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THE STRATEGIC IMPORTANCE OF U.S.-KOREA ECONOMIC RELATIONS

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I. 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, the U.S. confrontation with North Korea—a charter member of the "axis of evil"—has intensified in recent years. Yet today, increasing numbers of South Koreans, accustomed for decades to living 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. The gap in the two countries' respective assessments of the North Korean threat has widened dangerously, threatening to undermine their alliance.

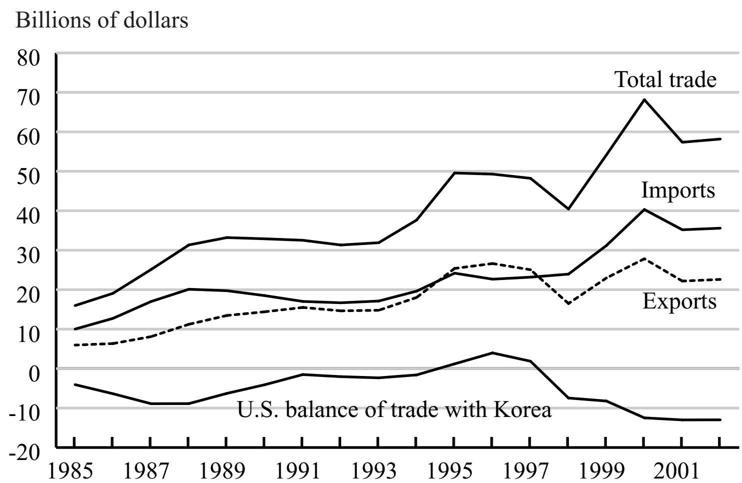
The divergence in threat perceptions has been reinforced by differences in attitudes toward a host of issues that have emerged in the post-9/11 world. Within South Korea, long-standing resentments, alleged U.S. arrogance, unilateralism, racism, and recent specific irritants—including the perceived denigration of both the Sunshine Policy and President Kim Dae-jung by the Bush administration during the March 2001 summit as well as the deaths of two South Korean schoolgirls in a military training accident and the subsequent acquittals of the U.S. service personnel involved—contributed to massive anti-U.S. 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 and a general lack of support for the U.S.-led war on terrorism and, subsequently, for the U.S.-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 government appears to have secured broad support in the National Assembly behind the subsequent increase—to 3,000 combat troops—in the South Korean contingent, although the durability of this consensus will surely be tested if and when South Korean forces begin taking casualties. The survey by the Pew Research Center for the People and the Press (2002), *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.

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.

II. The Economic Relationship and Its Evolution

As shown in ***Figure 1,*** total trade between the United States and South Korea in 2002 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 the sixth largest export market (behind Canada, Mexico, Japan, Germany, and the United Kingdom) of the United States and the fourth largest market for U.S. agricultural products. In 2002 the United States ran a $13 billion merchandise trade deficit with South Korea.

Figure 1: **U.S.-South Korea Trade Volume, 1985–2002, in billions of dollars**

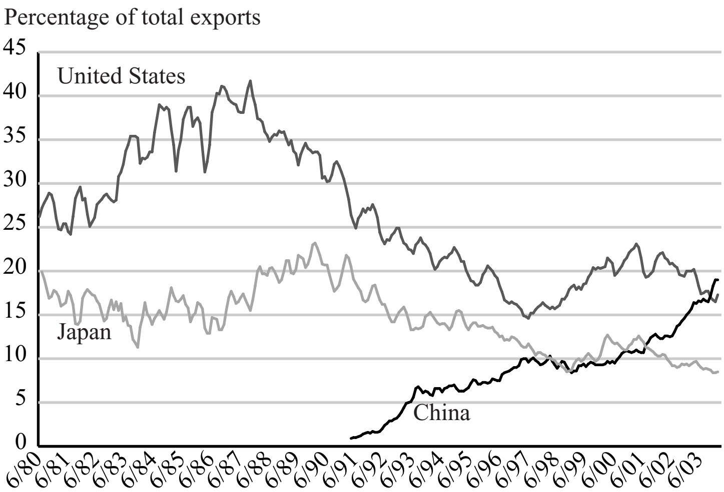


Source: Census Bureau, various years.

From the South Korean perspective, the share of merchandise exports going 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 2003 (***Figure 2***). Similarly, on the import side, after the United States briefly supplanted Japan as South Korea's primary supplier of imports in the late 1990s after the Asian financial crisis, the U.S. share of South Korean imports has once again begun drifting downward. In 2002 the United States supplied less than 15 percent of South Korea's merchandise imports (***Figure 3***).

The sectoral composition of U.S.-South Korea bilateral trade largely mirrors each country's global trade pattern (***Table 1***). U.S. exports to South Korea of natural

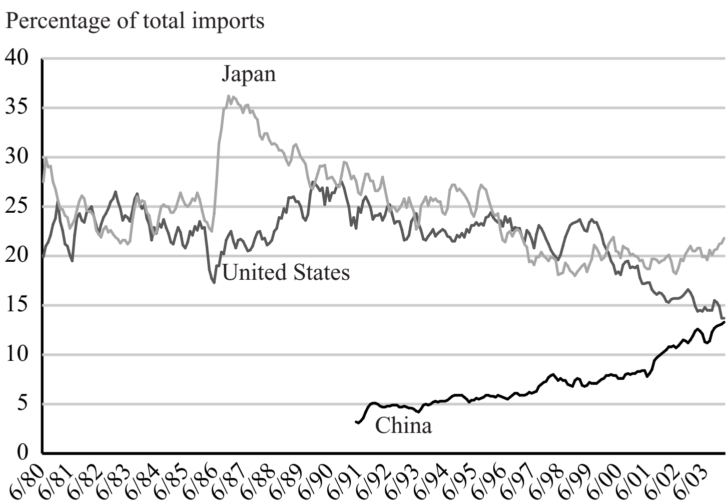
Figure 2: **South Korea's Exports, 1980–2003**



Source: BOK, various years.

Note: Three-month moving average.

Figure 3: **South Korea's Imports, 1980–2003**



Source: BOK, various years.

Note: Three-month moving average.

resources-based goods such as agricultural products (SITC 1) or mining (SITC 3) are supernormal, reflecting South Korea's dearth of natural resources. But most trade between the United States and South Korea is concentrated in the manufacturing sector, with more than half of overall trade and fully two-thirds of U.S. imports consisting of machinery and transport equipment (SITC 7), which includes machine tools, motor vehicles, and aircraft among other products.

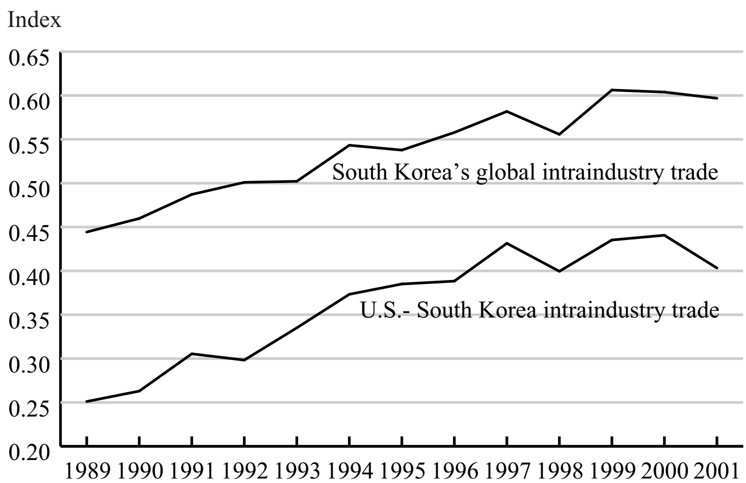
***Table 1:* Composition of Global and Bilateral U.S. and South Korean Trade, by Standard International Trade Classification (SITC), 2001, percentage**

SITC	South Korea				United States			
	Total exports	**Total imports**	**Bilateral exports**	**Bilateral imports**	**Total exports**	**Total imports**	**Bilateral exports**	**Bilateral imports**
0 Food and live animals	1.5	4.9	0.6	8.2	5.7	3.4	8.2	0.6
1 Beverages and tobacco	0.2	0.4	0.1	0.6	0.8	0.9	0.6	0.1
2 Crude materials, inedible, except fuels	1.1	6.4	0.5	9.6	3.8	1.8	9.6	0.5
3 Mineral fuels, lubricants and related materials	5.3	24.2	2.2	0.9	1.8	10.9	0.9	2.2
4 Animal and vegetable oils, fats and waxes	0.0	0.2	0.0	0.2	0.2	0.1	0.2	0.0
5 Chemicals and related products n.e.s.	8.4	9.4	2.8	12.1	11.3	7.0	12.1	2.8
6 Manuf. goods, classified chiefly by material	17.9	12.1	10.8	7.6	9.3	11.0	7.6	10.8
7 Machinery and transport equipment	56.0	34.2	67.4	50.6	52.0	42.3	50.6	67.4
8 Misc. manufactured articles	9.6	8.0	15.4	9.6	11.6	18.4	9.6	15.4
9 Commodities and transactions not classified elsewhere	0.0	0.1	0.0	0.6	3.7	4.2	0.6	0.0

Source: United Nations, various years.
Note: n.e.s., not elsewhere specified.

The prominence of the machinery sector is emblematic of the transformation of South Korea's global and bilateral trade pattern that has occurred over the past 40 years. As South Korea has developed, the predominant mode of trade has shifted from interindustry trade (the exchange of dissimilar goods, such as cloth for wheat) to intraindustry trade (the exchange of different varieties of similar products, such as different types of machinery). This is important because a given expansion of intraindustry trade is generally thought to pose smaller adjustment problems (and by extension fewer political frictions) than an equivalent expansion of interindustry trade.[1] As can be seen in ***Figure 4,*** which depicts South Korea's index of intraindustry trade, South Korea's intraindustry trade has grown steadily over time. The degree of intraindustry trade with the United States is somewhat lower than the global figure, which reflects the continuing prominence of natural resources–based products in the bilateral trade pattern.

Figure 4: **South Korea's Intraindustry Trade, worldwide and with the United States, 1989–2001**



Source: World Bank, various years.
Note: Measure varies from 0, indicating pure interindustry trade, to 1, indicating pure intraindustry trade. Data have been controlled for trade imbalance.

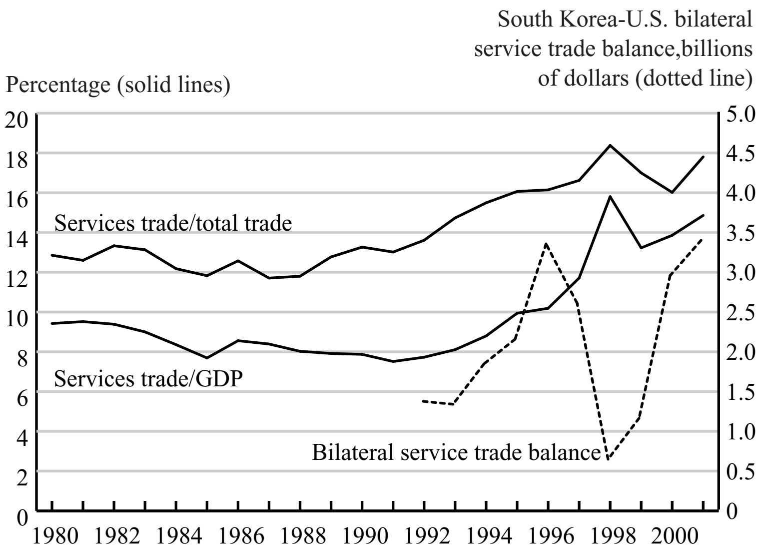
Bilateral trade in services, cross-border investment, and local sales by majority-owned foreign affiliates have grown more robustly than merchandise trade. The share of services trade in South Korean GDP doubled to 15 percent during the decade preceding 2001, and the United States is the major supplier of services to the South Korean economy. In 2002 the United States ran a $3.3 billion bilateral surplus (***Figure 5***).

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

1. It is easier to redeploy capital and labor to produce a different variety of a similar product than to turn farmers into factory workers or vice versa.

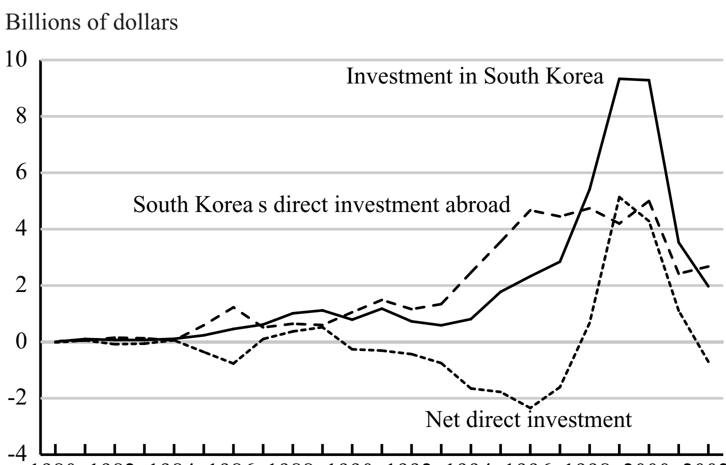
Asia in which the primary mode of U.S. investment was minority-stake joint ventures rather than majority-stake joint ventures or fully owned subsidiaries. Policy reform and market pressure have encouraged an expansion of FDI into South Korea in the aftermath of the Asian financial crisis. As shown in ***Figure 6,*** the inward flow of foreign investment from all sources experienced a one-time surge, as foreign investors

Figure 5: **South Korea's Imports and Exports of Services, 1980–2003**



Sources: World Bank 2003; Department of Commerce, various years.

Figure 6: **South Korea's Direct Investment, 1980–2002**



Sources Bank of Korea, various years.
Note: Based on balance of payments.

bought out their Korean joint-venture partners, and then subsequently declined (as it did elsewhere in the world).

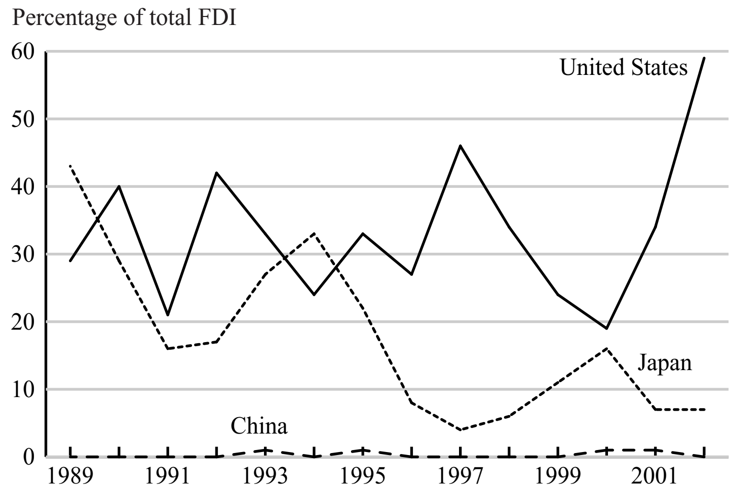
Beyond this overall result, the specifics of the bilateral picture are clouded by a number of data problems. The most widely cited data on South Korean FDI inflows are gross investment figures produced by the Ministry of Commerce, Industry, and Energy (MOCIE) on an approvals basis. These data may include investments that were planned but never executed, and they do not include reinvested earnings or take into account possible disinvestments. As a consequence, these data typically differ from the net investment figures produced on a balance-of-payments basis, sometimes quite substantially so. Moreover, the data on bilateral investment stocks and flows produced by the South Korean government diverge significantly from those produced by the U.S. Department of Commerce, sometimes even with respect to trends. A final complication is that, with the overall level of FDI into South Korea relatively small, a few big transactions such as the sale of Korea First Bank to Newbridge Capital or Daewoo Motor to GM can dominate the data for a particular year. Some of these big transactions have been routed through tax havens such as the Cayman Islands so that they show up in the South Korean data as investments from the Cayman Islands—not Europe or the United States.

With these caveats, what we can say is that the flow of U.S. investment into South Korea grew much more rapidly than trade in the aftermath of the Asian financial crisis, peaked between 1999 and 2001, and then declined, though it remains significant.[2] In recent years the United States has been the single largest investor South Korea, though in some years American investment may have been exceeded by European investment from all sources. According to the South Korean data, Europe in aggregate 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 (***Figure 7***).

Globally, U.S. trade is increasingly intrafirm, so that the expansion of the U.S. investment presence in South Korea could be expected to increase U.S. trade with South Korea. The U.S. Department of Commerce's 1999 Benchmark Survey (Department of Commerce 1999) indicates that majority-owned affiliates accounted for 7 percent of U.S. exports to South Korea, mostly in computers and telecommunications equipment, while 1 percent of imports took the form of intrafirm trade. 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,

2. According to U.S. government figures, the stock of U.S. investment in South Korea grew by more than 10 percent in 2002.

Figure 7: **FDI in South Korea, 1980–2002**



Source: Ministry of Commerce, Industry, and Energy, various years.
Note: FDI on an approval basis.

majority-owned affiliates of U.S. firms racked up services sales of $1.7 billion in South Korea (while South Korean affiliates in the United States had sales of $385 million).

According to the 1999 Benchmark Survey, overall economy-wide sales were concentrated in wholesaling (29 percent) and computers and electronics products (14 percent). The same source indicates that majority-owned U.S. affiliates employed more than 43,000 South Koreans, with computers and electronics products and wholesale trade again being the leading sectors. These figures have surely risen in the intervening years.

In sum, the United States remains an important economic partner for South Korea although the character of that relationship is changing. South Koreans perceive that U.S. prominence in merchandise trade is eroding, especially in comparison with China. However, in the emerging areas of services and investment, the U.S. 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.

III. Economic Policy Issues

The overall trend in South Korean trade policy is toward greater liberalization. Over a period of roughly twenty years, South Korea has greatly reduced the protection of its domestic market. In the industrial sector, tariffs have been cut to levels comparable with other OECD member countries, and quantitative import restrictions have been eliminated. The share of imports in the South Korean economy increased to 42 percent despite a substantial decline in the real exchange rate after the financial crisis. The share of imports in the domestic consumption of manufactures is higher than in the United States and more than three times higher than in Japan.

Agriculture

In the agricultural sector, the trend has clearly been toward liberalization—since the opening of the beef market in 2001, rice is the only product subject to quantitative restrictions. Yet significant barriers remain. The average bound tariff in agriculture is 62 percent. A number of agricultural products remain subject to tariff-rate quota schemes, where the average out-of-quota tariff is 50 percent. Forestry and fishery tariffs remain unbound (i.e., can be increased by fiat). U.S. producers also complain that import clearance procedures; customs procedures; and standards, testing, certification, and labeling requirements all impede access to the South Korean market. For their part, South Korean agricultural exporters similarly allege that excessive customs delays are caused by unnecessary inspections and quarantines in the United States.

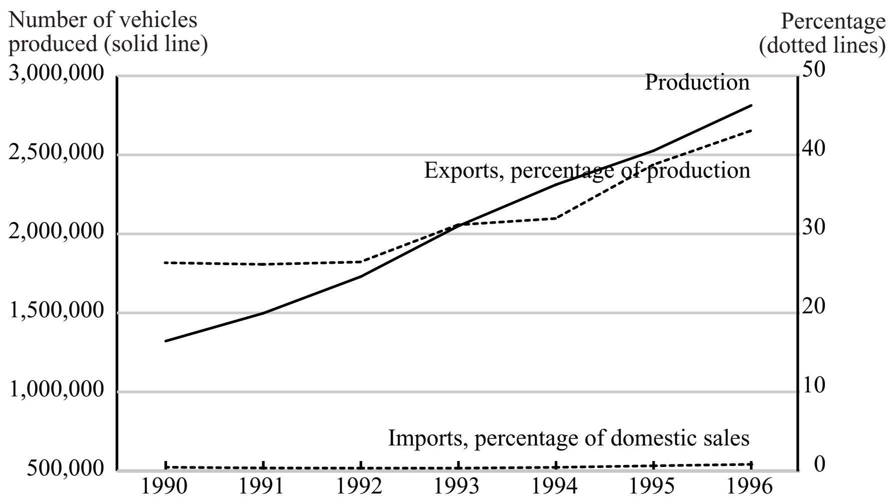
South Korea's external barriers are reinforced by trade-distorting internal supports. After declining during the mid-1990s, producer support—measured as monetary transfers to agriculture as a share of the total value of output at domestic producer prices—has risen and was 64 percent in 2001, a figure higher than that of Japan, twice the OECD average, and 20 times higher than that of the United States. Transfers are more than $400 per capita, and the share of transfers in national income—nearly 5 percent—is more than three times the OECD average. The net result of external trade barriers and internal supports is that South Korean consumers face food prices that are more than two and one-half times the world level. Although a number of agricultural exporters around the world have complained about recent increases in U.S. farm supports, given South Korea's fundamental lack of competitiveness in bulk commodities, it is unlikely that the U.S. subsidies have a significant impact on South Korean access to the U.S. market.

Industry

The liberalization trend is less ambiguous in the industrial sector. South Korea has scrapped all quantitative controls in the industrial sector, including the import diversification system that discriminated against Japan. The average tariff in the industrial sector is 7.5 percent, and, as part of a multilateral initiative, South Korea has agreed to reduce bound tariffs to zero on all or most products in the paper, toy, steel, furniture, semiconductor, and farm equipment sectors. Tariffs on scientific equipment, textiles, and apparel are also being cut.

The motor vehicle sector stands out as a source of continuing friction. South Korea is the world's fourth largest producer (after the United States, EU, and Japan; or the fifth largest if Germany and France are counted separately) (***Figure 8***). South Korea exports more than 40 percent of domestic production, making it the world's second-largest exporter behind Japan. The United States is South Korea's number one export destination, and in 2002 imports from South Korea accounted for nearly 6 percent of U.S. car sales but less than 2 percent of sales of light trucks. The latter are inhibited by a 25 percent U.S. tariff—the bizarre legacy of a 40-year-old trade dispute between the United States and Europe over chickens, of all things.

Figure 8: **South Korea's Motor Vehicle Industry, 1990–1996**



Sources: Korea Automobile Importers and Distributors Association, various years (domestic sales, production, and export sales); Korea Automoble Manufacturers Association, various years (import sales).

The South Korean domestic automobile market is a highly concentrated oligopoly in which a single firm, Hyundai/Kia, accounts for more than 80 percent of sales, although it is hoped that more competition will be injected into the market by the purchase of Daewoo Motor by GM. Imports comprise less than 1 percent of domestic consumption.[3] Of the vehicles imported into South Korea, exports from the United States account

3. By comparison, imports make up 5–6 percent of domestic consumption in Japan, and 25–30 percent in the United States and the EU.

for one-fifth, and exports by Automotive Trade Policy Council members (DaimlerChrystler, Ford, and GM) from all sources make up one-third. Motor vehicles stand out as a noticeable exception to the pattern of increasing intraindustry trade in the manufacturing sector.

Automobiles imported into Korea are subject to an 8 percent tariff and, more important, are subject to internal taxes based on engine size. The latter measure, although it is applied equally to imported and domestically produced cars, has the effect of discouraging the sales of foreign models that tend to be larger and more luxurious. These internal taxes and various standards and certification requirements, residual restrictions on U.S. firms' consumer financing activities, and certain aspects of consumer auto loan financing were subject to bilateral memorandums of understanding concluded in 1995 and 1998; these continue to be issues of concern to the U.S. government.

Nam and Yang (2003) purport to model the potential impact of changes in consumer preferences on trade in the South Korean and world motor vehicle markets, but their results (that an elimination of South Korean preferences for domestically produced vehicles would result in a decrease in South Korean imports, an increase in South Korean exports, a widening of the trade gap, a rise in South Korean welfare, and a fall in U.S. welfare) appear to be driven by their assumed increase in South Korean productivity—not the elimination of domestic bias in consumption. Their model is such that it does not allow them to investigate the issue of discriminatory internal taxation.

For their part, the South Koreans are most concerned about the U.S. application of U.S. trade remedy laws such as antidumping (AD), countervailing duty, and safeguard statutes, especially in regard to the steel and semiconductor industries. Although AD laws, the bête noire of trade policy instruments, may appeal to a certain sense of fairness and economic rationality—firms should not be subject to predation—they are fundamentally flawed in both their theory and application. Dumping may arise even under competitive market conditions because of market segmentation, transport costs, or other trade impediments. Indeed, even in perfectly competitive markets, firms may choose to price below marginal cost in the initial stages of production with the expectation that costs will eventually fall. In fact, it was Texas Instruments, a U.S. firm, that pioneered "forward pricing" in the semiconductor industry. Likewise, competitive firms may temporarily price below costs if production or distribution is characterized by quasi irreversibilities or hysteresis. This may occur in a floating-exchange-rate system as a function of transitory overshoots.[4] Finally, there are severe

4. Dumping rules include provisions for exchange rate fluctuations but not misalignments.

problems with the cost-based methods used in the implementation of the law by a frankly protectionist bureaucracy in the United States.

Perhaps most important, AD actions effectively create a price-floor policy, making the imposing country a high-cost production location when AD duties are imposed on imported inputs. During any cyclical weakening of demand, foreign firms will be tempted to cut their home prices because their ability to compete in foreign markets is restricted by the AD action. The result is that downstream users of the product (manufacturers of computers or telecommunications products in the case of semiconductors, for example, or automobile assemblers in the case of steel) in net importing regions will be put at a competitive disadvantage.

The United States is the world leader when it comes to AD actions, averaging 42 a year between 1980 and 2000, more than half of which ended in affirmative determinations and the imposition of duties. At present, South Korea is subject to 15 U.S. AD orders. South Korean neuralgia with respect to U.S. AD practices is at least in part a product of past outrageous U.S. actions: for example, the 1985 imposition of 65 percent dumping margins on 64 small firms producing photo albums; this effectively ended all such U.S. imports. In fact, there is extensive evidence that the mere filing of AD cases has a demonstrable effect on product pricing and trade flows. Domestic producers can often intimidate foreign producers, which want to avoid costly legal action in the United States, into raising prices and restraining exports merely by filing a case that may be later withdrawn. If one simply allocates proportionately the welfare loss estimated by Galloway, Blonigen, and Flynn (1999), AD cases against South Korea reduce U.S. economic welfare by approximately $260 million annually.

Steel is primarily not a bilateral issue, although South Korea figures prominently. Globally the industry is characterized by excess capacity due to ubiquitous national promotion policies, including tolerance of cartels. Nor is this problem new: legislation was introduced in the U.S. Congress in 1968 to impose import quotas, and, in the decades since, the industry has periodically been afforded special protection in the United States. Indeed, over the past 20 years, the U.S. industry has responded by adding 20 million tons of capacity, while the EU, for example, was reducing capacity by 50 million tons. Even while domestic production has increased, however, employment in the steel industry has fallen steadily due to the adoption of efficiency-enhancing technological improvements.

In 1998 the United States experienced a surge of steel imports as a result of the booming U.S. economy, the slump in Asia, exchange rate movements, and a reorientation by Russian producers toward foreign markets. In 1999, after the worst had passed and conditions were improving, the industry filed AD cases and sought special protection, abjuring conventional escape-clause relief. The steel quota bill failed, but the industry continued its political campaign. In 2000, Sen. Robert Byrd (D-W.V.) successfully inserted into an agriculture bill a rider that would give U.S. steel producers, rather than the U.S. government, the roughly $40 million in proceeds from AD duties. The agriculture bill, including the Byrd amendment, was signed into law in October 2000 and came under immediate attack in the World Trade Organization (WTO) by U.S. trade partners, including South Korea. As in earlier cases, the WTO ruled against mostly procedural aspects of U.S. practices.

In June 2001 the Bush administration, trying to square the circle, announced the Multilateral Initiative on Steel that sought multilateral negotiations to reduce excess capacity and the initiation of new international rules to govern the steel trade with the aim of eliminating subsidies. The initiative also took the highly unusual step of self-initiating a Section 201 safeguards investigation, eventually imposing a three-year schedule of duties that declined from 19 percent in the first year to 11 percent in the final year. South Korea and others challenged this policy in the WTO. After an adverse WTO ruling, the Bush administration withdrew the tariffs in December 2003.

The semiconductor industry also has a long history of trade disputes, going back to the Semiconductor Trade Agreement concluded between the United States and Japan in 1986 that, ironically, encouraged the development of the industry in South Korea. Unlike the situation with respect to steel, South Korea is firmly the focus of the current dispute over semiconductors which began in 2001 and centers on U.S. (and EU) allegations that the South Korean government has used its influence over the financial system to prop up Hynix Semiconductor to the detriment of U.S.-based Micron Technology (and Germany's Infineon).

For a time it appeared that the dispute would be resolved through an offer by Micron to take over Hynix that was supported by Hynix's creditors, but it was scuttled by the Hynix board. In November 2002, Micron filed a countervailing-duty case against Hynix, alleging that the South Korean government's actions amounted to an illegal subsidy, and on 1 April 2003 the U.S. Department of Commerce announced a preliminary countervailing duty of 57 percent against Hynix's chips. Micron's stock price rose 12 percent on the April Fool's Day announcement. In the meantime, the EU and Taiwan are pursuing similar complaints under their respective laws.

If, as expected, the Europeans reach a similar outcome, several results predictably will follow. Chip prices will rise in the United States and the EU, helping Micron and Infineon but hurting downstream users in those locations. Hynix will be forced to dump its chips in Asia, primarily hurting emerging Chinese producers but lowering costs to chip users in Asia such as electronics assemblers in China and Southeast Asia. Hynix will probably lose market share as its capital-starved plants lose competitiveness. The net result will be to encourage a further migration of electronics production from the United States and Europe to Asia.

Beyond trade remedy laws, South Koreans complain about the complexity of the decentralized, multilayered regulatory system of the United States that in certain respects does not conform to international norms and that places a particular burden on small firms trying to enter the U.S. market. Industrial-products exporters complain that they are subject to unnecessary testing and certification standards, such as being required to obtain an Underwriters Laboratories (UL) mark for equipment already certified in South Korea and not intended for consumer use.

Decentralization and complexity are also at issue with respect to government procurement. Existing WTO rules do not cover procurement by all states and many municipalities. Many of these have Buy American laws, especially in steel and transportation vehicles, two sectors of South Korean comparative advantage.

Intellectual Property Rights

South Korea has considerably improved intellectual property rights (IPR) protection as a result of internal demands from emergent South Korean intellectual property producers as well as bilateral and multilateral external pressure. In 2002, as part of its annual Special 301 ritual, the U.S. government downgraded South Korea from its Priority Watch List to its Watch List with regard to IPR protection. With the exception of nascent issues with respect to the Internet—digital copyrights, for example—most of the U.S. concern appears to center less on the inadequacy of existing laws and regulations and more on enforcement, particularly with regard to computer software, pharmaceutical patents, trade secrets, and copyrights.

Services

Trade in services is on the agenda of the Doha Round of the WTO, and WTO members have reportedly made liberalization requests to South Korea covering all 12 services sectors recognized by the WTO. Financial and legal services are expected to figure prominently in South Korea's negotiations. In the financial services area, U.S. interest centers on residual restrictions on foreign access in the insurance and banking sectors. South Korea's is the second largest insurance market in Asia, with $47 billion in premiums paid in fiscal year 2001; and, although the sector has been significantly liberalized, residual restrictions on the activities of foreign firms, especially in the non–life 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; it owns shares of six of the eight nationwide banks (with a majority position in two of these) and three of the six major local banks (with a majority stake in two). According to the IMF, when bank ownership stakes are 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, however, to induce fresh capital and managerial know-how, 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.

South Korean practices in the legal services area are fairly restrictive. Although non-Koreans can be licensed to practice law providing they meet the criteria applied to Koreans, the scope for non-Koreans to provide other services is both circumscribed and subject to nontransparent delineation. There are, for example, no provisions for non-Koreans to practice non-Korean law, nor for non-Koreans to provide legal consultancy services through local firms, although in practice this occurs. Although given the overabundance of lawyers in the United States one is tempted to congratulate the South Koreans for keeping them at bay, the absence of internationally recognized firms and the apparent dearth of international-standard, high-quality service providers presumably will act as an impediment to South Korea's self-identified goals of internationalization and the establishment of a regional business hub.

Beyond financial and legal services, other areas of concern to the United States include construction, advertising, accounting, engineering, direct selling, and television and cinema foreign-content quotas.

In the services sector, South Koreans complain about the Jones Act, which requires that merchandise transported entirely or partly by water between points in the United States must be carried by U.S.-built, U.S.-owned, U.S.-crewed, and U.S.-documented vessels. This cabotage rule undoubtedly impedes both the sale of South Korean vessels as well as South Korean maritime services in the United States.

Investment

To a certain extent the ability to supply investment services is contingent on the ability to invest locally. While South Korea did experience a substantial increase in investment after the financial crisis, inward FDI has fallen in recent years, and, as of 2000, South Korea ranked 23rd out of the 25 OECD member countries for which these data are available in stock of inward FDI as a share of GDP, besting only Japan and Iceland.

Foreign investors typically identify three barriers to investment in South Korea (two apply equally to domestic investors as well). Labor market problems are the most widely cited impediments to investment in both surveys of U.S. 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—as long as the government is willing to bail out management, any union leader who compromises would be, in American parlance, a chump.

The stated goal of the Roh Moo-hyun government to revitalize President Kim Dae-jung's Tripartite Commission of business, labor, and government has further raised concerns that South Korea may be headed toward a corporatist labor market model along continental European lines. Policies and institutions matter: although South Korea, the United States, and France all have similar unionization rates, labor market practices differ significantly between the United States and France. U.S. investors have expressed concerns regarding issues such as restrictions on redundancies, mandatory severance pay, and the potential criminal liability of expatriate managers for a broad range of infractions.

The second impediment to investment is a lack of transparency in financial accounting. The impact on FDI is particularly acute. In the Global Business Policy Council (2002) annual survey of corporate executives, South Korea placed 18th in the annual FDI confidence index, lagging such countries as India, Poland, and Thailand. The consulting firm PricewaterhouseCoopers (PwC), which actually calculates an opacity index (2001), ranked South Korea 31st out of 34, beating out 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 UK, and Singapore (the least opaque economies in North America, South America, Europe, and Asia, respectively)—admittedly a tall order—it would triple its FDI inflow. This is more than just theory or an econometric exercise. At least one large institutional investor places South Korea in its "tier three/semitransparent" category and imputes a significant "transparency risk premium" in its calculations of hurdle rates for investment in the South Korean economy (LaSalle 2001).

The third barrier to foreign investment consists of financial, tax, and other regulatory problems that, for example, impede the repatriation of revenues by multinational firms to their home offices. Other impediments to foreign investment include the issue of "borrowed technology"[5] and locational restrictions that primarily relate to measures undertaken to discourage geographical concentration in the area around Seoul.

Both South Koreans and the U.S. Chamber of Commerce in Korea complain about U.S. immigration rules that require all South Koreans to obtain visas to visit the United States, regardless of purpose. The time for processing these visas can be quite long

5. South Korean firms license technology extensively, and these licenses typically contain provisions that the license lapses if ownership of the licensee firm changes.

and can interfere with normal business activities and training involving South Korean nationals.[6]

The two countries have been trying unsuccessfully to conclude a bilateral investment treaty (BIT) for a number of years; the inability to reach a compromise on the South Korean screen quota has been a principal impediment. Growing two-way investment flows suggests that the absence of a BIT is less a critical barrier to interdependence than it is a testimony to the intractability of some cultural issues.

Modalities

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

Second, economically rational or not, the single best predictor of U.S. 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. This has also been a period of relatively robust macroeconomic performance and low unemployment—even with the recent U.S. recession—and trade policy issues have not gotten much political traction in this relatively benign macroeconomic environment. 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; it has been supplanted by China together with the perennial foci of U.S. trade policy complaints, Japan and the EU.

Finally, there have been changes in both policy and the institutional environment. The United States and South Korea have very different histories and very different political cultures and institutions. It is not surprising that, as an immigrant society, the United States has institutions that put a great emphasis on inclusion, transparency, and procedural justice. South Korea, in contrast, has a system of governance that historically has allowed for greater bureaucratic discretion in policy formation, and that policy has had an activist, infant-industry-promoting bent. While South Koreans may view the complainant-driven U.S. system as litigious, Americans could be forgiven if they regard the bureaucrat-dominated South Korean system as opaque.

6. In addition, the visa issue may also discourage the sale to South Koreans of U.S. tourism, education, and medical services that require cross-border personal mobility.

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. This is quite important, given the very different political cultures in the two societies and the tendencies for Americans to see disputes with South Korea as a product of duplicity and for South Koreans to regard these disputes as arising from predatory bullying by the United States.

Table 2 shows that both countries have made use of the WTO dispute settlement mechanism in managing bilateral trade disputes. Each has initiated six cases. Of the first three cases brought by the United States in the early days of the WTO, two involved agricultural inspection procedures and basically went into the suspended animation of bilateral consultations; the third, relating to shelf-life standards, was resolved bilaterally. The United States prevailed in its next two cases on discriminatory internal taxes on alcoholic beverages and the beef quota, and South Korea revised its policies accordingly. The WTO ruled against the United States in its most recent complaint involving government procurement.

Initially, South Korea was not as quick to bring complaints to the WTO, but it has been more active in recent years. All of its cases have involved U.S. application of AD or safeguard measures. The first case, on color television dumping, was resolved when the United States withdrew the AD order. The second case, also involving dumping, this time of DRAMs, was settled bilaterally. South Korea prevailed in the third case, involving steel dumping, when the WTO ruled in its favor and the United States brought its policy into conformity. The fourth case, involving safeguard measures applied to lead pipes, was settled bilaterally. The sixth case, involving safeguard measures applied to steel, was resolved when the United States revoked its tariff. In the remaining case, DS234, "Continued Dumping and Subsidy Offset," an arbitrator gave the United States until the end of 2003 to bring its practices into conformity; hence it will probably be 2004 before this issue is finally resolved one way or the other.

What is apparent from this record is that the United States is most concerned about South Korean internal impediments to trade, and South Korea is most concerned with U.S. AD practices. For both countries, the existence of the WTO system has encouraged bilateral and out-of-court types of 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 the two pending steel-related cases.

***Table 2:* U.S.-South Korea Trade Disputes**

Case	Date	Case number	Resolution
United States as a complainant since 1995			
Measures concerning the testing and inspection of agricultural imports	4/6/1995	WT/DS3	Pending consultation
Measures concerning the testing of shelf life	5/3/1995	WT/DS5	Settled bilaterally
Measures concerning inspection of agricultural products	5/24/1996	WT/DS41	Pending consultation
Taxes on alcoholic beverages	5/23/1997	WT/84	Appellate panel ruled in favor of the United States; South Korea revised contested measure
Measurements affecting imports of fresh, chilled and frozen beef	2/1/1999	WT/DS161	Panel ruled in favor of the United States; measures implemented by South Korea
Government procurement	2/16/1999	WT/DS163	Panel ruled against the United States
South Korea as a complainant since 1995			
Antidumping duties on color televisions	11/6/1997	WT/DS89	South Korea withdrew complaint when United States withdrew antidumping duties
Antidumping of DRAMs 1 MB and above	3/30/1998	WT/DS99	Settled bilaterally
Antidumping measures of stainless steel plate in coils	6/8/1999	WE/DS179	Panel ruled in favor of South Korea; measures implemented by the United States
Safeguard measures on imports of circular welded carbon quality line pipe	6/15/2000	WT/DS202	Settled bilaterally
Continued Dumping and Subsidy Offset Act of 2001	9/1/2001	WT/DS234	Joined as a third party against the United States; United States measures to conform pending
Safeguard measures on certain steel products	3/26/2002	WT/DS251	Appellate panel ruled in favor of South Korea; United States withdrew contested measure

Source: World Trade Organization, 2002.

Preferential Trade Initiatives

A final issue confronting the United States and South Korea is their participation in preferential trade agreements that can potentially help or harm both members and third-party nonmembers, most directly through trade creation and diversion. At present the most relevant of these is U.S. participation in NAFTA, which may have had a nonnegligible adverse impact on South Korea by diverting trade and investment to

Mexico and has 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, and China), the last one effectively a revival of the old East Asian Economic Caucus idea of former Malaysian prime minister, Mahathir Mohamad. President Roh Moo-hyun has also mentioned bringing North Korea into the fold. The credibility of these proposals, however, is questionable in light of the participants' WTO obligations. Article 24 of the General Agreement on Tariffs and Trade (GATT) and Article 5 of the General Agreement on Trade in Services (GATS) specify the conditions under which preferential trade arrangements are consistent with signatories' WTO obligations. The WTO must be notified of the intent to form an FTA; it must not raise barriers to other parties; tariffs within the FTA must be reduced to zero within "a reasonable time period," which was codified in the Uruguay Round agreement as 10 years; trade restrictions must be abolished in "substantially all sectors;" and liberalization should target the service sector per the GATS. For South Korea and Japan and their potential partners, the problem is the "substantially all sectors" requirement and how it relates to their economically inefficient but politically influential agriculture sectors.[7]

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), and an FTA 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 four reach similar conclusions: an FTA with South Korea would have a limited impact on Japan and a potentially negative impact on South Korea.[8] 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

7. Agriculture is also the reason why occasional proposals for a U.S.-South Korea FTA are not credible.

8. 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.

if the FTA expanded to include the ASEAN+3; Scollay and Gilbert reach the opposite conclusion.

The one explicitly dynamic model of a Japan-South Korea FTA, that of McKibbin, Lee, and Cheong (2002), produced under the auspices of a South Korean government think tank, obtains a positive impact on both Japan and Korea but a negative impact on the United States as well as some other Asian countries.

IV. Conclusions

The economic relationship between the United States and South Korea, characterized by increasing intraindustry trade, increasing 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 vehicle sector is an exception to the trend of rising intraindustry trade; steel remains a perennial, though not essentially a bilateral, problem; and AD practices in the United States and capital channeling in South Korea are 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, which has provided the two countries with a less politicized forum in which to resolve their differences.

The decrease in contention 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, and in Seoul the rise of China has added to interest in regional initiatives, which may adversely impact U.S. interests.

The net result may well be a relative decoupling of 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.

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