THE OUTLOOK FOR KOREA-U.S. ECONOMIC RELATIONSHIP

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Introduction

Since the end of World War II, the United States and Korea have enjoyed a very close relationship in many important areas. Such relationship started with the liberation of Korea in 1945 by U.S. troops from the Japanese occupation of almost four decades and also included the shedding of blood by Americans for the defense of South Korea from the North Korean and Chinese invasion during the bitter Korean War of 1950-53. Most Koreans, especially those older Koreans who personally experienced the tumultuous years of the Japanese occupation and the Korean War, still harbor such goodwill and sense of gratitude towards America and Americans that perhaps no other country has earned in Korea's long history. Even now, the United States is maintaining a significant military presence, including its ground troops, in order to assist the Korean government in repelling any potential military threats from the heavily militarized North Korea.

Over the past several decades, however, the close relationship has extended from the military and political arenas of early years to the economic areas such as trade and investments. The U.S. economy is the largest in the world, with its GDP of $10 trillion or 32% of the world economy, whose global GDP at market exchange rates stood at $31.4 trillion ($44.5 trillion on the purchasing power parity base) in 2000. Out of the total world exports of $6.22 trillion in 2000, the United States absorbed 20% or $1,258 billion of them. In comparison, the Korean economy with its GDP of $457 billion in 2000 is only one-twentieth of the U.S. economy and the Korean per capita income was $9,628 in 2000 compared to $35,000 in the United States. Due to the sharp depreciation of the Korean won in the aftermath of the 1997 financial crisis, the Korean per capita income had actually shrunk from $11,380 in 1996 to only $6,723 in 1998 and $8,551 in 1999. The United States id also the biggest market for Korean exports, accounting for 22% and 21% respectively of total Korean exports in 2000 and 2001. With the total bilateral trading volume of $67 billion in 2000, Korea was the United States' 6th largest export market and 8th largest trading partner.

In recent years, the economic relationship between the two countries has extended from that of important trading partners to the partners also in foreign direct and portfolio investments, joint ventures, technology and management know-how transfers, etc. As the U.S.-Korea economic cooperation has intensified during the past two decades, there has been a corresponding increase in trade and other disputes between the two countries. As the 21st Century has dawned, the two countries need to take stock of their current and prospective economic relationship and to develop a coherent strategy to strengthen their already strong economic relationship while minimizing any potential frictions. This paper will first review the past economic relationship between the two countries, both positive and negative and then, based on the analysis of the past economic relationship, it suggests the outlook and potential areas for further strengthening the strategic economic partnership to mutual benefits.

Evolution in the U.S.-Korea Trade Relationship

The early years of the U.S.-Korea economic relationship can be characterized as that of donor-recipient, as Korea was struggling to recover from the double disasters of the Second World War under the Japanese occupation and the Korean War. One can fairly characterize the 1940s and 1950s as the decades of the worst deprivation for the Korean people due to the two wars and their after-effects. After the end of the Korean War in 1953, with the per capita income of only $67 in 1953, $87 in 1962 and $100 in 1963, Koreans were much poorer than the Philippinos and Turks in those years enjoying per capita incomes of $251 and $259 respectively in 1963. The United States, in addition to their military assistance during and after the Korean War, provided massive development aid to Korea both for humanitarian assistance and for postwar reconstruction efforts.

Following the political turmoil in the aftermath of the April 19 student revolution in 1960 and the May 16 military coup d'etat, the new military government led by President Park Chung Hee embarked upon an ambitious economic development plan with the main focus on a nationwide export drive in order to earn the necessary foreign exchanges for importing both modern manufacturing plants and raw materials. From the late 1960s through 1970s, the United States was the main export market for Korea. Korean exporters were able to exploit the relatively generous treatment by the U.S. government of most exports from developing countries including Korea. In the 1960s, main Korean export items were light industrial goods such as textiles and toys. Even though Korea liberalized its import regime somewhat in the 1960s, especially around 1967 when Korea joined GATT (General Agreement on Tariffs and Trade), most of the liberalization was for raw materials and intermediate goods necessary for the new Korean factories, and the average tariff rate remained high at about 40% during the most of the decade. During the 1970s, the average tariff rate was reduced to around 30% but other non-tariff barriers actually increased in order to protect nascent Korean industries being established with the active government support and encouragement.

During the 1960s and 1970s, however, the U.S. government was especially tolerant of the Korean exports, as Korea was such a poor country but also a strategically very important country in terms of both political and military perspectives during the Cold War between the East and West. Such a generous trade posture of the United States during this period was especially important to Korean economic development, since foreign trade was truly the engine of growth for Korea, with the total foreign trade volume equivalent to more than 60% of Korea's GDP in the 1970s. The Korean export drive started to make impact on the U.S-Korea trade balance, which reversed from the chronic trade deficits vis-à-vis the United States in the 1970s to trade surpluses beginning in 1981.

TABLE 1 - KOREAN TRADE WITH THE UNITED STATES, 1975-2000
(Million dollars)

Year	*Exports to U.S.*	*Imports from U.S.*	*Balance*
1975	1,536	2,082	-546
1980	4,433	4,685	-252
1981	5,474	5,116	358
1982	6,012	5,529	483
1985	10,712	5,965	4,756

1987	17,991	8,099	9,892
1990	19,360	16,942	2,418
1991	18,608	18,904	-296
1992	18,090	18,287	-197
1993	18,138	17,928	210
1994	20,553	21,579	-1,026
1995	24,131	30,404	-6,272
1996	21,670	33,305	-11,635
1997	21,625	30,122	-8,497
1998	22,805	20,403	2,402
1999	29,600	24,943	4,657
2000	37,806	29,286	8,520
2001	31,358	22,431	8,927

Source: *Korea Trade Information Service (KOTIS)*, KITA, and *Direction of Trade Statistics*, various issues, IMF.

As Korean bilateral trade surpluses vis-à-vis the United States increased in the 1980s, the U.S.-Korea trade relationship attracted increasing attention from the U.S. side. During the 1960s and 1970s, Korea suffered chronic bilateral trade deficits vis-à-vis the United States. The bilateral trade volume exploded from $232 million in 1962 to $10.5 billion in 1981 to $26 billion in 1987, when the United States suffered a trade deficit of almost $10 billion. Consequently, American policymakers came under increasing pressures both to protect domestic producers from the "unfair" export practices of Korea and to open markets more widely to U.S. exports in Korea. Furthermore, there was a growing alarm among some U.S. policymakers and opinion leaders that Korea might become "another Japan" which was bent on an export-focused mercantilist strategy.

Consequently, the U.S. government pressured Korea to intensify liberalization of its trade and investment regime and to remove its substantial trade barriers. The Korean response was that a confrontational approach on the part of the U.S. government could be counterproductive and any trade friction should be resolved through bilateral negotiations gradually rather than in one lump. The Korean side argued at that time that after all the Korean bilateral trade surplus was only a relatively recent phenomenon starting in 1981 and prior to that year, Korea had suffered trade deficits vis-à-vis the United States for 25 years! Furthermore, the Korean overall current account balance had suffered from chronic deficits for decades until 1985 despite its bilateral trade surpluses vis-à-vis the United States in the 1980s and it turned into a surplus only from 1986 through 1989. Korea's current balance account turned into deficits again continuously from 1990, except for 1993, until 1997 when Korea tumbled into its worst financial crisis.

Starting from 1991, however, the Korean trade surplus vis-à-vis the United States reversed into trade deficits and the U.S. pressure on Korea for a blanket trade liberalization policy was replaced by sectoral trade disputes, involving such export items as automobiles, steel, etc. In fact, the economic relations between the two countries have substantially broadened in the 1990s to include not only bilateral merchandise trade but also trades in services, investments, capital flows, and cross-border mergers and acquisition activities. Hence, the economic policy dialogue between the two countries has expanded to include this broader agenda. Such a broader policy dialogue has accelerated due to the Korean financial crisis of 1997. When the Korean government negotiated during the crisis a large-scale financing package from multilateral financial institutions of the IMF, the World Bank and the Asian Development Bank, the United States as one of the dominant shareholders in these institutions exerted a crucial behind-the-scene influence to formulate stringent loan conditionality to further liberalize Korea's trade regime, to open up its financial markets to foreign investors and financial institutions, and to modernize its economic system in accordance with the international best practices in such areas as corporate governance, financial regulation and supervision, accounting and auditing standards, etc.

The U.S. role during and after the Korean financial crisis was regarded by some Koreans as overly interventionist and paternalistic, but the overall impact should be considered positive for the Korean economy. There is no question that for a couple of decades prior to the 1997 financial crisis, Korea was slow to adopt a policy of globalization and liberalization of its economy due to strong vested interests in the country. Its capital market was underdeveloped, and the banking and financial system remained relatively primitive with lack of modern credit evaluation and risk management skills. Financial regulatory and supervisory structure needed a significant improvement. Korean business firms relied too much on debt financing resulting in dangerously high debt-to-equity ratios, and too many enterprises were under state controls and thus inefficient and unproductive. Industries were highly concentrated among large chaebols and the country did not nurture healthy and vibrant small and medium-scale industries. Korean accounting and auditing standards were such that most observers could not trust their veracity. In sum, Korea needed to launch a wholesale reform of its economic and financial system, and the 1997 financial crisis and the subsequent external pressure on Korea has brought about much needed economic reforms. In this sense, the 1997 crisis can be a blessing in disguise. Still, reforms are far from complete, especially in the political system and the government bureaucracy as well as the labor sector and state-owned or –controlled enterprises.

Further Developments in Bilateral Economic Relations

The United States has been the most important trading partner for Korea during the past two decades, while Korea has been among the top ten trading partners for the United States as well. While over 99% of Korean exports to the United States are manufactured goods, 89% of U.S. exports to Korea are manufactured goods and the rest is composed of agricultural products. Over the years, Korean export items for the U.S. market shifted from clothing and other textile products and toys in the 1960 and 1970s to machinery, consumer electronics, semiconductors, and cars in the 1980s and 1990s. Main import items from the United States have not changed much, composed mainly of machinery, electric and electronic equipment, and agricultural products. In 2001, the United States was again the number one export market for Korea and the number two import source after Japan for Korean importers, while Korea was the sixth largest export market and the eight largest import source for the United States, the same ranking as in 2000.

TABLE 2 – TRADE PARTNER RANKING BETWEEN U.S. AND KOREA

	1980	*1985*	*1990*	*1995*	*1997*	*1998*	*2000*	*2001*
Korean Exports to U.S.	1	1	1	1	1	1	1	1
Korean Imports from U.S.	1	1	1	1	1	1	2	2
U.S. Exports to Korea	15	7	7	5	5	9	6	6
U.S. Imports from Korea	11	8	6	8	8	9	8	8

Source: IMF, *Direction of Trade Statistics*, various issues.

For example, even though the Korean textile industry ranks No. 5 in the world in terms of its export volume its export share in the U.S. market has experienced a steady decline from 9.7% in 1990 to 5.7% in 1994 to only 3.8% in 2000. A similar decrease was experienced by Taiwanese textile exporters to the United States, while the share of Chinese textile exports in the U.S. market declined less precipitously from 14% in 1990 to 10.5% in 2000. On the other hand, the textile exports of the two NAFTA countries of Canada and Mexico experienced sharp increases from 0.7% and 2.7% respectively in 1990 to 2.9% and 14.9% in 2000. This example demonstrates the classic case of trade diversion rather than trade creation due to the formation of a regional trade bloc such as NAFTA.

In addition to merchandise trade, there has been a significant increase in foreign direct investment flows between the two countries, especially after the 1997 financial crisis. Before the crisis, the Korean government did not actively promote foreign investments in Korea. In fact, a number of restrictive measures had been adopted, resulting in a relatively closed market for foreign investors in Korea. Consequently, foreign direct investments played only a minor role in Korean industrialization. In terms of the inward FDI stock to GDP ratio, Korea lagged substantially behind the world average as well as that of the Southeast Asian countries.

As part of the IMF and World Bank loan conditionality subsequent to the 1997 financial crisis, the Korean government has agreed to remove a number of entry barriers to foreign direct investments in Korea. Among the various measures were new steps to be taken by the government to encourage privatization of state-owned enterprises and active cross-border M&As and to foster the entry and/or takeover of Korean firms by domestic and foreign firms. The 25% ceiling on foreign equity ownership in Korean firms was also removed in 1998 by a change in the Securities Exchange Law and in the same year the Korean parliament enacted a new law, the Foreign Investment Promotion Act, in order to accelerate foreign direct investments in Korea.

As a result, there was a sharp increase in U.S. acquisitions and new direct investments in Korea since 1998. Some of the U.S. companies making new investments included Fairchild Semiconductor Corp., Enron Corp., Bowater, Inc., Columbia Chemicals Co., Motorola, Inc., and Ford Motor Co. Along with such manufacturing and industrial sector direct investments, foreign investment into the Korean service sector has gained greater importance in recent years. For example, like many European financial institutions, some American financial institutions have made substantial investments in Korea, such as Goldman Sachs' $100 million investment in Kookmin Bank (later merged with Korea Housing Bank), takeover of Seoul Bank by Newbridge Capital, and $50 million investment by Lake Forest Finance Co. into Chung Buk Bank. Direct investments by Korean firms in the United States have been also active in the 1990s, including Samsung Electronics' $18 million investment in the semiconductor sector, $60 million investment by Saerom Technology in the communication field and $15 million investment by Taekwang Company in the footwear industry.

Currently, General Motors Company is in active negotiation to acquire Daewoo Motors as part of GM's global strategy to maintain its premier market position in the world. As of 2000, the world car market was dominated by Big 5 of GM (8.74 million cars), Ford (6.75 million), Daimler Chrysler (4.85 million), Volkswagen (4.78 million), and Toyota (4.63 million). The Korean domestic car manufacturers of Hyundai, Daewoo and Samsung experienced a painful adjustment in the aftermath of the 1997 financial crisis. Samsung Motors was acquired by the French car company, Renoir, in 2000. The bankrupt Daewoo Group originally negotiated the sale of its Daewoo Motor Company to Ford, but Ford dropped out at the last minute and now GM has been in negotiations with Daewoo. However, the continuing labor troubles at Daewoo Motors have complicated the negotiation so far.

TABLE 3 – U.S.-KOREA FOREIGN DIRECT INVESTMENT FLOWS

(Data on the FDI arrival base, not announcement base)

	U.S. FDI Flows into Korea		*Korean FDI Flows into U.S.*	
	$ Millions	*As % of Total**	*$ millions*	*As % of Total**
1990	221	29.5	345	36.1
1992	246	34.2	346	28.4
1994	221	22.4	525	22.8
1996	393	17.2	1,568	36.9
1998	1,479	28.3	874	22.4
2000	1,687	16.8	1,132	30.8

**As % of the total FDI flows into Korea or as % of total Korean outward FDI flows.*

Source: Moonsung Kang and Suyeob Na, *Economic Policy under the Bush Administration and U.S. Economic Performance in 2001* (in Korean), KIEP, Seoul, Korea, 2001.

Pending Issues in U.S.-Korea Economic Relationship

As the two countries have intensified their economic relations over the years, perhaps it is inevitable that a number of bilateral economic disputes have also cropped, especially as the United States tends to separate external economic issues from the military and strategic consideration after the fall of the Berlin Wall. Unlike during the Cold War period, the U.S. government wants to separate its economic interests from the political-strategic issues. As a result, Korea can no longer expect a special treatment from the U.S. government in its trade and investment disputes with the United States. Some of the important bilateral economic disputes involve the issues related to automobiles, steel, intellectual property rights, and pharmaceutical products.

The United States has been the most important market for Korean automobile exporters, but the trade imbalance in autos between the two countries has caused a considerable trade dispute. The trade imbalance is so severe that the total annual export volume of U.S. autos to Korea is less than one day's average export sale of Korean cars in the United States. Consequently, the U.S. government has insisted on a number of measures to be taken by the Korean government in order to redress such an imbalance. Such U.S. pressure has increased as the Korean share of the U.S. automobile market has increased from less than 1% in 1995 to 2.7% in 2000 and 3.6% in 2001 for both passenger cars and commercial vehicles, while the Korean market share increased to 4.4% of the U.S. passenger car market in 2000. In contrast, American cars accounted for only 0.1% of the total Korean car market in 2001. The U.S. government rightly pointed out that the previous Korean government measures such as taxes, tariffs and various non-tariff barriers discriminated against car imports into Korea. After many years of negotiations, the two governments signed the Automotive Memorandum of Understanding in 1998, requiring the Korean government to take a number of proactive measures to increase the market access to Korea by American automobile companies.

TABLE 4 – U.S.-KOREA AUTOMIBLE TRADE
(Number of passenger cars and commercial vehicles)

	1995	*1997*	*1998*	*1999*	*2000*	*2001*
Korean exports to U.S.	132,118	168,511	175,510	329,572	470,357	583,608
Korean imports from U.S.	2,578	4,166	1,227	739	1,268	2,283

Source: Moonsung Kang and Suyeob Na, *Economic Policy under the Bush Administration and U.S. Economic Performance in 2001* (in Korean), KIEP, Seoul, Korea, 2001.

Korean steel exports have also attracted U.S. government attention. The United States is the third largest export market for Korean steel producers after Japan and China. Korean steel exports increased sharply from $945 million in 1996 to $1,736 million in 1998 right after the Korean financial crisis, as domestic steel demand declined as a result of the severe economic recession caused by the crisis. Due to the weakened domestic steel industry in the United States resulting in the recent bankruptcy of the second largest U.S.

steel manufacturer, Bethlehem Steel, and the consequent massive worker layoffs, the U.S. government has been under a growing political pressure to deal with the foreign steel imports, including those from Korea. As a result, President George Bush recently imposed extra tariffs up to 30% on certain steel imports. Both the Korean government and the European Union countries have announced their plans to appeal to the World Trade Organization as a first step to deal with this new U.S. action.

The two countries have also worked on the measures to strengthen protection of intellectual property rights (IPRs) in general and especially protection of computer software programs. Korea enacted a revised Computer Program Protection Act in 2000 in order to enhance protection of computer software by correcting some of the deficiencies in its original act. The United States has also complained that new agricultural product rules proposed by the Korean government threaten U.S. beef exports to Korea, and both sides have engaged in active discussions in order to resolve this trade issue important to U.S. agricultural exporters. The two governments have also been working on a Bilateral Investment Treaty (BIT) with the view to promote further direct investment flows between the two countries. But some issues such as the Korean domestic movie quota rule have clouded the prospect for concluding the BIT soon.

In the summer of 2002, the governments of both countries continued their quarterly bilateral trade and economic talks. Topping the list of concerns for the United States are the auto trade imbalance, the Korean drug reimbursement pricing policy for foreign drugs considered as unfair to American pharmaceutical manufacturers, and biotech food labeling requirements imposed by the Korean government. On autos, the U.S. government continued to request that Korea lower its 8% tariffs to 2.5%. Foreign pharmaceutical producers complained that health care cost containment measures undertaken by the Korean government seemingly undermine a reimbursement pricing scheme agreed to by the United States and Korea, and which was deemed equitable for both foreign and domestically produced drugs. The United States sought changes to this policy for some time.

For Korea, the most important trade concern remains the steel safeguards action imposed by President George Bush in March 2002. Korea was granted a large exemption of 750,000 tons through POSCO's West Coast joint venture, but still the Korean government seeks further exemptions. Korea, along with six other countries, is challenging the safeguards action in the WTO, which referred the case to a dispute panel in June 2002. Korea has also complained about various provisions of U.S. trade laws that Korea feels unfairly treats Korean exports to the United States.

Outlook for the Korea-U.S. Economic Relationship

The United States and Korea have come a long way in their bilateral relationship, starting from the military and strategic cooperation and assistance in the early years to a close economic partnership in recent decades. During the past five and a half decades, Korea has evolved into the twelfth largest trading nation in the world and the thirteenth largest economy. Such a remarkable progress was possible in no small measure due the close diplomatic and economic relationship between the two countries. The military umbrella provided by the United States enabled Korea to concentrate upon rapid industrialization of its poor and underdeveloped economy coming out of the Korean War, and the United States has served as the most important market for Korean exports whose success has been critical to Korea's export-led economic development policy. American companies have been the important sources of technology for emerging Korean firms and U.S. financial institutions have played an important role in providing foreign capital to finance Korean investments in new industrial and infrastructure projects.

The so-called IMF crisis of 1997 has highlighted the importance of fundamental economic reforms for Korea, as half-finished reforms are worse than no reforms at all. The government can no longer fine-tune the Korean economic reforms on a selective basis. One of the lessons that Korea learned after the crisis was that the liberalization of short-term capital flows only while regulating the long-term capital flows encouraged many Korean financial institutions such as commercial banks and merchant banks to borrow short-term Eurodollars abroad in massive amounts in order to speculate in questionable long-term investments such as Russian Eurobonds and long-term loans to risky South Asian companies. There are many other such examples of selective reforms resulting in quite unexpected consequences. In short, the old Korean economic policy paradigm focusing on micromanagement of the economy by the government has to be replaced by the global standards of market-based reforms.

In this sense, the close U.S.-Korea economic relationship can provide far more benefits than those arising from trades and investments. Closer economic cooperation in all spheres of economic activities, including trade, banking and finance, capital market activities, foreign exchange operations, joint ventures, technology transfers, capital flows, etc., can assist Korea in the wholesale modernization and globalization of the economy. The new report by the American Chamber of Commerce (AMCHAM) in Korea indicates that international business executives based in Asia consider Seoul the least attractive place to live and conduct business among the five Asian cities of Seoul, Tokyo, Hong Kong, Singapore and Shanghai. To prove this point, in fact, there is only one multinational company (MNC) maintaining its Asian regional headquarters in Seoul (Volvo), while the Asian regional head offices of 944 MNCs are located in Hong Kong and over 200 in Singapore.

The lost decade of 1990s for Japan demonstrates to the world that Japan can no longer play the role model for the Korean economy. The dynamic U.S. economy is the most important role model, which can provide Korea with the best business practices suitable to global standards. The Korean economy has to compete successfully in the world economy in order to survive and prosper in this increasingly globalized economy. Already, whether we like it or not, the Korean economy is integrated into the world economy not only in trade but also in other areas of economic activities. Today's Dow Jones and NASDAQ stock price movements are immediately transmitted to the Korean stock market on the same day. Both Korean policymakers and businessmen have to behave proactively to take advantage of the many benefits of such a closer economic partnership between the two countries, while minimizing its potential ill effects as well.

In this sense, the growing economic power of China can provide a new challenge for the future Korea-U.S. economic relations. China is effectively becoming a global manufacturing base for multinational corporations due to low land costs, low-wage labor pool without the labor militancy common in Korea and other countries, and the recent entry of China into the WTO. Consequently, China has attracted huge amounts of foreign direct investments (FDIs) in recent years, averaging over $40 billion per year. In 2002, the total FDI inflows into China are likely to exceed $50 billion. In contrast, the total FDI inflows into Korea are less than 10% of China's inflows. In fact, many Korean firms have set up manufacturing plants in China in recent years in order to escape the high labor costs as well as frequent labor problems in Korea. Also, American firms along with Japanese and European companies have invested heavily in China to penetrate the Chinese market as well as to use China as the production base for global markets. Thus, Korean exporters to the U.S. market will face an increasing competition from China, which enjoys distinct cost advantages over Korea. The only way to cope with this challenge is for Korean firms to move up the technology chain so that Korean export products maintain both the quality and technological advantages over Chinese exports.

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