 25X1

Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

15 April 1988

25X1

South Korea: Economic Challenges Facing the Roh Administration

SUMMARY

President Roh Tae Woo's immediate economic challenges are to hold down inflation after two years of double-digit growth and to respond to foreign demands for a reduction in South Korea's $10 billion current account surplus. Determining the appropriate mix of won appreciation and market opening to ameliorate these problems, however, is provoking bureaucratic contention. The Economic Planning Board (EPB) sees appreciation of the won as the simplest and most effective response to both challenges, but industry--a major source of financial support for the ruling party--worries that currency appreciation and sharply rising wages will erode its international competitiveness. Reflecting this uneasiness, the Ministry of Trade and Industry, among others, is emphasizing formal market opening measures over won appreciation to reduce the surplus, although few in Seoul expect such an approach to bring either significant liberalization or a tailing off in the trade surplus any time soon. 25X1

25X1

This memorandum was prepared by the Office of East Asian Analysis. Information available as of 15 April 1988 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Korea Branch, Northeast Asia Division, OEA 25X1

EA M 88-20047

25X1
25X1

25X1

The first test of Roh's leadership in this area may come after the spring wage negotiations, when business leaders could press the government to compensate for higher wages by slowing the pace of won appreciation. Over the long run, the problems of the trade surplus and inflation also could increase pressure on Seoul to liberalize its financial sector and to seek new ways to invest Korea's surplus overseas. 25X1

Economic Strength

Roh Tae Woo assumed the presidency in February with the Korean economy operating at peak performance. After two years of 12-percent-plus annual growth in GNP, South Korea now boasts a per capita income near $3,000. The unemployment rate has dropped to a meager 3.3 percent, despite large numbers of new workers entering the labor force. In contrast to most developing countries, South Korea's foreign debt--about $36 billion at the end of 1987--is falling rapidly, while holdings of foreign assets are on the rise. 25X1 25X1

Inflation: Prices and Politics

Since Roh's election last December, bureaucrats and planners in the economic ministries, the central bank, and official think tanks have warned that the economy could face significant problems. Specifically, they have repeatedly warned that the pace and pattern of economic growth threaten to renew inflation. Recent statistics--some publicized, some not--have borne out their concern:

25X1

o Early returns for 1988 raised concern about further price hikes outside the economic planners' target range; in January, wholesale and retail prices jumped 0.6 percent--an annualized inflation rate of 7.2 percent. 25X1

Political worries have added a sense of urgency to the anxiety generated by recent indications of rising prices. With National Assembly elections slated for 26 April, Roh wants to deprive his opposition of the chance to make inflation an issue that could be used against the ruling party. He has publicly said that price stability is his top economic priority. 25X1

Uncertainty about the outcome of this spring's wage negotiations--which run from March to May--also has exacerbated inflationary fears. Last summer's unprecedented series of strikes, accompanied by union organizing activity, helped produce wage increases of some 20 percent, more than double the average annual increase since 1980. In this year's bargaining, labor and management appear far apart. The Federation of Korean Trade Unions

 25X1

supports wage increases of 30 percent. Senior business leaders have so far kept their own counsel, but surveys by the Korea Productivity Center indicate the business community plans to offer only an 8- to 9-percent wage hike. For its part, the government has shown no eagerness to intervene. In a recent press interview, Roh seemed tolerant of labor demands, suggesting electoral politics may inhibit official jawboning and, at least in 1988, compel business to look to other means, such as increased automation, to hold down labor costs. [redacted] 25X1

The Current Account: Agreement on the Problem, But Not the Solution

South Korean economists blame the country's burgeoning current account surplus--some $10 billion in 1987, up from $4.6 billion the previous year--for much of the inflationary pressure. According to the US Embassy, some economists in Seoul envision a current account surplus of $10-13 billion and a GNP growth rate exceeding 10 percent in 1988. In fact, the monthly values of new letters of credit issued during January and February--an indicator of the trend of exports--show 30- and 20-percent increases over the same months last year. [redacted] 25X1

Essentially, income from exports and overseas construction projects has expanded the domestic money supply, contributing to the inflation of real estate, stock, and commodity prices. Government officials and central bankers have publicly said they intend to stem the upward pressures. The Bank of Korea has begun to siphon off excess money by issuing monetary stabilization bonds. Economic planners are also saying that the supplementary budget for 1988 will be held below $671 million (500 billion won), even though the more tight-fisted approach will delay many of the public works projects promised by Roh during last year's presidential election campaign. [redacted] 25X1

An Alternative Scenario

A serious recession in the United States could dramatically alter the economic challenge facing President Roh. With almost 40 percent of its exports--over 14 percent of GNP--destined for the United States, South Korea would quickly feel declining demand in the US market. The current account and trade surpluses would begin falling, turning Seoul's attention to moderating the speed of the decline and holding down unemployment. Instead of appreciating the won, Seoul would probably be looking for an opportunity to depreciate it as well as accelerate construction of many of the public works projects Roh promised when he campaigned for the presidency. Seoul would probably aggressively counsel labor against wage demands that could threaten the competitiveness of South Korean exports. [redacted] 25X1

Notwithstanding these steps and the seeming unanimity of views on the need to curb inflation in large measure through reductions in the current account surplus, [redacted] government officials are at odds over how to effectively use 25X1 25X1

25X1

 25X1

their primary policy tools--market opening and won appreciation. All the ministries agree in principle that South Korea's markets must be open to more foreign goods, but the consensus breaks down over which imports are permissible. There also is major disagreement over how much leeway Seoul has to accommodate US demands for a stronger won. [redacted] 25X1

Market Liberalization. The differences among the economic ministries over market liberalization seem to be a matter of degree--in effect, an argument over how much emphasis should be placed on opening the economy to more imports. Ministry of Trade and Industry (MTI) officials believe liberalization--not won appreciation--should be the centerpiece in Seoul's strategy to deal with lowering the current account surplus [redacted] 25X1 25X1 Indeed, the plan to reduce the surplus announced in February emphasizes the elimination of formal barriers to imports and the repeal of various export-promotion measures, strongly reflecting the MTI approach (see the appendix for details of the plan). [redacted] 25X1

Those who have reservations about MTI's emphasis on market opening contend that the kind of "liberalization" the Ministry has in mind is no guarantee that imports of the designated goods will increase. We, too, believe that MTI's approach highlighting the removal of formal barriers will do little to enlarge the market for imports. In fact, MTI likes to emphasize its plans to reduce formal impediments to trade because it believes the remaining tariff and non-tariff barriers will render most foreign goods that would compete directly against domestic products noncompetitive, [redacted] 25X1

Seoul's recent approach to several outstanding trade disputes also suggests market "liberalization" is unlikely to bring major increases in imports. In the case of both high-quality beef and cigarettes, well-entrenched domestic interests with considerable clout are blocking concessions to US demands, even when imports--particularly beef--would have little direct impact on domestic producers. Pressures to permit trade in services have met similar obstacles. Seoul has given ground only in response to a US request that joint ventures involving foreign firms be allowed in the life insurance business. In this special case, moreover, the opposition was limited to a few bureaucrats who were concerned about keeping major domestic industrial combines out of the financial sector, rather than generated by the private sector. [redacted] 25X1

With National Assembly elections set for 26 April, political factors also are slowing any forward movement on market-opening steps. [redacted] 25X1

Won Appreciation. More than the contention surrounding market opening, the debate over won appreciation to stem the rise in the current account surplus has generated controversy in South Korea.

[redacted] 25X1

Appreciation of the won would promote imports by reducing the gap in price between expensive foreign goods and domestic products as well as erode the price competitiveness of South Korea's exports. Without such currency adjustments, market liberalization would have little effect on the current account surplus, because domestic producers would still be shielded from strong foreign competition. A study in 1987 by the Korea Institute of Economics and Technology concluded that a 10-percent appreciation of the won would increase imports by 4.4 percent, reduce exports by 7.7 percent, and decrease the current account surplus by $1.5 billion. [redacted] 25X1

Members of the business community, especially export industries, have strong reservations about the rising value of the won--some for good reasons. For Korean producers of textiles and footwear--who supplied over a quarter of all exports in 1987--increased prices translate into loss of business to competitors in Hong Kong, Thailand, the Philippines, or China. Indeed, data on the issuance of new letters of credit indicate export orders for Korean textiles are no longer increasing. Manufacturers of consumer electronics and cars also are worried, although they have less cause for concern. Even with the gradual appreciation of the won in 1987 and early 1988, orders for South Korean electrical and electronic goods are up over 30 percent this year. Auto exports, up over 70 percent compared with January and February 1987, likewise are booming. [redacted] 25X1

For their part, economic policy makers in Seoul recognize that a strong won is necessary to deal with the trade surplus and expect to remain under pressure from Washington, but they also are feeling the heat from businessmen, who are against any rapid moves. 25X1 [redacted] Ministry officials privately told the US Embassy that they were being deluged with complaints from businessmen when the won broke the 770-to-the-US-dollar mark in February. With the won now above 750, the flow of complaints undoubtedly has become even heavier. [redacted] 25X1

The Outlook: In the Short Run, Roh Is the Key

Despite the lines that have been drawn in the debate over policy to stem the current account surplus and dampen inflation, the pattern and politics of decisionmaking in Seoul suggest that action at the top may not be swift. Roh's initial impulse has been to delegate economic decision making to his Cabinet ministers. [redacted] 25X1 In our view, one result of this approach is likely to be ineffectual interministerial compromises. The February plan for reducing the current account surplus is an example. The plan purported to be an across-the-board attack on the surplus, but avoided any commitment to roll back the exchange rate advantage South Korea gained in 1987 or to eliminate nontariff barriers to imports. [redacted] 25X1

Even if Roh eventually takes a stronger hand, his views of the economy as expressed in conversations with US officials indicate he still may not realize how rapidly Korea's outlook has improved. In a meeting with the US delegation to his inauguration, for example, he spoke of the Korean economy as still being in its "infant" stage, suggesting that progress on trade would have to be step by step. Even if Roh was being disingenuous in characterizing Korea's economic status, other factors also are likely to impede his inclination to act swiftly. Before weighing in, Roh would have to consider the short-term political costs. To appear to be conceding to foreign demands--whether it be for currency appreciation or market opening--would hand both the opposition and others, such as the students and radicals who have already identified trade problems as part of their "cause," a potential issue. We believe these political factors are short-term influences on Roh's perspective, but he nevertheless may decide that the need to burnish his credentials as a democratic politician open to public concerns is more pressing than the advantages of trade reform. [redacted] 25X1

In any case, we expect economic developments in 1988 to aggravate existing differences of opinion over market opening versus won appreciation. To head off the increased inflationary pressures caused by Korea's trade surplus, economic planners and central bank officials are likely to push for more won appreciation. [redacted] 25X1

If businessmen have to pay a high price for labor peace in the spring wage negotiations, they almost certainly will press Seoul to ease, if not reverse, the pace of won appreciation. The business community will undoubtedly appeal to the ruling party--which it has supported financially during both the presidential and National Assembly election campaigns--to put the central bank and the technocrats at the EPB in their place, and to ignore their arguments about the dangers of reigniting inflation. [redacted] 25X1

The Longer Term

Notwithstanding the impediments to market opening and significant won appreciation in the short run, several developments indicate that economic policy makers may be laying the groundwork for changes over the long term. For example, a widely reported seminar paper presented by a Korea Development Institute researcher in mid-February emphasized that Seoul would have to accelerate currency appreciation in tandem with market liberalization to halt the growth in the surplus. The paper also broke ground in providing a domestically oriented rationale for cutting the surplus, arguing that failure to do so would reduce economic efficiency, skew investment and output, stimulate inflation, and exacerbate trade friction. EPB officials also have begun publicizing the domestic advantages of won appreciation, pointing out the beneficial effects from restrained growth on the money supply and inflation. They have also cited the effect of a

 25X1

stronger won in encouraging investment in production for domestic rather than foreign markets, and in helping alleviate trade disputes.

A broader effort appears under way to educate the public--and perhaps the senior political leadership as well. 25X1 In response to a mid-February request from the ruling Democratic Justice Party, the EPB recommended that a panel from government, academia, and business should compile a set of recommendations similar to the Maekawa Report on economic restructuring prepared for Japan's Prime Minister Nakasone in 1986. An EPB 25X1 official may have been describing one objective of the effort when he told the US Embassy that a public relations campaign would be necessary to convince people that consumption of luxury goods, particularly from abroad, was not unpatriotic and that imports helped expand consumer choice and reduce prices. 25X1

A failure to deal with the current account surplus presents other, long-term problems for Seoul. Even under the best circumstances, a tapering off in the growth of the current account surplus--and an easing of its inflationary pressures on the economy--are unlikely until next year, when price changes induced by won appreciation should be fully reflected in the volume of imports and exports. In the meantime, Seoul will have to begin grappling with how to invest the proceeds from its surplus overseas. Korean officials so far have avoided the issue by using surplus foreign exchange to repay foreign debt. But Seoul is running out of debts to repay and instead will have to look for opportunities to place an increasing portion of the current account surplus abroad. 25X1

Deregulation of capital outflows--essentially the elimination of regulations that require official approval for the transfer of even a few thousand US dollars over-seas--would stimulate foreign investment as well as ease inflationary pressure by providing an external outlet for surplus funds. This decision also is caught up in interministerial policy differences, however. According to the US Embassy, economic reformers want to begin to loosen capital controls by first abolishing restrictions on normal foreign exchange transactions. They believe the step will reduce domestic manufacturers' opposition to won appreciation.[1] Whatever the merits of their policy arguments, proponents of financial deregulation will need Roh's support to overcome the opposition of entrenched bureaucratic and business interests--a battle on a complex subject he is unlikely to join until after the 1988 political season and the Olympics are behind him. 25X1

---

1 The Ministry of Finance, and perhaps the Ministry of Trade and Industry as well, appear to see such actions as directly undercutting their power. An end to capital controls would give the private sector freedom to tap deregulated foreign capital markets, eliminating the bureaucracy's ability to ration credit--a major source of MOF and MTI influence. 25X1

25X1

APPENDIX

Key Elements of Seoul's New Package To Reduce the Current Account Surplus

Eliminating import restrictions
Beginning in April, the Ministry of Trade and Industry will approve import licenses for 145 additional items. The step puts 95.4 percent of the 7,911 items in the South Korean tariff nomenclature in the "liberalized" category, although as in the past the action does not guarantee that newly liberalized items will be imported. There may be no demand for them, or other barriers could prevent importation.
Seoul will remove 48 items from its import surveillance list, which is used to prevent sudden surges in imports. Also, Seoul plans to ease import inspection and quarantine procedures by the end of April. Experience suggests extended negotiations will be necessary before all procedural problems are overcome.

Reducing import tariffs and export loans to promote balanced growth of imports, exports, and domestic demand
Seoul is preparing to cut tariffs on 117 items, but the quantity of imports benefiting from the lower rate will be limited. The government also will cut tariffs on 319 items--including cosmetics, fertilizers, and computer equipment--from a list of 982 for which the United States has requested reductions.

Maintaining the won at a level equitable relative to the currencies of trading rivals
Retaining parity would keep South Korean exporters more competitive than those in Japan or Taiwan. Since September 1985, the won has risen only 16 percent compared with 41 percent for the New Taiwan dollar and 67 percent for the yen.

Reducing special excise taxes to increase domestic demand
Seoul will reduce the 40-percent excise tax on video-tape recorders and the 20-percent tax on subcompact cars to stimulate domestic sales. Higher domestic sales could slow export expansion, as well as increase auto parts imports---an estimated 30 percent of the components in Korean cars.

Lifting restrictions on foreign exchange transactions
Seoul intends to change its foreign exchange regulations to allow individuals to hold as much as $5,000 in foreign currency, to raise the ceilings on the foreign exchange holdings of insurance and securities companies, and to eliminate reporting requirements for service transactions and book imports that involve $10,000 or less in foreign currency. The ceilings for insurance and securities companies are likely to continue to rise--increased portfolio investment overseas is an easy means of relieving the pressure placed on the domestic money supply by the current account surplus.

25X1

SOUTH KOREA: ECONOMIC CHALLENGES FACING THE ROH ADMINISTRATION 25X1

DISTRIBUTION:

DEPARTMENT OF STATE

1 - WILLIAM CLARK, DEPUTY ASSISTANT SECRETARY FOR EAST ASIAN AND PACIFIC AFFAIRS, RM 6205,
1 - HARRY DUNLOP, DIRECTOR, OFFICE OF KOREAN AFFAIRS, RM 5313,
1 - ROBERT SUETTINGER, DIRECTOR, OFFICE OF ANALYSIS FOR EAST ASIA AND PACIFIC, RM 8840,
1 - WILLIAM PIEZ, DEPUTY ASSISTANT, BUREAU OF EAST ASIAN AND PACIFIC AFFAIRS, RM 6205,
1 - KENNETH C. QUINONES, DEPUTY DIRECTOR, EAP/RA, RM 4310,
1 - TED KLOTH, OFFICE OF KOREAN AFFAIRS, RM 5313,
1 - BILL NEWCOMB, INR/EC/CER, RM 8442,
1 - JOHN MERRILL, INR/EAP, RM 8840,
1 - JOSEPH A. MUSSOMELI, OFFICE OF KOREAN AFFAIRS, RM 5313,
1 - TONY INTERLANDI, OFFICE OF KOREAN AFFAIRS, RM 5313,
1 - WILLIAM WALLER, CHIEF/DEVELOPING COUNTRIES, RM 3829,
1 - PETER ITO, PM/ISP, RM 7424,
1 - JIM PRZYSTUP, POLICY PLANNING STAFF, RM 7330,
1 - DAVID JOHNSON, S/S/O, RM 7516,

NATIONAL SECURITY COUNCIL

1 - JAMES A. KELLY, SPECIAL ASST TO THE PRESIDENT & SR. DIR. FOR ASIAN AFFAIRS, RM 493,
1 - STEVE DANZANSKY, SPECIAL ASST TO THE PRESIDENT & SR. DIR. FOR INT'L ECONOMIC AFF, RM 363,

DEPARTMENT OF DEFENSE

1 - DR. KARL JACKSON, DEPUTY ASSISTANT SECRETARY FOR EAST ASIA AND PACIFIC AFFAIRS, RM 4E817,
1 - RADM EDWARD BAKER, JR., DIRECTOR, EAST ASIA AND PACIFIC REGION, INT'L SECURITY AFFAIRS, RM 4C839,
1 - LTC JOE FLANZ, HQDA (DAMI/F11/NORTHEAST ASIA), RM 2A474,
1 - CAPT. WALTER ANDERSON, DEPT. OF ARMY/CURRENT INTELLIGENCE/NE ASIA, RM 2B515,
1 - JAY SLOAN, DEFENSE INTELLIGENCE OFFICER, EA/P, RM 2C238,
1 - COL. STEVEN DELP, DB-2D, RM C2951,
1 - GUY ARRIGONI, DE-2, RM B6823,
1 - LTC. JERRY WILLIAMS, JSI-3C, RM 1C930,
1 - LTC. RICH FISCHER, OJCS/J-5/NE ASIA/KOREA DESK, RM 2D977,
1 - COL. JAMES MORGAN, JR., DIRECTOR FOR FOREIGN INTELLIGENCE, RM B7940,
1 - ROGER BIESEL, DB-2 D 1, RM C2230A,

COMMERCE DEPARTMENT

1 - JOAN MCENTEE, DEPUTY UNDER SECRETARY FOR INTERNATIONAL TRADE, RM 5898,
1 - SCOTT GODDIN, OFFICE OF PACIFIC BASIN, RM 6854,
1 - KIM FITZGERALD, OFFICE OF INTELLIGENCE LIAISON, RM 6854,
1 - MEL SEARLES, DEPUTY ASSISTANT SECRETARY FOR EAST ASIA AND PACIFIC, RM 3820,

OFFICE OF THE USTR

1 - PETER ALLGEIER, ASSISTANT TRADE REPRESENTATIVE FOR ASIA AND THE PACIFIC, RM 322,
1 - SANDRA KRISTOFF, DEPUTY ASSISTANT TRADE REPRESENTATIVE, RM 322,
1 - LYNN TRESSLER, INTELLIGENCE LIAISON, RM 123,

DEPARTMENT OF TREASURY

1 - RANDALL FORT, OFFICE OF SPECIAL ASST. TO THE SECRETARY FOR NAT'L SECURITY, RM 4324,
1 - WILLIAM BARREDA, DIRECTOR, OFFICE OF INTERNATIONAL TRADE POLICY, RM 4428,
1 - PATSY HAAS, OFFICE OF INTERNATIONAL BANKING & PORTFOLIO INVESTMENT, RM 5320,
1 - TODD CRAWFORD, OFFICE OF DEVELOPING NATIONS FINANCE, RM 5221,

OTHER

1 - HENRY NATHAN, CHIEF, G911, RM 1A-187,
1 - ALFRED PERSI, ASIA TEAM LEADER, INTERNATIONAL TRADE POLICY, RM 5546S,
1 - GLEN HALM, OFFICE OF FOREIGN RELATIONS, ILAB, RM S5006,

INTERNAL

1 - NIO, EAST ASIA, RM 7E62,
1 - NIO, ECONOMICS, RM 7E47,
1 - CHIEF [redacted] /DO, RM 3D01,
1 - CHIEF, EA [redacted] RM 5E18, 25X1
1 - CHIEF, OGI/FSIC/PI, RM 2G28,
1 - CHIEF, OGI/ECD RM 3G46,
1 - CHIEF, OEA/NEA/KOREA, RM 4G43,
1 - CHIEF, OEA/NEA/JAPAN, RM 4G31,
1 - CHIEF, OEA/NEA/STI, RM 4G43,
1 - CHIEF, OEA/NEA/DIVISION, RM 4G43,
1 - CHIEF, OEA/CHINA DIVISION, RM 4G20,
1 - CHIEF, OEA/SEA DIVISION, RM 4F24,
1 - DIRECTOR, OFFICE OF EAST ASIAN ANALYSIS, RM 4F18,
1 - CHIEF, OEA/PRODUCTION, RM 4G48,

1 - CHIEF, FBIS/ANALYSIS GROUP, RM 3S05,
1 - DDI, RM 7E44,
1 - SENIOR REVIEW PANEL, RM 5G00,
1 - OCA REGISTRY, OFFICE OF CONGRESSIONAL AFFAIRS RM 7B24,
1 - PDB STAFF, RM 7F30,
1 - CHIEF, LDA/EAD/AB, RM 1H18,
6 - CONTROL BRANCH, OFFICE OF CURRENT PRODUCTION AND ANALYTIC SUPPORT, RM 7G07,
1 - INTELL. SUPPORT STAFF, OFFICE OF CURRENT PRODUCTION AND ANALYTIC SUPPORT, RM 7G50,
1 - INTELL. LIAISON STAFF, OFFICE OF CURRENT PRODUCTION AND ANALYTIC SUPPORT, RM 7G50,
1 - CHIEF, PRODUCT EVALUATION STAFF, RM 2F42,
1 - NIC, ANALYTIC GROUP, RM 7E47,
1 - CHIEF, DDO/EA DIVISION, RM 5D00,
1 - CHIEF, DDO/EA [redacted] RM 5C45,
1 - CHIEF, DDO/EA [redacted], RM 5C19,
1 - CHIEF, DDO/EA [redacted], RM 5C19,

[redacted]

25X1