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Backgrounder

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IMPROVED TRADE TIES WITH THE U.S. REQUIRE SOUTH KOREAN ECONOMIC LIBERALIZATION

INTRODUCTION

Bouncing back from the nearly complete destruction of the Korean War just over three decades ago, the Republic of Korea (ROK or South Korea) now ranks among the world's twelve top trading countries. With American economic, political and moral support, the ROK is a rags to riches story probably unequalled in modern history. Accompanying ROK growth, of course, are challenges and problems. Among the most annoying are the growing pains as the U.S.-ROK relationship rapidly shifts from one of patronage to partnership and as the ROK becomes a target of American protectionist pressures.

Some Americans charge that South Korea is a "new Japan" which, on the one hand takes advantage of the open U.S. economy, while on the other hand restricts access to its own markets. These U.S. frustrations are fueled by the overall American trade deficit and by the $4.3 billion U.S. deficit in trade with the ROK. This has prompted the U.S. to cut Korean textile imports and to attempt to exclude the ROK from the Generalized System of Preferences program, which offers measured tariff reductions to developing economies.

Much of the U.S. ire over the trade deficit is misdirected. South Korea is not a "new Japan." Its economic size, technological base, and entrepreneurial spirit contrast sharply with the Japanese, as do its political, military, cultural, and historical ties with the U.S. Still, the U.S. has a right to expect reciprocal treatment from its trading partners and to apply pressure when requests for reciprocity are ignored. This year, for instance, the Reagan Administration initiated extensive negotiations with Seoul aimed at, among other things, securing U.S. access to the ROK insurance market and adequate copyright and patent protection for U.S. goods. Although significant agreements were reached on both issues and on other disputed trade matters, some U.S.-ROK trade tensions remain. They should be resolved over time.

Seoul is making good faith efforts to respond to specific American requests. Through an aggressive liberalization program, the ROK government under President Chun Doo Hwan has opened South Korean markets to a wide range of U.S. goods and services, eased restrictions on U.S. investment in South Korea, expanded ROK investment in the U.S. that create jobs for Americans, and launched serious studies to identify long-range policies to promote smooth trade relations in the future. The Chun Administration has pursued this in the face of significant domestic political opposition.

While Seoul deserves praise for these efforts, continued ROK liberalization is necessary. In particular, Korea should give the U.S. greater access to South Korean beef, citrus, wine, and lumber markets. At the same time, U.S. businesses should pay more attention to the growing trade and investment opportunities in Korea to insure that they benefit from Korea's liberalization measures and are not beaten out by the Japanese and other competitors.

Much is at stake in the trade ties between the U.S. and South Korea. More than most trading nations, the ROK's economic well-being is heavily dependent on U.S. markets. Last year, sales to the U.S. accounted for over one-third of all South Korean exports, making South Korea the seventh most important U.S. trading partner. As such, American businesses and consumers derive significant benefits from the U.S.-ROK economic partnership. Americans and Koreans stand to gain much in the future. How much will depend on how far Seoul proceeds with liberalizing the ROK economy and how much the U.S. resists harmful calls for protectionist measures.

THE ROK'S ECONOMIC DEVELOPMENT

During the first half of this century, Korea suffered tremendous hardships. While Japan's crushing defeat and total surrender to the U.S. and allied forces in 1945 ended 35 years of harsh and often brutal Japanese colonial rule over the Korean peninsula, Koreans were faced with partition of their country. In 1950, communist North Korea invaded the South, sparking a three-year civil war which left the ROK's economic infrastructure nearly obliterated. What kept South Korea alive throughout the 1950s was some $1 billion in direct U.S. aid.

It was not until the economic policies of President Park Chung Hee in 1962 that the economy began to spurt. Using its highly motivated and relatively inexpensive labor pool, South Korea imported raw materials, forged them into manufactured products, and moved toward an export-driven economy. From 1962 to 1981, nominal per capita income soared from $96 to $1,636 and annual gross national product (GNP) grew an amazing 9.1 percent annually, much higher than most developing nations. This performance won South Korea its reputation as an "economic miracle."

THE ROK ECONOMY TODAY

The ROK now is a highly successful "newly industrialized nation." Its economic development policies have become textbook examples for the developing world. Last year, its annual GNP exceeded $80 billion and per capita income topped $2,000. With lower oil prices and the appreciation of the Japanese yen improving the ROK's ability to compete with Japan's goods in world markets, South Korean economists are predicting GNP growth of 10 percent this year.

The ROK's economic future is not without potential pitfalls. More than most of the world's important trading nations, the ROK's economy is heavily dependent on trade. Over one-third of South Korea's annual GNP is derived from sales of exports, compared to around 13 percent for Japan and only 7 percent for the U.S. Sluggish export performance has an immediate and pervasive impact on South Korea's economy.

Another pressing South Korean concern is its $45 billion foreign debt, which equals more than 50 percent of the nation's GNP. The ROK's debt service must be paid with foreign exchange earned through trade, making the export sector a crucial factor in South Korea's ability to retain its enviably high credit rating with international lending institutions.

U.S.-ROK TRADE RELATIONS

Over the last three decades, sensible economic policies and ROK determination, together with a strong American financial commitment to South Korea's development, have yielded close and mutually beneficial U.S.-ROK trade relations. Last year, two-way trade between the U.S. and the ROK exceeded $17 billion, making South Korea America's seventh most important trading partner. The ROK last year sold 36 percent of its exported goods to the U.S., making America its most important trade partner. Major South Korea exports to the U.S. include textiles and footwear, electronics, steel, and ships. U.S. sales to the ROK include machinery, chemical products, metals, and agricultural goods. South Korea buys 60 percent of all its farm products from the U.S., making it the fourth-ranking international market for American farmers.

Last year, South Korea registered a $4.3 billion trade surplus with the U.S. Because this comes at a time when the record U.S. world trade deficit is of great concern to the American public and policy makers, trade tensions between Seoul and Washington are mounting. While Americans are justified in raising questions about free access to South Korean markets, viewing the ROK as a "new Japan" confuses the picture. The size of the two economies is the most striking contrast. Japan's annual GNP is fifteen times as large as South Korea's. Japan is not burdened by foreign debt and in fact is a creditor nation. Also significant is that the ROK annually spends 6 percent of its GNP for defense while Japan spends only about one-sixth of that.

Though South Korea currently enjoys a bilateral trade surplus with the U.S., for years its trade balance worldwide has been in the red. South Korea's cumulative trade deficit for the period 1980 to 1985 totals over $13 billion. On the other hand, Japan enjoyed a world trade surplus of over $33 billion in 1985 alone.

South Koreans are particularly irritated by their image as a "new Japan" given Seoul's chronic trade imbalance with Tokyo. Last year, the ROK suffered from a $3 billion deficit with Japan and $2.6 billion in the first half of 1986 alone, an alarming 79.8 percent increase over the same period last year. As in Washington, a high priority of the South Korean government is its efforts to gain greater access to Japanese markets.

AMERICAN TRADE PRESSURES

Growing American frustration over the U.S. trade deficit has increased frictions between Washington and Seoul dramatically. There are moves to pressure the ROK to give U.S. products greater access in South Korea and to curtail South Korean exports to the U.S. Legislation introduced this year in the U.S. Senate sought to remove or "graduate" the ROK and several other Asian nations from the list of countries that participate in the Generalized System of Preferences program. This GSP system was established by the Trade Act of 1974 and inaugurated in 1976. Founded on the tenet that "trade, not aid" is the more effective mechanism for improved economic development in Third World nations, the program offers low or zero tariff rates on selected imports from participating countries.

The system was extended until 1993 under the Trade and Tariff Act of 1984. Last year, South Korean products totaling $1.65 billion were exported to the U.S. under the GSP system, accounting for 12.4 percent of all U.S. GSP imports that year and making the ROK the second largest beneficiary in the program after the Republic of China on Taiwan (ROC). Other major beneficiary nations are Brazil, Mexico, Hong Kong, Israel, and Singapore.

The 1984 law included a clause requiring an annual review aimed at "graduating" a beneficiary country's export if that commodity is judged to be competitive in the international market. Also, any nation whose annual per capita income exceeds $8,500 becomes ineligible for the program. The Reagan Administration currently is reviewing the ROK's status under the system and will announce its findings next month. Based on the competitiveness criteria, it is estimated that some $300 million worth of South Korean goods will lose their GSP status next year.[1]

Legislation introduced in the the U.S. Senate this year sought to graduate South Korea, Taiwan, and Hong Kong completely from the GSP program within two years. The proposals would have altered fundamentally the program's original intent of tying GSP benefits to item-specific competitiveness criteria. Similar legislation is expected to be introduced in the next Congress.

As part of the Reagan Administration's "trade policy action plan" to improve access of U.S. firms to designated markets, and to cool U.S. protectionist fires, Reagan this fall used his authority under Section 301 of the 1974 Trade Act to pressure the ROK for American access to its insurance market and adequate protection for intellectual property rights. U.S. firms long have been frustrated by their inability to penetrate South Korea's $5 billion per year insurance sector and by the rampant ROK pirating of American trademarks, books, videotapes, records, computer software, and chemical formulas. The 301 action essentially put the ROK on notice that, if no progress had been made in these areas at the end of one year, the President might trigger retaliatory measures.

The proposed U.S. trade policy that caused the greatest alarm in the ROK recently was the Textiles and Apparel Trade Act of 1985, known as the "Jenkins bill." Openly protectionist, the Jenkins bill sought to bolster the sagging U.S. textile industry by heavily penalizing textile exporting countries. The plan threatened to cut textiles exported to the U.S. from the ROC, Hong Kong, and South Korea by as much as 30 percent and thus heap enormous costs on the American consumer by raising the price of clothing and footwear.[2] The measure

1. Business Korea, Seoul, Korea, September 1986, p. 14.

2. For an analysis of the Jenkins bill, see Edward L. Hudgins, "Why Limiting Textile Imports Would Hurt Americans," Heritage Foundation Backgrounder No. 458, September 30, 1985.

passed both the House and Senate, but was blocked when Ronald Reagan vetoed it.

ROK RESPONSES

Textiles

The South Koreans have taken actions to reduce U.S.-ROK trade tensions. The specter of the Jenkins bill prompted the ROK to take measures to calm the American cries for protection from Korean textile exports. On August 4, 1986, just two days before the House of Representatives sustained the Reagan veto on the bill, U.S. Trade Representative Clayton Yeutter announced a new U.S.-ROK textiles agreement which, together with similar pacts with the Republic of China and Hong Kong, represented "the tightest and most comprehensive ever negotiated by the U.S." The plan limited the growth of ROK textile exports to the U.S. between 1986 and 1989 to only 0.8 percent annually. According to Yeutter, this has "virtually frozen textiles and apparel imports" from South Korea at existing levels.[3]

While the new limits are certainly more acceptable to South Koreans than a 30 percent cut in textile exports to the U.S., they still represent a significant loss for the ROK. As a result of the "voluntary" restraints, it seems likely that the textile industry will soon cease to be the ROK's biggest foreign exchange earner.[4]

Section 301 Cases

Reagan's "Section 301" action in late 1985 calling on the ROK to provide U.S. access to the South Korean insurance market as well as adequate intellectual property protection set in motion a series of negotiations between Seoul and Washington. On July 21, 1986, the White House announced "successful conclusion" of the 301 discussions and reported that the ROK had agreed to allow U.S. firms to underwrite both life and non-life policies in South Korea.

Seoul moved quickly. Just three weeks after the agreement was announced, the Office of the U.S. Trade Representative reported to the Congress that "U.S. firms are now participating in a full range of

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3. The Washington Post, August 5, 1986, p. D1.

4. Korea Herald, Seoul, Korea, August 23, 1986, p. 1.

marine, fire and automobile insurance...[and we] expect American participation in the life insurance market by the end of this year."[5]

Also announced in the July liberalization package was the ROK's pledge to take several significant measures to improve the protection of intellectual property in South Korea. Legislation is being formulated in the ROK national legislature to protect U.S. books, movies, audio recordings, and computer software. The new laws also will extend patent coverage to chemical and pharmaceutical products as well as reform a variety of trademark regulations.

Tobacco

The lack of U.S. access to South Korea's $1.5 billion cigarette market long has been a point of contention between Seoul and Washington. For decades, the ROK government's Office of Monopoly has controlled tobacco farming and the cigarette manufacturing and marketing industry. The result was that 10 percent of all government revenues currently are derived from tobacco profits and taxes. Importation of cigarettes has been completely banned except for sales to foreigners in designated locations. In fact, for years it has been illegal for South Korean citizens even to possess foreign cigarettes.

In a surprise move coupled with the Section 301 resolution in July, Seoul announced an end to the ban on consumption of U.S. cigarettes. Effective September 1, 1986, the ROK allowed importation of 40 million packs of cigarettes annually, an amount representing one percent of its domestic market. While foreign cigarettes will be subject to high tariffs, U.S. tobacco companies hope to earn $15 million annually in the ROK. To facilitate the liberalization of the South Korean tobacco market, the government's Office of Monopoly will be converted into a public corporation. These modest first steps should be expanded. Eventually, the ROK should remove all barriers to foreign cigarettes.

Import and Investment Liberalization

Over the past five years, the ROK has liberalized restrictions and regulations concerning foreign investment in South Korea. As late as 1979, only about two-thirds of all imports could enter the ROK without prior licensing arrangements. At that time, the average tariff rate on industrial products was over 30 percent. Today, over 90 percent of incoming goods are free from licensing restrictions, while the average tariff level has been reduced to about 19 percent. The ROK has responded to specific U.S. requests by ending licensing

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5. Peter Allgeier, Assistant U.S. Trade Representative, Testimony before the House Special Subcommittee on U.S.-Pacific Rim Trade, August 11, 1986, p. 8.

restrictions on such items as lemons, raisins, glassware, construction equipment, auto parts, and cosmetics. Seoul also has announced a liberalization schedule for 1987 and 1988.

The ROK's liberalization efforts also have affected foreign investment. As of 1980, foreign investors were allowed to hold 100 percent equity in many domestic ROK industries. In 1984, the ROK lifted all controls on the repatriation of profits and designated over 600 industrial sectors in which foreigners can invest without government approval. Industries still closed to foreign investment include public utilities, the news media, and sensitive defense-related businesses. Those requiring approval prior to investment include what the government calls "infant industries" and a variety of agricultural sectors. The list of completely closed industries is shrinking and will comprise only 10 percent of all South Korean industries by 1988. Enhanced U.S. investment access to the ROK allows for joint ventures with South Korean firms that can improve the competitiveness of U.S. goods produced there and allow American firms to be better poised for penetrations of Japan's markets.

While the U.S. government is pressing for further ROK concessions and economic liberalizations, the U.S. Trade Representative's office points out that "the Korean government, unlike most other developing countries, unilaterally has adopted a timetable for further liberalizing of its economy...[and that] Korea's market-opening measures have been implemented on a non-discriminatory basis."[6]

Some Koreans note that U.S. companies have not moved effectively to take advantage of the reforms. By contrast, they say, Japan has been the largest beneficiary of the import and investment liberalizations. Example: of the 31 goods liberalized in January 1984, the U.S. captured only 16 percent of the ROK's total imports of those goods while Japan took 44 percent.[7] In a discussion with The Heritage Foundation, ROK Trade and Industry Minister Rha Woong Bae called on U.S. businessmen to "try harder to sell American products in Korean markets." Referring to the recent opening of South Korean electronics industries to foreign investment, Rha explained that the first major foreign factory is being built by the Mitsubishi Electronics Company, pointing out that "the Japanese [rather than the Americans] again appear to take the lead, and this will not contribute to lessening the trade gap between the U.S. and Korea."[8]

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6. Ibid.

7. Korea's Economy, Korean Economic Institute, Washington, D.C., May 1986, p. 3.

8. "The Republic of Korea: Facing the Future," Heritage Foundation Lecture No. 70, July 10, 1986, Seoul, Korea.

Other ROK Measures

Under the 1986 to 1991 economic plan, the ROK is placing a high priority on reducing the current U.S.-ROK trade imbalance. A Ministry of Trade and Industry official recently expressed Seoul's desire "to slash our trade surplus with the U.S. to $1.6 billion or so by 1991," down from over $4 billion last year.[9] Seoul is taking a number of steps to do this. Last April, an ROK buying mission came to the U.S. and signed $275 million in purchase agreements. Another mission slated for next February will shop for American goods in 15 states. The ROK government is also considering importing an estimated $30 million worth of Alaskan crude oil.

Seoul is particularly interested in finding ways to adjust its trade with Japan. In recent years, the ROK's trade deficit with Japan roughly has equalled its surplus with the U.S. The South Korean government is urging domestic companies to shift their purchases of some items from Japanese to U.S. suppliers, especially in the areas of construction equipment, coal, and machinery. The recent strengthening of the yen should help this by making U.S. goods more price competitive with Japanese and improve the competitiveness of South Korean products in Japan.

Finally, the ROK is steadily increasing its direct investment in the U.S. Over the past decade, South Korea has invested about $100 million in major U.S. projects including television plants in New Jersey and Alabama, a coal mine in Pennsylvania, and semiconductor factories in California. This year, a joint steel venture in California between USX Corporation and the ROK's Posco Company will amount to $150 million in South Korean investment over the next four years.

U.S. Commerce Department staffers recently reported that "the ROK government intends to step up its encouragement of Korean overseas investment...and government officials give every indication that they intend to include investment in the U.S. as a strategic priority." This growing ROK investment in the U.S. benefits both Americans and South Koreans. Such investments not only create U.S. jobs and stimulate local economies but also have positive public relations value for the ROK's image as a trading partner. South Koreans also understand that building their factories in the U.S. gives them direct access to American markets in a way that does not add to the U.S. trade deficit.

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9. Korea Herald, August 27, 1986, p. 4.

ROK PUBLIC REACTION TO U.S. PRESSURE

The South Korean media have been largely critical of U.S. trade measures and charge that Americans fail to take into account the vulnerability of the ROK's export-driven and heavily indebted economy. South Korean public reaction to Washington's pressure for market access and cuts in certain ROK exports to the U.S. has been very emotional and nationalist. Many South Koreans are particularly stung by charges that they represent a "new Japan." They feel that the ROK is becoming a scapegoat which Americans use to vent their frustrations over trade frictions with Tokyo. South Koreans also feel that the U.S., after generously supporting the ROK through the hard times of the 1950s and 1960s, now ironically is punishing South Korea for its success.

On occasion, these frustrations have led to organized demonstrations and even violence. In November 1985, a group of South Korean university students seized the office of the American Chamber of Commerce in Seoul to protest U.S. trade policies. Though this first-ever outspoken anti-Americanism was limited to a few radical students, it is alarming that mingled with the mainstream view of America as a trusted "big brother" are accusations of "U.S. economic imperialism."

Another sensitive aspect of U.S.-ROK trade disputes relates to South Korea's current domestic political situation. A clash over the proposed revision of the ROK constitution to pave the way for national elections next year has escalated political tensions between the ruling and opposition parties to their highest level since President Chun took office five years ago. U.S. trade pressure and the resulting ROK concessions have provided political ammunition for government critics and will likely force the Chun Administration to become more cautious in its approach to further economic liberalization. As in the U.S., trade and economic policies are hot topics of debate in South Korea during election years.

CONCLUSION

While the ROK in its early days relied heavily on economic aid from the U.S., South Koreans used American assistance as a spring-board to success. As a result, U.S.-ROK trade relations are experiencing growing pains associated with this transition. This is aggravated by high U.S. trade deficits and frictions with other important American trading partners.

In return for the trade and security benefits South Korea derives from the U.S., the ROK has reciprocal obligations. In recent years, South Korea has made good faith efforts to ensure improved access to its markets through an ambitious liberalization program. Responding to U.S. requests, the ROK just this year has accepted "voluntary" quota restraints on textiles, opened its insurance markets to U.S. firms, allowed the import of American cigarettes, strengthened intellectual property protection, dramatically increased its investment in the U.S., and begun long-range planning to reduce its dependence on U.S. export markets while increasing the ratio of goods it purchases from America. All of this is in addition to the import and foreign investment liberalization plan that was begun five years ago and remains on schedule today.

In view of all of this, Washington should make reasoned assessments of U.S.-ROK economic ties and ignore emotional protectionist arguments. The current GSP guidelines, for example, which set item-specific criteria for participation in the program, should be kept. Safeguards preventing tariff advantages for goods which are adequately competitive in the U.S. market are in place and working. Legislation designed to exclude South Korea or any other country from the program based simply on the feeling that a nation is ready to fend for itself defeats the purpose of the GSP system.

The U.S. should press Korea to carry out its planned liberalization and to consider expediting some market-opening measures. In particular, the ROK's citrus and high quality beef markets, which remain essentially closed to U.S. exports, should be opened. High ROK tariffs on lumber and wine exports from the U.S. should be reduced. Korean concessions in these areas could help neutralize much of the political pressure for U.S. protectionist measures aimed at Seoul.

Finally, American businesses should consider the expanding sales and investment opportunities in Korea. Otherwise, Japan and other competitors may become the greatest benefactors of ROK economic liberalizations.

Much is at stake in the U.S.-ROK trade relationship. Two-way trade now exceeds $17 billion annually and is rapidly increasing. Continued expansion of mutually beneficial economic ties will depend on the pace of South Korea's liberalization efforts and on America's ability to resist pressure for destructive protectionist measures.

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