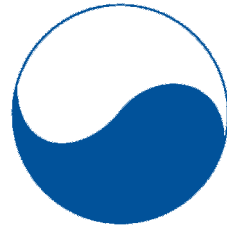

Korea's Economy 2005



a publication
of the
Korea Economic Institute
and the
Korea Institute of
International
Economic Policy

Volume 21

CONTENTS

Part I: Overview and Macroeconomic Issues

Economic Outlook for Korea in 2005 <i>Huh Chan-guk</i>	1
--	---

Part II: Financial Institutions and Markets

The Post-Crisis Transformation of Korea's Banking System <i>Thomas Byrne</i>	9
--	---

Prospects for Developing Korea's Financial Market <i>Jeon Jong-gyu</i>	13
--	----

Part III: Structural Reform

Responses to Financial and Economic Distress in Korea and Japan <i>Thomas Cargill and Hugh Patrick</i>	17
--	----

New Frontiers of Financial Reform in Korea <i>Kwon Jae-joong</i>	23
--	----

Part IV: External Issues

U.S.-Korea Economic Relations View from Washington <i>Nan N. Fife</i>	29
View from Seoul <i>Ji Hye-yang</i>	38

Korea's Trade and Direct Investment <i>Christine Brown</i>	43
--	----

The Yellow Sea Economic Basin <i>Pietro Doran</i>	48
---	----

Part V: North Korea's Economic Development and External Relations

North Korea's International Economic Relations: Trends and Future Prospects <i>Oh Seong-yul</i>	55
---	----

KOREA'S TRADE AND DIRECT INVESTMENT: TRENDS AND PROSPECTS

by Christine P. Brown

In 2004, the Republic of Korea (henceforth, Korea) had an exceptional year in terms of trade and investment. Trade and investment—inward and outward—each increased by more than 30 percent when compared with 2003 and reached new heights since at least the Asian financial crisis. The trade sector provided enough growth to prop up a domestic economy that continued to underperform in terms of depressed consumer spending and business investment. The year 2004 also saw the continuation of a number of trends: one trend is that China continues to grow in importance to the Korea economy.

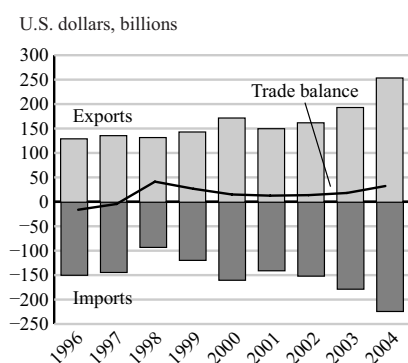
Exports Lead the Way

Despite a slowdown in real export growth in the second half of the year, higher oil prices, and an appreciating *won*, Korea's trade reached record levels in 2004 (*Figure 1*). According to the Ministry of Finance and Economy (MOFE), Korea's exports—the chief reason Korea's gross domestic product (GDP) growth was more than 4 percent for the year—reached a record \$254 billion in 2004, a 31.2 percent increase over 2003. Information technology and communica-

tions products had particularly strong years, with the export of mobile communication devices up 41 percent and semiconductors up 35 percent. Exports of automobiles—a perennial strong performer—were up 40 percent, and exports of ships were up 33 percent. On the strength of Korea's exports, which were combined with a 25 percent increase in imports, its trade surplus almost doubled to a record \$30 billion in 2004, after the \$15 billion recorded in 2003.

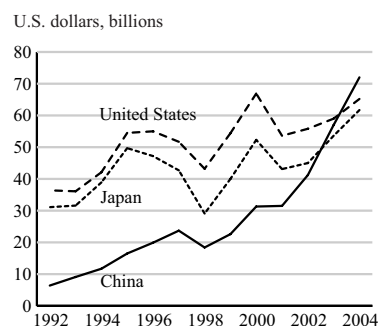
China's importance to Korea's economy continued to grow during 2004. After becoming Korea's number one investment location in 2002 and its number one export market in 2003, China (excluding Hong Kong) in 2004 became Korea's number one trading partner, its yearly total overtaking the United States for the first time (*Figure 2*). Korea's \$19.5 billion trade surplus with China was the highest level since the two countries established diplomatic relations in 1992. Although China has replaced the United States as Korea's number one trade partner, two-way trade between the United States and Korea increased by 18.3 percent to \$65.2 billion—evidence that the United States remains an important partner for Korea.¹

Figure 1: Korea's Trade Surplus, 1996–2004



Source: Economic Bulletin (Seoul: Ministry of Finance and Economy, 1996–2004), <http://english.mofe.go.kr/publications/economic.html>.

Figure 2: Korea's Two-Way Trade with Major Partners, 1992–2004



Source: Trade Statistics Database (Seoul: Korea International Trade Association, 1992–2004), www.kita.org.

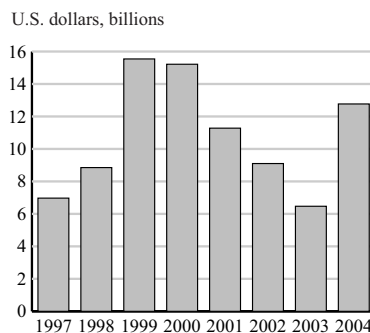
1. "Foreign Trade Statistics, Korea" (Washington, D.C.: U.S. Census Bureau), www.census.gov/foreign-trade/balance/c5800.html.

China remains a platform for manufacturing and assembly for Korean firms, but increasingly these Korean companies are also looking to the Chinese domestic market as a final destination for Korean products.² Products of Korean firms are now omnipresent in Shanghai—Samsung liquid crystal display (LCD) monitors are visible throughout the subway system, both in stations and on trains, providing passengers with the latest information about arriving trains and showing public service announcements as well as advertisements.

Investment Reaches New Levels

In contrast with sluggish domestic capital investment, inward and outward investment boomed in 2004. According to the Ministry of Commerce, Industry and Energy (MOCIE), inward foreign direct investment (FDI) nearly doubled to \$12.8 billion, exceeding the government’s goal of \$8 billion; this is the highest level since 2000 (*Figure 3*). More important, a significant portion of the investment was new. Greenfield investments—primarily in research and development and in the semiconductor, LCD, and automobile sectors—amounted to \$6.3 billion, virtually 50 percent of the 2004 total.

Figure 3: FDI into Korea, 1997–2004



Source: Statistics: FDI by Country (Seoul: Ministry of Commerce, Industry, and Energy), www.mocie.go.kr/eng/statistics/default/statistics_list.asp.

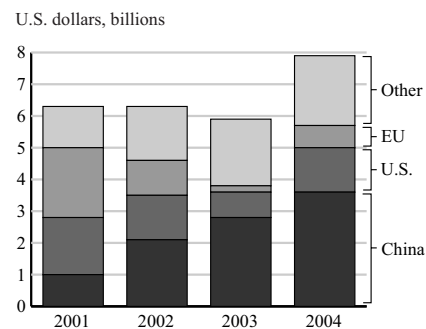
Mergers and acquisitions represented another major portion of total investment, accounting for \$5.5 billion. The two largest investments were Citigroup’s acquisition of KorAm Bank and Shanghai Automotive Industry Corporation’s purchase of Ssangyong Motor.

The United States and Japan continued to be the largest foreign investors in Korea, with the United States investing \$4.7 billion (up 281 percent from 2003) and Japan investing \$2.25 billion (up more than 300 percent compared with 2003).³

The return to positive year-on-year growth of FDI has been attributed to not only the general recovery of the global economy but also the Korean government’s efforts to improve the regulatory environment and to implement policies, such as expanding the availability of tax incentives and cash grants, that attract foreign companies.

At the same time as inward investment flows increased, Korean overseas direct investment (ODI) increased (*Figure 4*). According to MOFE, Korean firms invested \$7.9 billion overseas—a 37 percent increase over 2003—with the largest investments made in the United States and in China.⁴ Korea’s in-

Figure 4: Korea’s Overseas Direct Investment, by Major Recipient, 2001–2004



Source: Press releases (Seoul: Ministry of Finance and Economy, 2001–2004), <http://english.mofe.go.kr/>.

2. “Korean Firms Look to China’s Local Market,” News bulletin no. 545 (Seoul: Korea International Trade Association, Trade Research Institute, 14 January 2005), <http://global.kita.net>.

3. Statistics: FDI by Country (Seoul: Ministry of Commerce, Industry, and Energy), www.mocie.go.kr/eng/statistics/default/statistics_list.asp.

4. “Korean Overseas Direct Investment Totaled US\$7.94 Billion in 2004,” Press release no. 677 (Seoul: Ministry of Finance and Economy, 25 January 2005), http://english.mofe.go.kr/news/n_body.php?t=eh_news_press&i=689&p=1&q=&w=.

vestment in China increased 32 percent to \$3.6 billion in 2004, making Korea a larger investor in China than the United States or Taiwan. Korea's investments into the United States amounted to \$1.42 billion.

Government Policies Mirror Trends

The Korean government has mirrored these trends in implementing trade policies. From a point only a few years of ago, when Korea was one of the few countries completely committed to the multilateral system, it is now actively involved in the explosion of free trade agreements (FTAs). Since completing its FTA with Chile in 2003—although ratification took until April 2004—the government has been pursuing agreements with other countries. As evidence of the importance of Korea's FTA policy, the Ministry of Foreign Affairs and Trade (MOFAT) has established an entire office dedicated to implementing the government's FTA policy.⁵

While Korea pursues agreements with the countries of Norway, Iceland, Switzerland, and Liechtenstein through the European Free Trade Area (EFTA) as well as with Canada and Mexico, the real focus of Korea's FTA policy has been Asia. Korea has concluded an agreement with Singapore, is negotiating with Japan, is committed to negotiations with the Association of Southeast Asian Nations (ASEAN), and is open to a trilateral agreement comprising Korea, Japan, and China.

Is the Korea-China Honeymoon Over?

One of the hottest topics of discussion in Korea's trade patterns is the future of Korea-China trade. Since the normalization of economic and diplomatic relations in 1992, China-Korea trade has steadily increased, accelerating with China's accession to the World Trade Organization and the slowdown in both the U.S. and the global economy.

Thus far, China has successfully engaged the Asian region through economic diplomacy, particularly in Korea where China has been viewed favorably. Until recently, most of the frictions—such as the garlic trade dispute—between the two countries have originated on China's side. The honeymoon in Korea-China relations may be drawing to a close, however, as the Goguryeo historical dispute in the summer of 2004 and the more recent outrage over the early January 2005 breakup of a press conference held by Korean lawmakers in Beijing by Chinese law enforcement may portend. Recently, these disputes have been overshadowed by a dispute between Japan and Korea over the Tokto (or Takeshima) islands, but as China continues to emerge in the region it is not inconceivable that another dispute could arise between Korea and China that could grab the headlines back.

One of the reasons that Korea has seen China as an opportunity is the natural complementarity of the two economies, with Korea providing the value-added manufacturing and China the low-cost assembly. For this relationship to be sustained, Korea needs to maintain its competitive edge over China. Questions are already being raised, however, about how quickly China will first equal and then overtake Korea technologically. Reports by both private and public institutions highlight the growing competitiveness of the two economies.

In 2004, the Korea Development Bank released a report that concluded that China is on average only 3.8 years behind Korea, but in some sectors that period can be much shorter—1.8 years for consumer electronics, 2.3 years for communications equipment, and 2.5 years for computers.⁶ Overall, China is expected to match or overtake Korea in three years in all sectors except semiconductors, automobiles, and shipbuilding. In addition, the World Economic Forum's report on global competitiveness indicated that Korea's overall competitiveness ranking fell from 14th to

5. "MOFAT Establishes FTA Bureau at the Trade Negotiations Headquarters" (Seoul: Korean Overseas Information Service, 14 December 2004), www.korea.net/news/news/newsView.asp?serial_no=20041213013&part=104&SearchDaT=.

6. "South Korea Loses Its Competitive Edge to China," headline no. 4360 (Seoul: Korea Development Bank, 24 August 2004), <http://www.kdb.co.kr>.

29th—largely because of a worsening macroeconomic situation. Korea's technology competitiveness ranking fell from sixth to ninth, which raises some concern.⁷

Concern over technology leakage to China is also growing.⁸ In September 2004, MOFE began requiring approval before Korean companies can transfer technology overseas.⁹ While Korea currently has a trade surplus with China, the Korea International Trade Association (KITA) expects that, although Korea's exports to China will expand over the medium term (until 2007), a turning point will come in 2008 as the advantage shifts to China and as its exports, particularly in the electronics sector, begin to grab an increasing share of third-country markets.

Should Trends Be a Concern?

Should Korea be concerned about China's growing share of its trade and investment? Is Korea becoming overly dependent on China?

China's share of Korea's trade is now slightly greater than the U.S. share. From a 20-year perspective, this development actually represents a better balancing of Korea's foreign trade because 20 years ago the U.S. share was closer to 40 percent. The concern is that China's economy—given its internal problems, concerns about overheating, and relatively early stage of development—is vulnerable to fluctuations, and, as Korea becomes more dependent on China, it also becomes more vulnerable to those fluctuations. When China took steps to slow its economy this fall, Korea noticed a decline in its export growth—and, because of its dependence on trade with China, with exports

to China accounting for 6.6% of GDP, the downturn in China's economy has a significantly greater impact on Korea's economy than it does elsewhere.

Outlook for 2005

These factors will undoubtedly continue to play out in 2005 and beyond. Most forecasters—public and private—expect Korea's economy to grow between 4 and 5 percent; regardless of where in that range Korea's growth rate falls, exports are expected to continue to serve as the primary driver of Korea's economic growth in 2005. The government recognizes this likelihood, and, as it implements policies to improve the domestic economy, it is also implementing policies to continue the strong performance of the trade and investment sectors. Among these initiatives are the establishment of the build-transfer-lease (BTL) system and the simplification of machinery and equipment investment.¹⁰

While Korea's trade performance is expected to continue to be strong, a number of external factors could make an impact on Korea, including a slowdown in the economic growth of its key trade partners—China, the United States, and Japan—and rising oil and material prices. Experts have already acknowledged that exports are not expected to increase at the same rate as in 2004. Although MOCIE, KITA, and the government's Korea Trade-Investment Promotion Agency (KOTRA) expect exports to continue to increase in the double digits, the pace of growth is forecast to be slower in 2005. KITA and MOCIE predict that exports will grow at 10.2 percent and 12.1 percent, respectively.¹¹ On the investment side, concerns about industrial relations, the regulatory environment,

7. *Global Competitiveness Report 2004–2005* (Geneva: World Economic Forum, 2004), <http://www.weforum.org/gcr>.

8. "S. Korea fears High-Tech Leakage to China," United Press International, 24 August 2004, <http://www.upi.com>.

9. Scott Snyder, "Turning Point for China-Korea Relations?" *Comparative Connections* [Center for Strategic and International Studies, Pacific Forum] (3rd quarter 2004), www.csis.org/pacfor/cc/0403Qchina_skorea.html.

10. "DPM Lee Elaborated on the Comprehensive Investment Initiative," Press release no. 671 (Seoul: Ministry of Finance and Economy, 21 January 2005), http://english.mofe.go.kr/news/n_body.php?t=eh_news_press&i=682&p=2&q=&w=.

11. "Exports in 2005 Projected at US\$281 Billion," News release no. 543 (Seoul: Korea International Trade Association, Trade Research Institute, 14 January 2005), <http://global.kita.net>; "Trade Outlook for 2005," *MOCIE News* (5 January 2005), www.mocie.go.kr/eng/news/press/press_view.asp?num=1946&page=3&table=eng_press&keyfield=&key=.

and security could dampen the mood of investors. Even though external factors are largely out of the control of the Korean government, the Roh Moo-hyun administration is taking a proactive stance by continuing efforts to reform the economy and improve the environment for FDI. The Roh administration has stated that one of the key purposes of its FTA strategy is to upgrade the Korean economy and make it more competitive. In addition, the government has initiated an interagency committee, chaired by Commerce and Industry Vice Minister Cho Hwan-eik, to promote FDI.¹² It is hoped that these efforts, as well as the government's planned stimulus of the domestic economy, will be enough to counter some of the dampening effects of a worsening external sector.

Ms. Brown is Director of Congressional Affairs and Trade Policy at KEI. This article draws on her "Implications of South Korea's Growing Economic Links with China," presented at Boston University, November 8, 2004; and "Trade and Investment in 2004" Korea Insight, February 2005.

12. "Korea to Attract \$12 Billion of Foreign Direct Investment," Korea eGovernment Portal, 23 January 2005, www.korea.net/News/News/NewsView.asp?serial_no=20050123003.



Korea Economic Institute

Korea Economic Institute
1201 F Street, N.W., Suite 910
Washington, D.C. 20004

PRESORTED STANDARD
U.S. POSTAGE
PAID
PERMIT #3777
WASHINGTON, DC