack of support for the US-led war on terrorism, and subsequently, for the US-led war against Iraq. Consideration by the National Assembly of legislation authorizing South Korea's modest noncombatant support of the war provoked another round of at times violent demonstrations in opposition to the government policy. The Pew Research Center for People and the Press survey on "What the World Thinks in 2002" 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.

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The relationship between the United States and South Korea operates on many levels. The economic relationship is one important aspect. The question naturally arises whether the economic ties could mitigate conflict in other aspects of the overall relationship between the two countries or whether economic irritants could further exacerbate conflict.

The Economic Relationship and its Evolution

In 2002, total trade turnover between the United States and South Korea was $58 billion, up slightly from the previous year but well below its peak of $67 billion in 2000. For several years, South Korea has been America's sixth largest export market (behind Canada, Mexico, Japan, Germany, and the United Kingdom) and its fourth largest market for agricultural products. Last year, the United States ran a $13 billion merchandise trade deficit with South Korea.

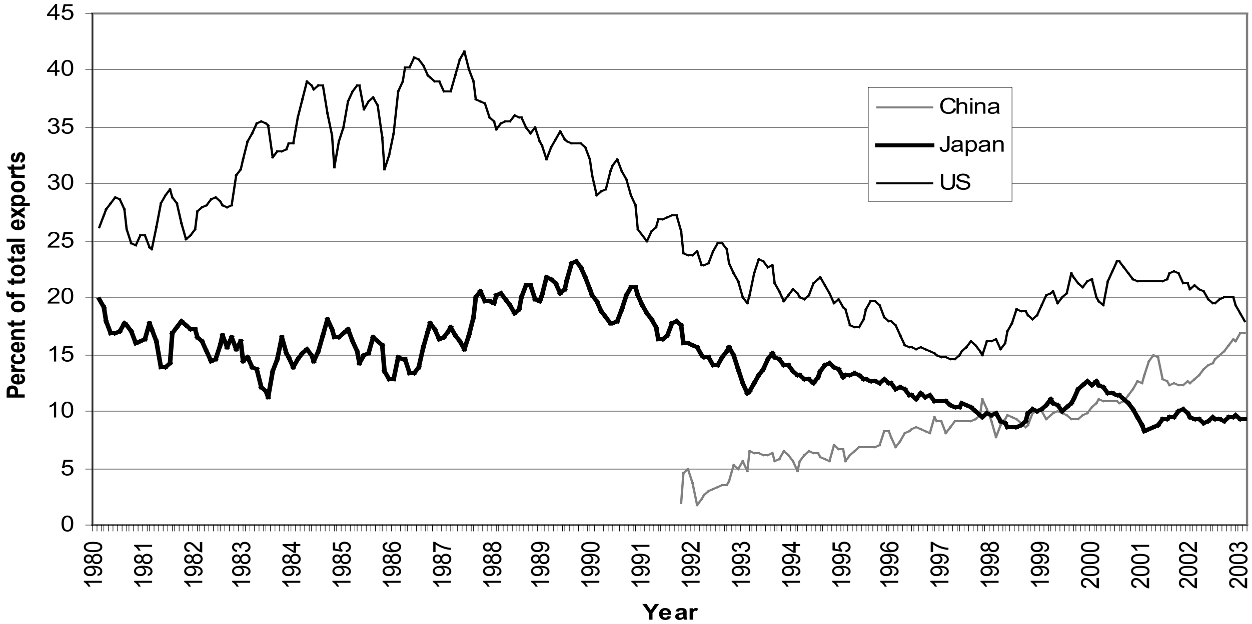
From the South Korean perspective, the share of merchandise exports to the United States has fallen dramatically from more than 40 percent in the late 1980s to less than 20 percent in 2002, with China actually surpassing the United States as South Korea's number one export destination in some recent months (figure 1). Similarly on the import side, after briefly supplanting Japan as South Korea's primary supplier of imports in the late 1990s after the Asian financial crisis, the US share of South Korean imports has once again begun drifting downward, and in 2002 the United States supplied less than 15 percent of South Korea's merchandise imports.

Bilateral trade in services, cross-border investment, and local sales by majority-owned foreign affiliates have grown more robustly than merchandise trade. The share of services trade in South Korean GDP doubled to 15 percent over the decade to 2001, and the United States is the major supplier of services to the South Korean economy, running a $3.3 billion bilateral surplus in 2002.

The provision of services generally requires investment—if only to establish a local presence. Historically, South Korea maintained an unwelcoming stance toward foreign direct investment (FDI)—indeed, South Korea and India were the only countries in Asia where the primary mode of US investment was minority-stake joint ventures rather than majority-stake joint ventures or fully owned subsidiaries. Policy reform and market pressure have encouraged an expansion of FDI into South Korea after the Asian financial crisis. As shown in figure 2, the inward flow of foreign investment from all sources experienced a one-time surge as foreign investors bought out their Korean joint-venture partners and then subsequently declined (as it did elsewhere in the world). As of 2000, 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.

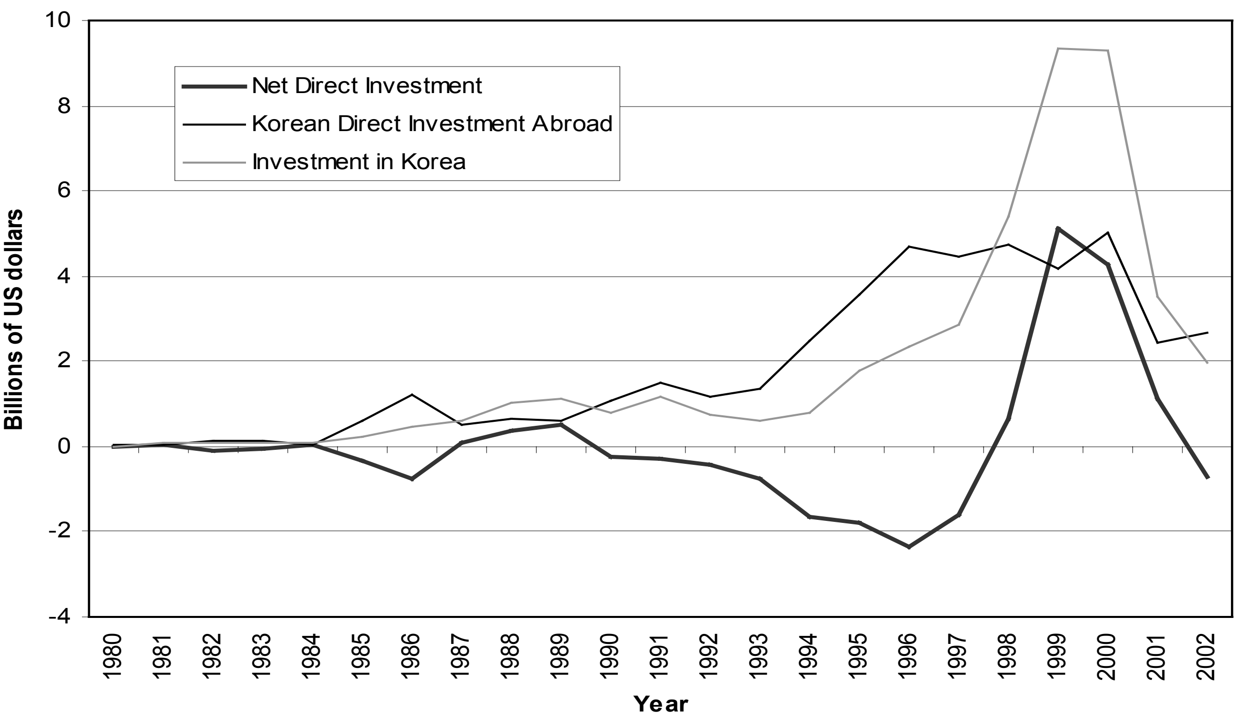
The flow of US investment into South Korea increased much more rapidly than trade after the Asian financial crisis, peaked between 1999 and 2001, and then declined, though it remains significant. (Indeed, according to US government figures, the stock of US investment in South Korea grew by more than 10 percent in 2002.) In recent years, the United States has been the single largest investor in South Korea, though in some years, European investment may have exceeded US investment in the

Figure 1 South Korean exports, 1980–2003



Note: Three-month moving average.
Source: Bank of Korea Statistics Database.

Figure 2 South Korean direct investment, 1980–2002



Note: Based on balance of payments.
Source: Bank of Korea Statistics Database.

aggregate. According to South Korean data, Europe still owns a larger cumulative stock of investment than the United States. Japan trails far behind the United States and Europe, and China is essentially a nonfactor with regard to inward FDI.

The increase in investment is also intimately tied to the growth of services trade (which typically requires a local presence) as well as local sales of South Korean affiliates of foreign firms. In 2000, the most recent year for which data are available, majority-owned affiliates of US firms racked up sales of $1.7 billion in South Korea (while South Korean affiliates in the United States had sales of $385 million).

In sum, the United States remains an important economic partner for South Korea, though the character of that relationship is changing. South Koreans perceive that American prominence in merchandise trade is eroding, especially in comparison with China. However, in the emerging areas of services and investment, the US role is growing. In essence, the United States is losing its relative prominence in the older, more slowly growing parts of economic life and is building an increasingly prominent position in the newer, more rapidly expanding areas.

Economic Policy Issues

Over the last quarter-century, South Korea has greatly reduced the protection of its domestic market. The share of imports in the South Korean economy increased to 42 percent despite a substantial decline in the real exchange rate since the financial crisis. In agriculture, rice is the only product still subject to quantitative restrictions. Yet bound tariffs average 62 percent, and a number of agricultural products remain subject to tariff-rate quota schemes. The external barriers are reinforced by trade-distorting internal supports. Producer support, measured as monetary transfers to agriculture as a share of the total value of output at domestic producer prices, stood at 64 percent in 2001—a figure higher than that of Japan, twice the OECD average, and 20 times higher than that of the United States. The result is that South Korean consumers face food prices that are more than two-and-a-half times the world level.

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In the industrial sector, tariffs have been cut to levels comparable to other OECD member countries, and quantitative import restrictions eliminated. The share of imports in the domestic consumption of manufactures is higher than that of the United States and more than three times higher than in Japan. Within the industrial sector, the most prominent disputes involve the semiconductor industry, where the United States has imposed a 57 percent countervailing duty on chips produced by Hynix; the steel industry, where South Korea (among others) has taken the United States to the World Trade Organization (WTO); and the motor vehicles sector, where South Korea exported 468,607 automobiles to the United States in 2002 while importing only 3,283.

In the services sector, US interest centers on financial services, particularly residual restrictions on foreign access in the insurance and banking sectors. South Korea is the second largest insurance market in Asia with $47 billion in premiums paid in fiscal year 2001, and while the sector has been significantly liberalized, residual restrictions on the activities of foreign firms, especially in the nonlife insurance area, remain.

The government maintains a substantial ownership stake in the banking system as a legacy of nationalizations undertaken during the 1997–98 crisis. According to the International Monetary Fund (IMF), when combined with government ownership in specialized and development banks, as of mid-2002, nearly 60 percent of the assets of the South Korean banking sector are government-controlled. Since 1998, the share of foreign ownership has tripled from about 10 percent to more than 30 percent as foreign ownership restrictions were relaxed with respect to nationalized banks undergoing restructuring to induce fresh capital and managerial know-how.

Labor-market issues are the most widely cited impediments to investment in both surveys of US investors and formal grievances filed with South Korean government. This is ironic inasmuch as labor militancy is at least partly a product of the government's financial-sector policies. 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. The Roh Moo-hyun government's stated goal of revitalizing former President Kim Dae-jung's Tripartite (business, labor, government) Commission has raised additional 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, labor-market practices differ significantly between the United States and France.

A second impediment to investment is a lack of transparency in financial accounting. The 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. In the "opacity index" calculated by the consulting firm PricewaterhouseCoopers, 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.

Modalities

Despite this discussion of ongoing sources of friction, economic relations between the United States and South Korea would appear to be less contentious than they were 10 or 20 years ago. One can point to three reasons. The first is changes in the composition of trade. The increasingly intra-industry nature of bilateral trade would be expected to create less of an adjustment burden for import-competing sectors.

Secondly, economically rational or not, the single best predictor of US trade policy actions is the rise of the bilateral trade imbalance. The United States has recently been through a period in which it ran surpluses or relatively modest deficits with South Korea. The counterpart to the rise of China in South Korea's trade pattern is the growing prominence of China in the United States. In effect, South Korea has fallen off the radar screen, supplanted by China, together with the perennial foci of US trade policy complaints, Japan and the European Union.

Finally, there have been changes in both policy and the institutional environment. Nearly a quarter-century of liberalization in South Korea has made a significant dent in the ubiquity and restrictiveness of policy-derived impediments to trade in South Korea. This reduction in fuel for the fire has been reinforced by the formation of the WTO, which has provided a less visibly politicized and bilateral forum for the United States and South Korea to resolve their trade differences.

Both countries have made use of the WTO dispute settlement mechanism in managing bilateral trade disputes, each initiating six cases. For both countries, the prospect of binding WTO rulings has encouraged bilateral "out of court" diplomatic settlements. When this has not been possible, both countries have won and lost cases, and thus far, the loser has brought its practices into conformity after adverse rulings. The big question is whether this will continue to be the case if the United States loses two pending steel-related cases.

In Washington, the rise of China has meant a diminution of at least relative attention paid to South Korea, while in Seoul the rise of China has added to interest in regional initiatives—which if implemented could harm the United States.

Preferential Trade Initiatives

A final issue confronting the United States and South Korea is their participation in preferential trade agreements, which can potentially help or harm both members and third-party nonmembers. At present the most relevant of these is US participation in the North American Free Trade Agreement (NAFTA), which may have had a nonnegligible adverse impact on South Korea by diverting trade and investment to Mexico and which certainly stimulated the proliferation of preferential arrangements globally. South Korea recently completed its first preferential agreement—a free trade area (FTA) with Chile.

Of greater relevance looking forward, however, are prospective preferential arrangements in Northeast Asia, including a Japan–South Korea FTA, a Japan–South Korea–China FTA, and an ASEAN+3 FTA (ASEAN plus Japan–South Korea–China). President Roh has also mentioned bringing North Korea into the fold. However, the credibility of these proposals is questionable in light of the participants' WTO obligations, most obviously that sectorally selective FTAs are not permitted—trade restrictions must be abolished in "substantially all sectors." For South Korea, Japan, and their potential partners, the question is how this requirement relates to their economically inefficient but politically influential agricultural sectors. (Agriculture is also the reason why occasional proposals for a US–South Korea FTA are not credible.)

A number of studies have attempted to model the impact of these proposals. The South Korean and Japanese governments commissioned studies of an FTA (Cheong 1999; Yamazawa 2000) that has been the subject of investigation by Brown, Deardorff, and Stern (2001) and Scollay and Gilbert (2001) as well. All four studies use static computable general equilibrium (CGE) models to evaluate a prospective Japan–South Korea FTA. These models have significant limitations, notably their inability to capture dynamic economic effects and the absence of any reaction functions on the part of other trading nations. Nevertheless, they are the obvious starting point for any serious analysis of a prospective FTA. All reach similar conclusions: an FTA with South Korea would have a limited impact on Japan and a potentially negative impact on South Korea. (To ameliorate this politically unpalatable outcome, Yamazawa conjures up exogenous productivity increases that generate welfare improvements for both economies—but these are caused by the assumed productivity shocks—not trade liberalization. Cheong achieves the same result through unspecified "preferential rules of origin" and the inclusion of China into the FTA.) Cheong does not discuss the impact on the United States, but the other three studies find that the United States would be adversely affected by trade diversion. Brown, Deardorff, and Stern find that the United States would benefit if the FTA expanded to include the ASEAN+3; Scollay and Gilbert reach the opposite conclusion.

The net result may well be a decoupling of relative interests that could reinforce the widening strategic differences between the two historic allies, especially if South Koreans come to regard China and Japan as acting more constructively than the United States with regard to North Korea.

An explicitly dynamic model of a Japan–South Korea FTA, produced by McKibbin, Lee, and Cheong (2002) under the auspices of a South Korean government think tank, obtains a positive impact on Japan and Korea but a negative impact on the United States as well as some other Asian countries. That said, the detrimental impact should not be overstated: according to one study, the fall in US welfare due to a Japan–South Korea FTA would be between $200 million and $300 million annually—a magnitude similar to the self-inflicted losses stemming from the 15 outstanding antidumping (AD) orders against South Korean producers.

Conclusions

The economic relationship between the United States and South Korea, characterized by increasing intraindustry trade, rising services trade, expanding intercorporate penetration, and growing FDI, appears to be evolving toward something more like the relationships that the United States maintains with most other rich OECD countries. This expansion of bilateral interdependence is not without its irritants, however—the motor vehicles sector is an exception to the trend of rising intraindustry trade; steel remains a perennial, though not essentially bilateral, problem; and AD practices in the United States, and capital channeling in South Korea to support Hynix are the sources of ongoing disputes.

Yet the trade relationship is not as contentious as it was 10 or 15 years ago. This is due in part to liberalization in South Korea and the formation of the WTO that has provided the two countries with a less politicized forum in which to resolve their differences.

It is also due to the declining relative importance of the two countries in each other's global relationships—at least with respect to merchandise trade. In Washington, the rise of China has meant a diminution of at least relative attention paid to South Korea, while in Seoul the rise of China has added to interest in regional initiatives—which if implemented could harm the United States.

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