Executive Summary
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Economic Lethargy: South Korea Needs a Second Wave of Reforms

Bruce Klingner and Anthony B. Kim

The economy of South Korea, Asia's third-largest economic power, shows favorable but conflicting indicators. Current performance reflects a strengthening recovery, but inconsistent economic policies, lingering systemic deficiencies, and increasingly competitive rivals create significant long-term challenges.

South Korea has made significant strides since the 1997 Asian financial crisis forced it to open its markets and implement sweeping market-oriented reforms, but failure to implement necessary follow-on reform measures could undermine long-term competitiveness. The five years of the Roh Moo-hyun administration were marked by uneven economic policies, conflicting signals from senior officials, and rising public animosity toward overseas companies, all of which hindered domestic and foreign investment.

To avoid economic stagnation, South Korea must revitalize and strengthen its reform efforts. Restrictive governmental policies and unfavorable labor conditions are sapping economic strength. Moreover, while South Korea's reform efforts are stalled, those of its economic rivals are not. Without a second wave of economic reforms, investors increasingly will bypass South Korea for more profitable markets.

The December 2007 presidential election will be a referendum on South Korea's economic future. Economic issues are at the center of the debate, and the leading candidates offer strikingly different policy prescriptions. Lee Myung-bak, the conservative Grand National Party candidate, and independent conservative candidate Lee Hoi-chang advocate a pro-growth economic strategy based on deregulation, tax reform, and more openness to investment. United New Democratic Party candidate Chung Dong-young advocates redistributionist economic policies, growth through economic cooperation with North Korea, and maintaining current protectionist policies against foreign investors.

What Should Be Done. U.S. policymakers should emphasize to the next South Korean president the mutual benefits of free-market economic policies. In particular, Washington should:

- **Build support for a stronger U.S.–South Korea economic relationship.** The U.S. must explain clearly and fairly the advantages of the Korea–U.S. Free Trade Agreement (KORUS FTA) without prejudice to any one sector's treatment.
- **Communicate U.S. priorities to South Korea through open and early dialogues.** The U.S. must assure the new leadership that it is willing

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to provide unequivocal and vigorous support for South Korea's financial, economic, and political reforms.

- **Encourage South Korea to create a more inviting business atmosphere.** To maintain its advantage over its regional competitors and advance economically, South Korea must overcome xenophobic fears of foreign investment and accelerate ongoing reform efforts.

For its part, South Korea's next economic team should (among other actions):

- **Improve competitiveness by enhancing economic freedom.** Commitments to slashing the regulatory burden and increasing transparency must be strengthened to encourage more entrepreneurial activity.
- **Shore up public support for the KORUS FTA.** Implementation of the KORUS FTA would give South Korea a significant regional trade advantage and send a powerful signal to foreign and domestic investors.
- **Promote the rule of law in dealing with militant labor unions.** South Korea's labor market flexibility has long been hampered by high costs and the militancy of the country's labor unions.
- **Accelerate corporate governance reform.** South Korea's corporate governance reform project remains incomplete despite progress since the 1997 financial crisis.
- **Pursue tax reform.** South Korea needs to consider a more competitive corporate tax rate, both to attract greater corporate investment and to remain competitive in Northeast Asia.
- **Open the service sector and increase its flexibility.** Increasing the viability of the service sector would give South Korea another engine of growth and reduce its excessive reliance on exports.
- **Reduce balanced regional growth restrictions.** The economic damage caused by the decision to move the capital from Seoul to a regional area could be minimized by reducing the number of government agencies to be moved and making a portion of the land available for business use.

Conclusion. South Korea possesses enviable economic strengths. It enjoys a stable political system, a strong cultural work ethic, a highly educated workforce, and a history of technological innovation. But the country is fast approaching a critical juncture. If it continues the policies of President Roh Moo-hyun, it will see its economic growth gradually diminish.

The danger is not that South Korea's economy will burst but that it will become less attractive to investors, causing them to invest elsewhere. Changing perceptions of the political, security, and investment environments will lead to changes in the amounts that portfolio managers choose either to invest in South Korea or to redirect elsewhere. These alterations in investment behavior are determined not only by risk assessment but also by changing perceptions of profitability. South Korea has typically had a low payout compared with regional rivals.

To avoid economic stagnation, South Korea must allow market forces to replace government and labor intervention. If implemented, such reforms would unleash the full potential of the South Korean people and significantly improve the country's economic competitiveness and strength as a U.S. business partner. Seoul should improve its investment environment through legislative reforms and implement structural reforms to increase the competitiveness and profitability of South Korean firms.

The South Korean economic engine requires a major overhaul, not just tinkering under the hood. South Korea's next president needs to show a more adept hand on the economic helm as well as a willingness to take bold action early in his term.

—Bruce Klingner is Senior Research Fellow for Northeast Asia in the Asian Studies Center, and Anthony B. Kim is Policy Analyst in the Center for International Trade and Economics, at The Heritage Foundation.

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South Korea has made significant strides since the 1997 Asian financial crisis forced the country to open its markets and implement sweeping market-oriented reforms, but failure to implement necessary follow-on reform measures could undermine long-term economic competitiveness. The five years of the Roh Moo-hyun administration were marked by uneven economic policies, conflicting signals from senior officials, and rising public animosity to overseas companies, all of which discouraged domestic and foreign investment in Korea.

To avoid economic stagnation, South Korea must revitalize and strengthen its efforts at reform. Restrictive governmental policies and unfavorable labor conditions are sapping economic strength. Moreover, while South Korea's reform efforts are stalled, those of its economic rivals are not. Without a second wave of economic reforms, South Korea will suffer declining competitiveness, and investors will increasingly look to more profitable markets.

The December 2007 presidential election will be a referendum on South Korea's economic future. Economic issues are at the center of the debate, and the leading candidates offer strikingly different economic

Talking Points

- The South Korean economy faces long-term challenges due to inconsistent economic policies, systemic deficiencies, and increasingly competitive rivals.
- Lingering obstacles such as restrictive governmental policies, insufficient transparency, and labor union militancy that undermines the rule of law have driven away foreign direct investment, prevented the creation of dynamic indigenous small and medium enterprises, and discouraged investment by domestic firms.
- U.S. policymakers should encourage the next South Korean administration to implement mutually beneficial market-based policies that enhance economic freedom and competitiveness.
- Seoul should accelerate corporate governance reform, pursue tax reform, constrain government spending, open the service sector, reform education, and reduce balanced regional growth restrictions.
- Allowing market forces to replace government and labor intervention would unleash the full potential of the South Korean people and significantly improve the country's economic competitiveness and strength as a U.S. business partner.

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Whoever wins, the U.S. should encourage South Korea's new president to implement mutually beneficial market-based policies.

Clouds on the Economic Horizon

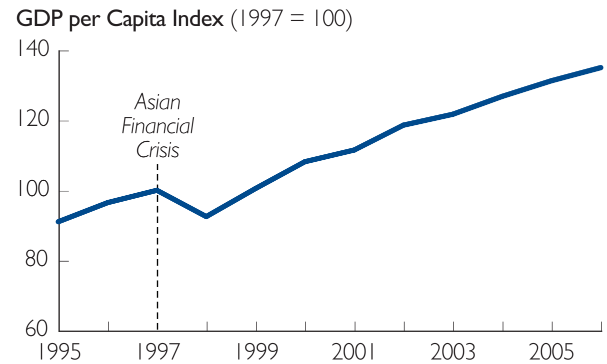
The South Korean economy has been expanding steadily in recent years. Thanks largely to robust exports, South Korea's average annual real GDP growth rate over the past five years has been almost 5 percent.[1]

As painful as the 1997 financial crisis was, it gave South Korea a strong incentive to make its economic system more open and transparent. To their credit, successive governments have taken steps to address economic problems by reforming financial sectors, increasing regulatory transparency, strengthening corporate governance, and opening the market to more competition. In addition, they have continued to promote South Korean competitiveness by embracing foreign trade and integrating into the global trading system.

Although it took time for post-crisis reforms to restore investor confidence, the subsequent recovery was stronger and swifter than recoveries in other emerging-market countries. Ten years after the financial crisis, the South Korean economy has rebounded, with real per-capita GDP passing the pre-crisis level. (See Chart 1.)

Chart 1 B 2090

South Korea's Economic Recovery After 1997



Source: World Bank, World Development Indicators Online, at *http://go.worldbank.org/B53SONGPA0* (December 1, 2007; subscription required).

Reaching a growth rate of more than 4 percent in 2007, South Korea has achieved 17 consecutive quarters of uninterrupted economic growth.[2] In that time, it has overcome such challenges as the consumer debt crisis, rising oil prices, and the strengthening currency (the won). The economy has also enjoyed stable money: The Bank of Korea has been able to keep inflation under its target range of 2.5 percent to 3.5 percent.[3]

As Chart 2 indicates, although consumer sentiment with respect to the South Korean economy has fluctuated during the past five years, overall sentiment since January 2007 has been positive.[4] This is based to some degree, however, on positive expectations for the Korea–United States Free Trade Agreement (KORUS FTA) and the Six-Party Talks on North Korea, both of which remain unfinished.

1. "Country Briefs: South Korea," *The Economist*, October 24, 2007, at *www.economist.com/countries/SouthKorea/profile.cfm?folder=Profile-FactSheet* (December 4, 2007).
2. International Monetary Fund, "Republic of Korea: 2007 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Korea," *IMF Country Report* No. 07/344, October 2007, at *www.imf.org/external/pubs/ft/scr/2007/cr07344.pdf* (December 4, 2007).
3. *Ibid.*
4. The Consumer Expectation Index measures consumers' expected sentiment six months in the future compared with the present situation. The Consumer Present Situation Index measures current sentiment compared with sentiment six months ago.

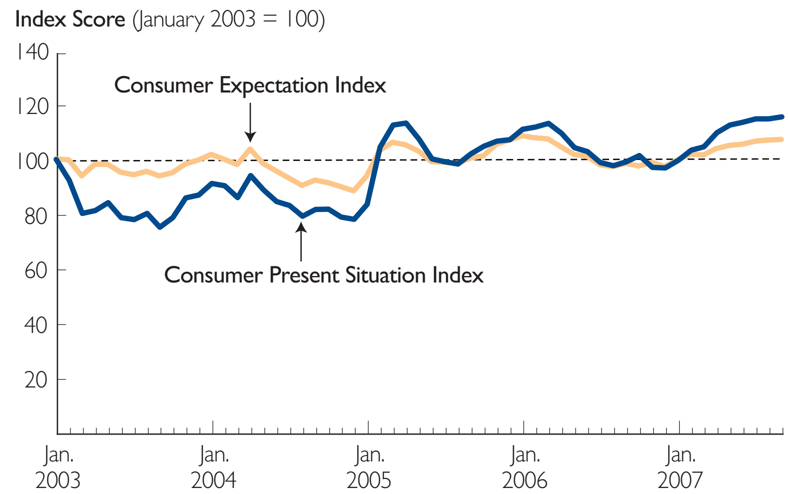
The continuing rise of the Korea Composite Stock Price Index (KOSPI) over the past two years has also been cited as an indicator of the country's growing economic strength. As one of the best performing indices in the world, the KOSPI has risen over 40 percent since mid-2005 and has set record highs above the 2,000 mark.[5] After sluggish performance for most of 2006, the KOSPI index has regained almost all of the ground lost since January 2007. (See Chart 3.)

External factors, however, might have buoyed the Korean bourse artificially. The first factor was a series of laws clamping down on real estate speculation that reduced the attractiveness of investing in property, which Korean investors preferred over financial investments by a ratio of 80 to 20 (as compared with 40 to 60 in Japan and 35 to 65 in the United States).[6] As part of its vision to reduce economic disparities, and in an effort to curb rising real estate prices, the Roh administration levied new taxes on individuals who own more than one house. The result has been a large influx of capital from individual investors who are shifting their portfolios away from real estate.

The second factor was the entry into the stock market of the government-run National Pension Service (NPS). The NPS, facing a growing shortfall in its ability to pay the retirement benefits of a rapidly graying society, shifted its portfolio in 2006 from its typical 90 percent allocation in conservative bonds to stocks, hoping for higher returns. During the first seven months of 2006, the NPS invested $16 billion in local and over-

Chart 2 B 20xx

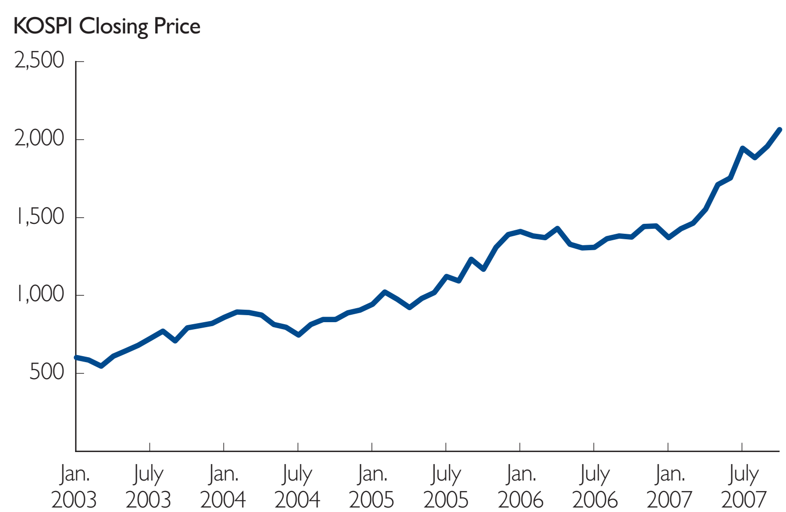
Consumers' Mood on the South Korean Economy



Source: Korea National Statistics Office, Consumer Sentiment Index, 2003–2007, at *www.nso.go.kr/eng2006/e01___0000/e01b__0000/e01bf_0000/e01bf_0000.html* (December 1, 2007).

Chart 3 B 2090

South Korea's Rising Stock Market



Source: Korea Exchange, "Current Index," at *http://eng.krx.co.kr/mki/ids/ids_I_001.jsp* (December 1, 2007), and Yahoo Finance, "KOSPI Composite Index," at *http://finance.yahoo.com/q/hp?s=%5EKS11* (December 1, 2007).

5. Ana Fifield, "South Korean Stock Exchange Hits Record High," *Financial Times*, July 25, 2007.
6. "Korean Investors Shift From Homes to Stocks," *Korea Times,* April 26, 2006.

Table 1 B 2090

Competitiveness Rankings

	South Korea	Singapore	Taiwan	Japan	China	Hong Kong
2007 Index of Economic Freedom	36	2	26	18	119	1
The Global Competitiveness Report 2007–2008	11	7	14	8	34	12
Doing Business 2008	30	1	50	12	83	4
IMD World Competitiveness Yearbook, 2007	29	2	18	24	15	3
Globalization Index 2007	35	1	37	28	66	2
2007 Corruption Perception Index	43	4	34	17	72	14

Sources: Tim Kane, Kim Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/research/features/index*; Michael E. Porter, Klaus Schwab, and Xavier Sala-I-Martin, *The Global Competitiveness Report 2007–2008* (Basingstoke, U.K.: Palgrave Macmillan, 2007); World Bank and International Bank for Reconstruction and Development, *Doing Business 2008: How to Reform*, 2007; International Institute for Management Development, *IMD World Competitiveness Yearbook, 2007* (Lausanne, Switzerland: International Institute for Management Development, 2007); "The Globalization Index 2007," *Foreign Policy*, November/December 2007, at *www.foreignpolicy.com/story/cms.php?story_id=3995* (December 3, 2007); and Transparency International, *Corruption Perceptions Index 2007*, at *www.transparency.org/policy_research/surveys_indices/cpi/2007* (December 3, 2007).

seas equity markets. It also pledged to purchase an additional $2 billion in the KOSPI by the end of the year to calm market jitters arising from the October 2006 North Korean nuclear test.[7] The influx of NPS money offset, to some degree, the foreign investor sell-off in recent years. The NPS plans to invest $13 billion in equities in 2007 and $16 billion in 2008.[8]

Similarly, the Korea Investment Corporation, a government-funded asset management company, announced that it would begin to buy stocks in 2008. The company will purchase $1 billion in the South Korean bourse during the first quarter of 2008 as part of a new program to achieve higher investment returns.

South Korea confronts structural and external challenges that could undermine and reverse long-term growth if not addressed properly and in a timely manner. Corporate investment has been sluggish, with the *chaebol* (large family-owned conglomerates) holding onto large cash reserves pending improved economic conditions. The steadily strengthening won is eroding South Korean exporters' profitability and competitiveness. Household debt is growing—a troubling reversal of the recovery from the burst credit card bubble of 2002–2003.[9]

Building Competitiveness

Beyond celebrating its recent economic recovery, South Korea should focus on building its economic potential by strengthening its commitment to reforms that enhance economic freedom and, therefore, competitiveness in its economic system.

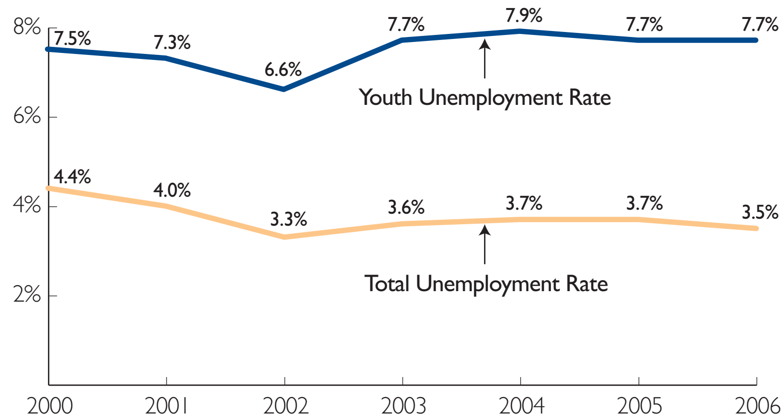
Today's economic growth and prosperity depend on maintaining and improving an environment in which entrepreneurial activities and innovation can flourish. Investment capital and entrepreneurial talent flow toward economies with low taxes, secure property rights, sound money, sensible regulatory policies, and greater transparency. Countries with higher degrees of openness and flexibility benefit from the free exchange of commerce and thereby enjoy sustainable economic growth and prosperity.

Indicators of competitiveness show the need for further economic reforms. Competing closely with Taiwan, South Korea ranks between Japan and China on most internationally recognized competitiveness indicators. (See Table 1.)

7. "National Pension to Power Capital Market," *Korea Times*, October 30, 2007.
8. "KOSPI to Top 1,700 Next Year," *Korea Herald*, November 29, 2006, and "National Pension Service to Boost Stock Investment," *Chosun Ilbo*, June 29, 2007.
9. "Stable But Facing Stagnation," Special Report, *Financial Times*, October 23, 2007.

Chart 4 B 20xx

South Korea's Labor Market



Source: Korea National Statistical Office, Employment & Unemployment, 2000–2006, at *www.nso.go.kr/eng2006/e01___0000/e01b__0000/e01bb_0000/e01bb_0000.html* (December 1, 2007).

South Korea's experience with free trade and open markets has been exceptionally good. As Asia's third-largest economy, South Korea is the world's 12th-largest exporter, producing nearly 3 percent of world goods exports.[10] Over three decades, as it pursued liberal trade policies, real per capita GDP rose from $550 to nearly $15,000.[11]

Yet with so many of the fundamentals for success in place—including large supplies of capital, a highly educated labor force, modern infrastructure, and a stable legal system—South Korea could still do better. The problem is South Korea's inability to let go of its protectionist past.

Layers of regulations and lingering government intervention persist, and the lack of economic opportunities, particularly among young people, encourages further frustration. South Korea's youth unemployment rate, standing at almost 8 percent, is more than double the overall unemployment rate of 3.5 percent. In response, anti-business sentiment and populist attacks on the free-market system have become more frequent. These developments, in turn, make it even harder to achieve the necessary reforms.

Factors Hindering South Korea's Future Economic Vitality

Economic Nationalism. Events in recent years indicate that South Korea's stance toward foreign investment is "at best ambivalent."[12] The populace perceives that foreign investment funds gained excessive "predatory" profits from purchasing troubled domestic firms during the Asian financial crisis and making billion-dollar tax-free profits upon their sale. This populist backlash triggered legislative and regulatory action against foreign financial firms and fueled demands for additional restrictions on foreign direct investment (FDI). President Roh sought to temper this movement by talking about the need for South Korea to create a business-friendly environment that can attract sufficient FDI to ensure the country's economic recovery and long-term growth.

But the public remains ambivalent about the effects of market liberalization. While cognizant of the need for open economies as trading partners for their own export-driven economy, South Koreans maintain a xenophobic apprehension about the dangers of opening their country to foreign firms. Then-Finance and Economy Minister Han Duck-soo expressed grave concern in 2006 over escalating negative sentiment regarding foreign capital: "It is problematic that the National Assembly, the people and the news media are all far too nationalistic when it comes to foreign capital." He implored

10. Korea National Statistical Office, "The Statistical Overview of Korea Toward the World," September 5, 2006, at *www.nso.go.kr/eboard_faq/BoardAction.do?method=view&board_id=106&seq=128&num=128&parent_num=0&page=14* (December 4, 2007).

11. World Bank, World Development Indicators, at *www.worldbank.org/data* (subscription required).

12. Economist Intelligence Unit, "County Report on South Korea," May 2006, and "Country Commerce, South Korea," 2007, at *www.eiu.com* (subscription required).

Koreans to abandon their "patriotic sentiment" when it comes to investment.[13]

Entrenched interests such as the *chaebol* played on public fears of foreign takeovers to derail domestic corporate reforms. Although the electorate supported Roh's efforts early in his administration to reform the *chaebol*'s secretive management practices, public concerns subsequently arose that overly aggressive measures would undercut South Korean competitiveness and derail economic recovery.

Although Roh has stressed the importance of foreign investment, he also responded to demands for protectionist policies. The president's progressive ideology and quest to create a more egalitarian society by attacking the old establishment conflicted with his acknowledgement of the need for pro-business initiatives. As Roh noted early in his administration, "The more we place emphasis on forging a business-friendly environment, the more aggravated and exacerbated the disparities in society will tend to become."[14]

Roh was also hampered by divisions within his government between pro-market advocates, such as the Ministry of Finance and Economy, and more protectionist agencies, such as the Financial Supervisory Service and Financial Supervisory Commission. As a result, Roh vacillated in his economic policies, creating an unpredictable business environment for investors.

Overzealous Investigation of Foreign Firms. The announcement by Lone Star, a U.S.-based company, that it intended to sell its majority shareholdings in the Korea Exchange Bank triggered at least four separate agency investigations by the Supreme Prosecutor's Office, Bureau of Audit and Inspection, Fair Trade Commission, and Financial Supervisory Office. None of the inquiries was initiated until after Lone Star announced its intention to sell at a $4.5 billion tax-free profit.

The controversial multi-agency investigation has generated accusations that the government was engaged in a "witch hunt" in response to domestic anger over excessive tax-free profits by foreign firms. Despite South Korea's claims that it was merely investigating suspected corporate wrongdoing, the government's prosecutorial zeal in pursuing Lone Star undermined efforts to attract greater foreign investment.

Seoul's assertions that it was not targeting Lone Star rang hollow when the finance ministry sought, unsuccessfully, to apply new tax laws retroactively to eliminate tax havens used in the Lone Star deal. The National Assembly also considered legislation that would have applied retroactively to Lone Star's 2003 purchase of the bank. Regulatory agencies stepped up raids against foreign firms and levied fines to gain tax revenues, and the National Tax Service, in April 2006, announced a new campaign to investigate 4,889 firms in which foreign investors owned at least 10 percent share holdings to determine whether they profited from unwarranted tax benefits. The effect of these actions has been to deter foreign investors.

Circling the Wagons Against Foreign Firms. The attempted hostile takeover of Korea Tobacco and Ginseng by corporate raider Carl Icahn set off renewed alarms over the perceived danger of foreign firms stealing Korean businesses. South Korean regulators considered implementing defensive measures to protect domestic companies from foreign hostile takeovers. The chairman of the Financial Supervisory Commission indicated that he was considering regulations to protect companies with state investment and firms regarded as strategically important against speculative foreign capital. Measures that were considered included legislation requiring an investor to purchase a majority share if it sought to assume management control and "poison pill" defensive measures to deter hostile takeovers by foreign companies.[15]

Although Icahn's abandonment of his takeover attempt reduced the impetus for government action, South Korean firms were unnerved and debated their own defensive measures. Some companies added "golden parachute" clauses to their

13. "Minister Regrets Negative Sentiment on Foreign Capital," *Korea Times*, February 16, 2006.

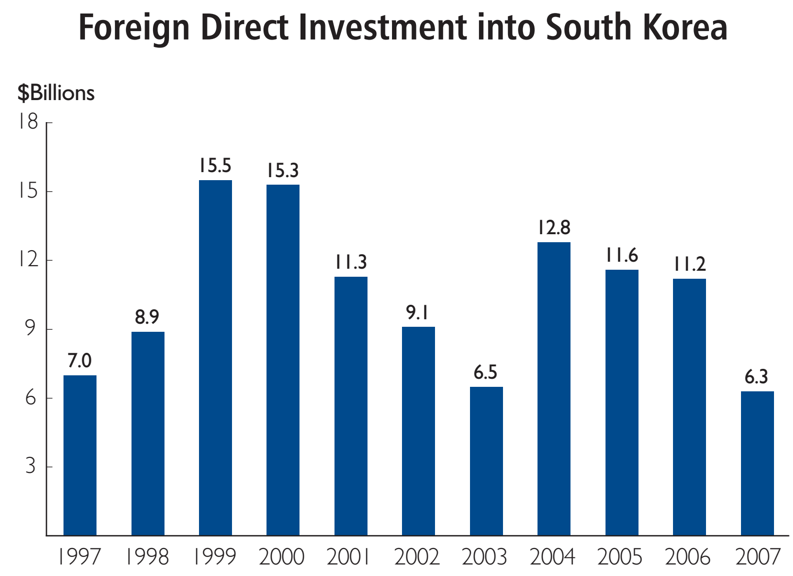
14. Reuters, "'Shrimp Between Whales'—S. Korea's Roh Seeks Role," November 8, 2005.

15. "Poison Pill: Take It or Not?" *Korea Times*, August 7, 2007.

corporate rules to make themselves less vulnerable to takeovers. In addition, South Korean financial firms have created "white knight" funds to deter foreign takeovers by increasing domestic investment in vulnerable local firms.

Business advocates, such as the Federation of Korean Industries (FKI), asserted that foreign takeover threats, especially in critical or strategic industries, may jeopardize South Korea's economic recovery and long-term national competitiveness. The FKI identified 58 South Korean companies with a high percentage of foreign ownership as vulnerable to foreign takeovers, including steel manufacturer POSCO, telecommunications firm KT Corp., Samsung Electronics, and Shinhan Financial Group.[16]

Chart 5 B 2090



Source: Invest KOREA, "Yearly Foreign Direct Investment," updated October 9, 2007, at *www.investkorea.org/InvestKoreaWar/work/ik/eng/bo/bo_01.jsp?code=102010608* (December 1, 2007).

Declining FDI Caused by Protectionism. Foreign business representatives criticized the government's anti-takeover initiatives as politically motivated attempts to undermine foreign competition. The government's actions and advocacy of protectionist measures have undermined Seoul's efforts to dispel perceptions that it was targeting foreign firms and have contributed to declining levels of foreign direct investment in South Korea. After reaching a peak of $15.5 billion in 1999, FDI has dwindled to $11.2 billion in 2006 and only $6.3 billion during the first nine months of 2007. (See Chart 5.)

South Korea has been losing out to regional competitors in attracting FDI because of unfavorable public sentiment toward foreign investors and "the continuing complexities of registration, notification, licensing and approval requirements."[17] Data from the United Nations Conference on Trade and Development (UNCTAD) show the disparity between South Korea's *potential* for FDI and its *actual* performance. South Korea ranked 17th out of 140 countries in the Inward FDI Potential Index but 109th on the Inward FDI Performance Index.[18]

Low Domestic Investment by Korean Firms. President Roh's policies have also hindered domestic investment. South Korean firms have invested heavily overseas due to uncertainty caused by Roh's economic policies and his strict prohibition on building manufacturing plants near Seoul. Roh's policies exacerbated businesses' concerns about high labor costs and government restrictions. South Korean companies set a record in overseas investment during 2005, sending abroad $6.4 billion, up 7.2 percent from 2004, according to the Export–Import Bank of Korea.[19] In 1996, South Korean

16. Federation of Korean Industries, "Threats of Hostile M&As and Its Countermeasures," March 6, 2006, at *www.fki.or.kr/en/research/View.aspx?content_id=b474037f-5788-46aa-89de-3ad36481ca4c&cPage=6* (December 4, 2007).
17. Economist Intelligence Unit, "Country Forecast: South Korea," 2006, at *www.eiu.com* (subscription required).
18. Heon Yong-jae, "To Be the Top Choice for Foreign Direct Investment," Samsung Economic Research Institute, November 9, 2006.
19. "Overseas Investment Hits Record High," *Korea Times*, February 13, 2006.

corporate investment was equal to 40 percent of GDP. By 2006, it had declined to 28 percent.[20]

This exodus of Korean firms to overseas markets has generated concerns over a "hollowing out" of the country's production capability and a steady decline in employment opportunities. The Ministry of Finance reported that 1,500 small- and medium-sized enterprises have departed the country every year since 1999. A Korea Chamber of Commerce survey of 299 Korean manufacturers operating in foreign countries showed that 95 percent did not want to return to South Korea. Respondents gave an overall score of 70 points out of 100 to the overseas investment environment, but only 58 points to South Korea's investment environment.[21]

This trend also holds for individual investors. The percentage of domestic household income going to South Korean market investment is still relatively small—around 10 percent, versus 40 percent in the U.S.[22] Korean investors increasingly are purchasing stock funds that invest in foreign-based assets.

Heavy Reliance on Exports. Fully 40 percent of South Korea's economy is reliant on exports. The five leading export sectors, including the semiconductor, automobile, and mobile phone industries, account for nearly half of total exports. This concentration leaves the country excessively vulnerable to downturns in a few key sectors.

Shrinking Technological Advantage Caused by Low R&D Investment. South Korea must upgrade its technological base if it hopes to remain ahead of its competitors, especially China. This means that firms must be able operate in a flexible and market-driven environment, but South Korea's environment is very inhospitable because of labor market inflexibility, rigid institutions, and government regulations.

One way for South Korea to improve its technological competitiveness would to work closely with highly developed nations through free trade agreements with, for example, the United States and the European Union.

Declining Export Profitability Caused by Strong Currency. The won's rising value is particularly detrimental to small and medium-sized enterprises (SMEs), which operate on a tighter profit margin and are less adaptable to changing business conditions. A Korea Federation of Small and Medium Business survey showed that 91 percent of SMEs have been seriously affected by the strengthened won, while 30 percent responded that their exports were unprofitable. SMEs account for 87 percent of South Korea's employment, 50 percent of its manufacturing output, and 40 percent of its exports.[23]

Unfavorable Labor Conditions Caused by Militant Unions. South Korea's labor unions are struggling to overcome dwindling membership—currently just 10 percent of the total labor force—and declining influence while also retaining the ability to disrupt the economy with massive strikes.[24] The populace has grown resentful of union intransigence, which is seen as undermining competitiveness and economic recovery.

The Challenge of China

Overreliance on Chinese Market. South Korea's economy has become increasingly dependent on the strength of China's economic growth. South Korean trade with the U.S. plummeted from 40 percent of total exports in 1986 to 13 percent in 2006, while exports to China grew from 5 percent of total exports to 27 percent during the same period.[25] In 2003, China surpassed the U.S. as South Korea's largest export market. South Korea is therefore increasingly vulnerable to "China shock": Any con-

20. "Korean Business Feels the Pinch Between China and Japan," *International Herald Tribune*, March 28, 2007.
21. "One in 2 Businesses Go Abroad to Invest," *Joongang Ilbo*, October 30, 2007.
22. Author discussion with portfolio investor adviser, April 2006.
23. International Monetary Fund, "Republic of Korea: Selected Issues," October 26, 2006, at *www.imf.org/external/pubs/ft/scr/2006/cr06381.pdf* (December 4, 2007).
24. *Hankook Ilbo*, "Lowest Labor Union Membership," November 9, 2007, at *http://economy.hankooki.com/lpage/news/200611/e2006110917112870300.htm* (December 4, 2007).

traction of the Chinese economy could have a devastating impact on South Korea's economy.

In 2004, South Korean financial markets and the won plummeted following comments by senior Chinese officials that Beijing would implement steps to slow down China's economy to prevent it from overheating. Seoul convened an emergency meeting of the National Security Council to monitor the impact and considered the need to diversify trading partners to reduce South Korean exposure to fluctuations in China's economy. Although the fear has since dissipated, South Korean economists point out today that the country's economy has become even more dependent on China's economic well-being.

Korean Investment in China: A Double-Edged Sword. Although the continuing expansion of China's economy is critical to the health of South Korea's export-dependent economy, it also represents a growing competitive threat. South Korean FDI in China has surged since the normalization of diplomatic relations in 1992, and China is now the single largest recipient of South Korean FDI. South Korean FDI is concentrated in China's northeastern coastal provinces, where South Korean firms can take advantage of low labor and transportation costs as well as a Korean-speaking indigenous population.

Transferring manufacturing processes to China provides cost-saving benefits to South Korean firms, but it also diminishes their competitive edge over the long term. As Chinese firms improve their technological capabilities, in part by assimilating foreign technology and expertise provided through FDI, South Korean companies will face increased direct competition in both the domestic and foreign markets.

China's Growing Technological Prowess. South Korea's underinvestment in research and development has led to a dwindling technological lead over China, reducing a critical competitive advantage. Chinese industry has matured from a low-cost, labor-intensive manufacturing platform to a direct challenger in many industries. There is concern that this trend will lead to a deterioration of South Korea's manufacturing sector, which accounts for a significant percentage of the nation's economic output and workforce.

The Korea Development Bank estimates that China's technology has already reached 95 percent of Korean levels and could surpass Korea's in almost all areas in five years.[26] The Ministry of Information and Communication reported in August 2007 that the technology gap between South Korea and China in 506 core information technology sectors has narrowed from 2.3 years in 2003 to 1.7 years in 2006.[27]

Chinese companies are already competitive with South Korean firms in the machinery, electronics, and textile sectors and have captured 80 percent of South Korea's small electronic and electrical sales. As a result, South Korea is losing U.S. market share in electronics components to Chinese competitors. South Korea's market share fell from 5.3 percent in 2000 to 4.0 percent in 2006, while China increased its share from 5.7 percent to 15.9 percent during the same period, according to the Korea Development Bank Research Institute.[28]

Since 2005, South Korea has been a net importer of steel from China. South Korean manufacturers, including those in shipbuilding and construction, increasingly have shifted to Chinese steel, which is generally 15 percent–20 percent cheaper than South Korean steel. Korean firms have been forced to reduce prices to compete, thereby also reducing their profitability.

South Korea remains the world's largest shipbuilder, with 40 percent of global market share, but even that industry faces growing Chinese threats. South Korea's shipbuilders have several years of back orders, especially for high-end ships such as

25. Samsung Economic Research Institute, "The Korea–US FTA and the Korean Economy," May 2007, at *www.seriworld.org/01/wldContV.html?mn=E&natcd=KR&mncd=0303&listopt=&sortopt=&key=20070601000001&pagen=2&gubun=00* (subscription required).
26. "Competition Welcomed," *Donga Ilbo*, May 5, 2006.
27. "China Closing Technology Gap With Korea," *Chosun Ilbo*, August 24, 2007, at *http://english.chosun.com/w21data/html/news/200708/200708240014.html* (December 4, 2007).
28. *Ibid.*

large tankers and gas carriers, but China has been cutting into South Korea's market for medium-size ships and is building production facilities to compete for very large cargo carriers and liquefied natural gas carriers.

China's growing competitiveness is often perceived as a long-term threat sometime over the distant horizon, but Korea's dwindling technological lead enables Chinese firms to compete today with smaller South Korean firms. While South Korea's *chaebol* remain strong and carry the country's economy, the more specialized are increasingly at risk.

Caught Between China and Japan. South Korean economists and business advocates warn that their country is being crushed by competition between a high-tech Japan and an increasingly competitive China. China has surpassed Korea in eight of Korea's 10 largest export categories: semiconducters, automobiles, wireless communications, petrochemicals, machinery, ships, petroleum products, steel, home appliances, and LCD panels. A survey of 143 U.S. buyer companies and 142 South Korean firms ranked Korea's export competitiveness as lower than Japan's and China's.[29]

Korea's trade deficit with Japan is increasing, while its trade surplus with China is decreasing. Seoul's overall trade deficit in the three-way trade relationship grew from $1.1 billion in 2005 to $4.5 billion in 2006 and $8.3 billion during the first eight months of 2007. South Korean exports have not decreased, but they have been outpaced by growing imports from China and Japan.[30]

What Should Be Done

U.S. policymakers should emphasize to the next South Korean president the mutual benefits of free-market economic policies. South Korea has the capacity to reinvent and reinvigorate its economy. The "economic miracle on the Han River" reflects the country's entrepreneurial spirit.

In particular, Washington should:

- **Build support for a stronger U.S.–South Korea economic relationship.** The U.S. must explain clearly and fairly the advantages of the KORUS FTA without prejudice to any one sector's treatment. The FTA sets unfortunate precedents in labor and environment, but it also offers American businesses and workers major new opportunities. It would broaden the bilateral relationship beyond the military alliance and counterbalance South Korea's growing trade ties with China.
- **Communicate U.S. priorities to South Korea through open and early dialogues.** The U.S. must explain to South Korea's new leadership that it is willing to provide unequivocal and vigorous support for ensuring South Korea's financial, economic, and political reforms. Strengthening the South Korean economy must take priority; a stable and prosperous South Korea is the key to U.S. security interests in Northeast Asia.
- **Encourage South Korea to create a more inviting business atmosphere.** For South Korea to maintain its advantage over its regional competitors and advance economically, economic reforms are necessary. This means overcoming xenophobic fears of foreign investment and accelerating ongoing reform efforts. The economic leadership should guard against complacency and be steadfast in providing unambiguous policy direction to deal effectively with lingering "reform fatigue."

For its part, South Korea's next economic team should:

- **Improve competitiveness by enhancing economic freedom.** Although a bold sense of entrepreneurship has played a key role in South Korea's tremendous economic success, the economic system remains shackled by pervasive regulatory and administrative barriers that limit entrepreneurial opportunities.

According to the *Index of Economic Freedom*, published annually by The Heritage Foundation and *The Wall Street Journal*, South Korea's economy remains "mostly free."[31] As Asia's third-

29. *Chosun Ilbo,* "Korea's Export to the US Lagging Rivals," March 12, 2007.

30. *Chosun Ilbo,* "Korea Caught in Middle of China-Japan Trade Sandwich," September 5, 2007.

largest economy, South Korea has the fundamentals in place; what is missing is political leadership to address more difficult issues that keep South Korea from being "free." A truly dynamic South Korean economy should be more flexible in order to adapt its social model to global realities. Commitments to slashing the excessive regulatory burden and increasing transparency should be strengthened to encourage more entrepreneurial activity.

- **Shore up public support for the KORUS FTA.** The Korea–U.S. Free Trade Agreement, if implemented, would give South Korea a significant regional trade advantage and send a powerful signal to foreign and domestic investors. The opening of South Korea's markets would provide a new growth engine to improve competitiveness and help to lock in economic reforms. The result would be greater investor confidence, which in turn could increase South Korea's sovereign credit ratings. In addition, boosting trade with the U.S. would diversify South Korea's trading base to decrease its susceptibility to sudden changes in China's economy.

  Relatively small, organized, and militant special-interest groups seeking to protect profits and jobs in their particular industries are well positioned and strongly motivated to work through the political process to thwart progress. To combat these interests, the government must put in place an effective and orchestrated campaign to build stronger support from the silent majority for the KORUS FTA.

- **Promote the rule of law in dealing with militant labor unions.** South Korea's labor market flexibility has long been hampered by high costs and the militancy of the country's labor unions. Despite noticeable progress in past years, labor laws are still viewed as restrictive by the standards of many other countries in the region. According to the World Bank's *Doing Business* report, South Korea's rigidity of employment ranks 131st out of 178 countries. The cost of dismissing a redundant worker is much higher that in the average Organisation for Economic Co-operation and Development (OECD) country.

  Moreover, although union membership has declined to only around 11 percent of the workforce, union militancy has increased in recent years,[32] disrupting South Korea's economic livelihood and rule of law. Further labor market reforms though constructive and close public consultations should be pursued, but violent and destructive protests should not be tolerated.

- **Accelerate corporate governance reform.** South Korea's corporate governance reform project remains incomplete despite progress since the 1997 financial crisis. According to a Governance Metrics International survey that assesses countries' rules on independent directors, audit and compensation committees, and voting rights, South Korea ranks among the lowest countries worldwide in governance.[33] Though the *chaebol* are South Korea's strongest economic competitors, their lack of management transparency makes them susceptible to corruption and unresponsive to shareholders who are not family members. These factors often translate into a "Korea Discount" that lets Korean shares trade at prices below those of comparable companies elsewhere. Currently, Korean stocks are dealt at a 24 percent discount, relative to the region.[34]

  Legal reforms are also necessary. *Chaebol* executives convicted of corruption should not be exempted from punishment on the grounds that their incarceration is deemed "detrimental to the country's economy."

- **Pursue tax reform.** The role of competitive tax policy in boosting economic growth and employment has led many countries around the

31. Tim Kane, Kim R. Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/index*.
32. Economist Intelligence Unit, "Country Profile: South Korea," 2007 at *www.eiu.com* (subscription required).
33. Governance Metrics International, "GMI Country Rankings," September 25, 2007, at *www.gmiratings.com/(4qqjma55a4aj4d45thlkmpq2)/Images/RankChart2007.pdf* (December 4, 2007).
34. "Cheap Korean Equities," *The Financial Times*, September 28, 2007.

world to undertake tax reform, thereby intensifying tax competition. Over the past six years, 24 of the 30 OECD economies cut their corporate tax rates, and none of the 30 raised its rates. OECD average corporate tax rates fell to 28.6 percent in 2005 from 33.6 percent in 2000.[35] Currently, South Korea's corporate tax rate stands at 25 percent, which is lower than China's and Japan's but higher than Hong Kong's and Singapore's. Hong Kong and Singapore are scheduled to reduce their corporate tax rates further to 16.5 percent and 18 percent, respectively.

South Korea needs to consider more competitive corporate tax rates to attract greater corporate investment and remain competitive in the Northeast Asian region. This reform should be designed to promote transparent and consistent enforcement of the tax law. Following Lone Star's controversial sale of Korea Exchange Bank, there has been growing sentiment among foreign investors that South Korea may use taxes as "a policy weapon against foreign companies," eroding their confidence in South Korea's bid to become a Northeast Asian financial hub.[36]

- **Keep government spending under control.** In light of its rapidly graying population, South Korea is likely to face increasing fiscal pressures. The government has been able to maintain relatively sound public finances, but the aging population will put considerable pressure on pension and health care expenditures. The next economic leadership team must exercise prudent and cautious spending management in order to deal with these fiscal pressures effectively.

  Further, the economic costs of engaging with North Korea should not be allowed to harm South Korea's overall fiscal health. Any additional economic initiatives with respect to North Korea, unlike those of the Roh administration, should be conditioned on clearly delineated political and economic reform measures by Pyongyang. Roh's engagement policy has provided billions of dollars in benefits to the Kim Jong-il regime while achieving appallingly little systemic reform or change in Pyongyang's behavior.

- **Open the service sector and increase its flexibility.** South Korea's service sector, which accounts for more than two-thirds of employment and almost 60 percent of GDP, remains inefficient.[37] Its productivity has recorded only marginal growth for more than a decade. The sector has been largely closed to foreign investment.

  Increasing the viability of the service sector would give South Korea another engine of growth and reduce its excessive reliance on exports. The Capital Market Consolidation Act, which liberalized the non-banking financial service sector by eliminating the regulations that restricted South Korean financial institutions to a narrowly defined range of services, was a commendable first step, but more needs to be done.

- **Reform education.** President Roh's egalitarian education policies have been a failure. Government interference in educational institutions' autonomy has driven more students abroad, in turn leading to soaring public school costs and undermining education-sector competitiveness. Roh's elimination of performance-based application testing, imposition of quotas on the number of law students per school, and rigid budgetary guidelines violate market principles and should be reversed.

- **Reduce balanced regional growth restrictions.** The decision to move the government capital from Seoul to a regional area triggered real estate speculation and led to huge government compensatory payments to owners of appropriated land. The process has created sufficient constituencies that make it impossible to reverse entirely, but the damage could be minimized by reducing the number of government agencies to be moved and making a portion of the land available for business use.

35. Kristian Weise, "Corporate Tax Warning," *OECD Observer* No. 261, May 2007, at *www.oecdobserver.org/news/fullstory.php/aid/2229/* (December 4, 2007).

36. Economist Intelligence Unit, "Country Forecast: South Korea."

37. International Monetary Fund, "Republic of Korea: Selected Issues."

Needed: A Paradigm Shift in Economic Strategy

South Korea possesses enviable economic strengths. It enjoys a stable political system, a strong cultural work ethic, a highly educated workforce, and a history of technological innovation. But the country is fast approaching a critical juncture. If it continues the policies of President Roh Moo-hyun, economic growth will gradually diminish. Overregulation and insufficient transparency have driven away foreign investment, prevented the creation of dynamic small and medium-size enterprises, and discouraged investment by domestic firms.

The danger is not that the South Korean economy will burst but that it will become less attractive to investors, who will increasingly bypass South Korea to invest elsewhere. The question is not just whether to invest in South Korea; the question is the degree to which such investment makes economic sense. Changing perceptions of the political, security, and investment environments will lead to changes in the amounts that portfolio managers choose either to invest in South Korea or to redirect elsewhere. These alterations in investment behavior are determined not only by risk assessment, but also by changing perceptions of profitability. South Korea has typically had a low payout compared with regional rivals.

If it is to avoid economic stagnation, South Korea must allow market forces to replace government and labor intervention. If implemented, these reforms would unleash the full potential of the South Korean people and significantly improve the country's economic competitiveness and strength as a U.S. business partner. Seoul should improve its investment environment through legislative reforms and implement structural reforms to increase the competitiveness and profitability of South Korean firms.

The South Korean economic engine requires a major overhaul, not just tinkering under the hood. The next South Korean president must show a more adept hand at the economic helm as well as a willingness to take bold action early in his term.

—Bruce Klingner is Senior Research Fellow for Northeast Asia in the Asian Studies Center, and Anthony B. Kim is Policy Analyst in the Center for International Trade and Economics, at The Heritage Foundation.