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South Korea: Economic Outlook [Redacted]

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Summary

South Korea has been touted as the "next Japan"--a reflection of both its economic success over the past 25 years and its efforts to move into knowledge- and technology-intensive industries. But Seoul faces obstacles Tokyo never had to contend with--such as a smaller domestic market, a heavy defense burden, and much stiffer world competition. Last year, the country experienced its most serious economic slowdown since 1981, but Seoul has taken pump-priming measures that are beginning to reverse the decline. Despite South Korea's large foreign debt and the likelihood that the economy will not expand at the high rates South Koreans have become accustomed to, future growth should be strong by world standards. The level of demand for Korea's exports, protectionism, and unpredictable oil and foreign exchange markets, however, represent factors

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outside Seoul's control that will affect this performance. Moreover, if growth continues to be below par, it will contribute to domestic political tensions, which in turn could sour the attitudes of foreign lenders and investors and undermine their confidence in South Korea's economy. [redacted]

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South Korea's Growing Industrial Strength

An aggressive private sector aided by government support and a low-paid but productive work force have made South Korea the world's 15th-largest exporter and perhaps its most advanced LDC. An underdeveloped agrarian society 25 years ago, South Korea has become competitive in several highly visible industries important to the economies of the developed countries:

- Shipbuilding. South Korean shipbuilders captured 15 percent of worldwide orders in 1984--second only to Japan. The outlook for shipbuilders is cloudy, but South Korea's competitive advantages will keep its yards well positioned to acquire a large share of new orders when the world shipping slump ends.
- Steel. South Korea has become the world's most competitive steel producer by combining low wages with technologically advanced plants. It plans to increase capacity by 75 percent over the next decade.
- Overseas construction. Orders grew an average of 28 percent annually between 1975 and 1983, but have decreased as oil prices have declined. At their peak in the early 1980s, South Korean firms accounted for over half of the world's 25 largest general building contractors. [redacted]

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Building on these successes, South Korean economic planners have targeted rapid expansion into knowledge- and technology-intensive industries:

- Automobiles. Seoul plans to boost automobile exports from 43,000 units in 1984 to 800,000 by 1991 using efficient, up-to-date assembly lines now under construction. Hyundai began selling cars in the United States in February, and Daewoo, strengthened by a technical and equity tieup with General Motors, is tripling its capacity.
- Semiconductors. Samsung and other leading electronics firms--with technical assistance from the United States and Japan--have begun producing 64K and 256K random-access memory chips and are gearing up for the 1-megabit-chip market. In addition, development of a 4-

megabit-chip is under way. The South Koreans could apply this technology to the production of other advanced electronics. [redacted]

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Astute economic planning, aggressive business strategies, and a well-disciplined and well-educated work force are pluses for Seoul's ambitious industrial strategy. The many underemployed college graduates and Koreans residing overseas also are a potential pool of talent. Seoul will be better able to encourage the inflow of new technology and to foster domestic as well as foreign investment because of its ongoing liberalization of foreign investment, technology transfer, imports, and the financial system. [redacted]

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South Korea--Not Another Japan

Despite the comparisons made between Japanese and South Korean economic successes, South Korea must cope with hurdles not faced by Japan two decades ago:

- Small domestic market. A population of only 40 million and a \$2,000 per capita income do not provide a South Korean domestic market large enough to be a springboard for many emerging industries, forcing reliance on foreign markets.
- Dependence on foreign inputs. Lacking a mature R & D infrastructure, South Korea depends upon foreign technology and capital for even rudimentary development of new industries.
- Protectionism. Forays into technology-intensive exports will result in head-to-head competition with developed trading partners. US-South Korean economic relations are strained by disputes over intellectual property protection, and frictions over trade in services and strategic trade controls will inevitably increase.
- Security issues. A relatively heavy defense burden--nearly 6 percent of GNP--acts as a brake on Korea's economic growth and channels scarce technical expertise from commercial endeavors, impeding South Korea's climb up the technology ladder.
- Foreign debt. South Korea must manage a \$46.7 billion debt--over half its GNP. Additional capital inflows could be at risk if foreign bankers became more concerned over South Korean political stability. [redacted]

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South Korea's difficulty in managing these obstacles was evident in 1985, its worst economic performance in four years.

- [REDACTED]
- Real GNP growth tumbled from a spectacular 12.6-percent annual rate in the first quarter of 1984 to 2.7 percent in the second quarter of 1985; it did begin to trend upward in the third quarter, however.
 - Sluggish export growth in 1985--about 3 percent--pulled growth down, while austere fiscal and monetary policies stifled domestic demand and investment.
 - Seoul's foreign debt grew faster than planned, with its \$46.3 billion tally in July exceeding by \$1.2 billion the overall target for 1985. (See the appendix for further discussion of the debt issue.) [REDACTED]

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Seoul's economic technocrats have instituted--albeit belatedly--a pump-priming package that includes:

- Expanding the money supply at about 150 percent more than the planned rate, increasing business loans, and paying off the bad debts of the corporate sector.
- Boosting 1986 budget outlays by 10.2 percent following a \$292 million supplemental budget in 1985.
- Aggressively devaluing the won to bolster export competitiveness. [REDACTED]

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Prospects

These measures signal that Seoul can respond to economic problems flexibly without panic or hasty policy shifts. Economic planners continue to favor programs that position South Korea for future growth by augmenting domestic investment and promoting exports, rather than "quick fix" solutions. We believe final figures will show real GNP gains of 4.5 to 5 percent for 1985, and 6 to 7 percent in 1986. [REDACTED]

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On balance, our cautious optimism about South Korea's near-term growth prospects is tempered by a recognition that future performance is largely outside Seoul's control. Slow economic growth and protectionist barriers in developed countries could cloud the economy's prospects beyond 1986, stifling exports and damaging Korea's international credit rating; bankers' confidence in South Korea is largely predicated on a rate of export growth that reduces Seoul's debt burden. South Korea's economy will be bolstered by favorable trends in exchange rate movements--primarily from a weakening dollar to which the won is closely tied--and declining oil prices. However, these markets are volatile and unexpected price movements could significantly alter the growth path of South Korea's economy. [REDACTED]

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Appendix: Managing a Large Foreign Debt

South Korea's \$46.7 billion foreign debt, the fourth-largest among LDCs, is a major determinant of Seoul's economic management strategy--South Korea's economic policy makers must balance economic growth against rapidly accumulating foreign debts. During 1985, for instance, Seoul overshot its \$45.1 billion debt target by far, because it was caught offguard by sluggish export growth, instituted pump-priming programs to revive the economy, and paid some of the bad debts of the corporate sector. To its credit, Seoul surpassed a major economic policy objective by reducing reliance on short-term obligations to 21 percent of the total--the lowest since the early 1970s. Although this debt is large compared to South Korea's GNP, healthy export earnings mean Seoul can service the debt payments. South Korea will, in our judgment, improve its ability to service its debt over the rest of this decade despite a deterioration in 1985 (see graphic on debt). We believe international lenders will continue to reward South Korea's creditworthiness by eagerly participating in future loan syndications at favorable rates--if the economy stays on track and domestic political problems remain manageable.

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SUBJECT: South Korea: Prospects for Growth [Redacted]

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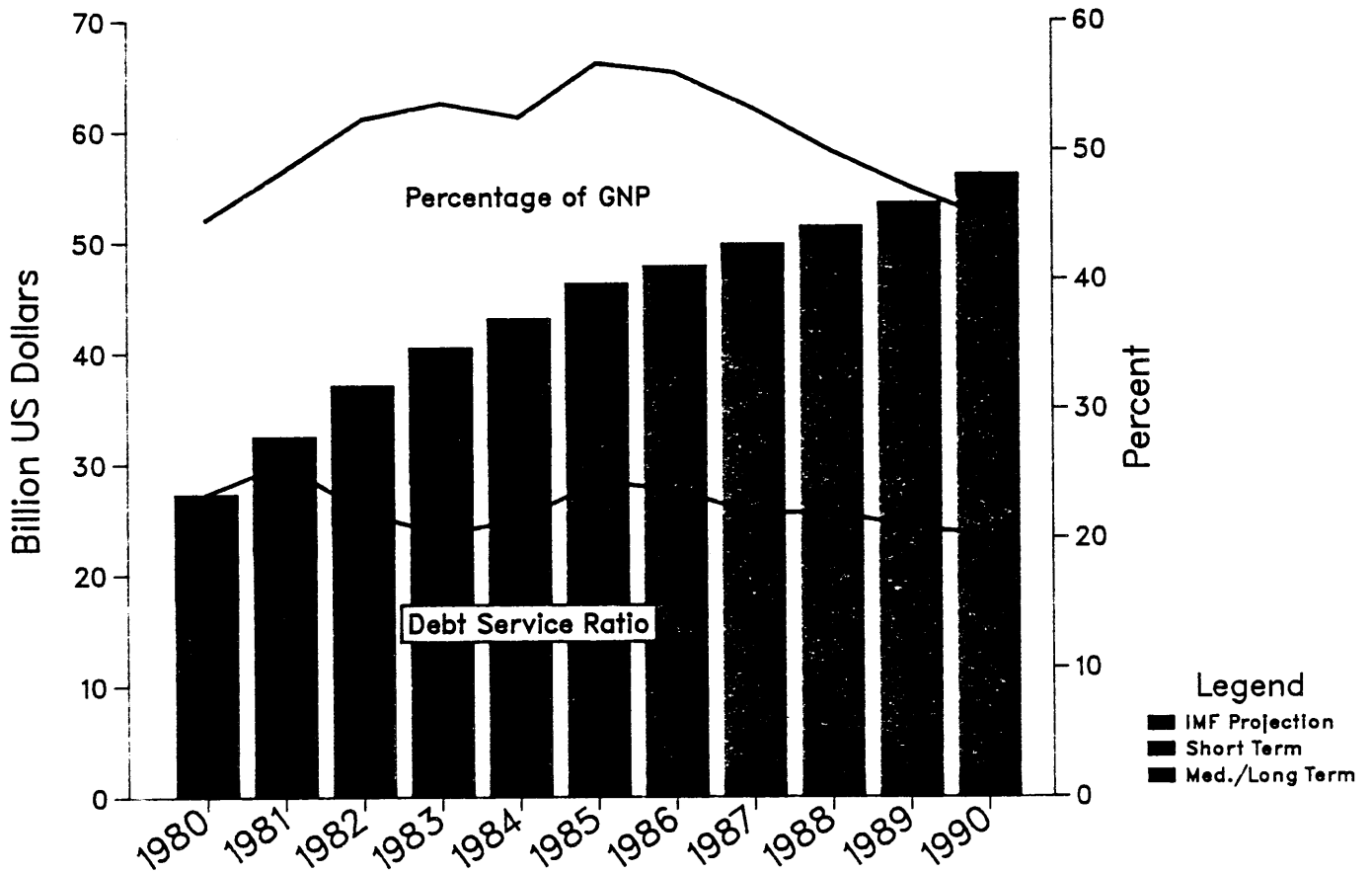
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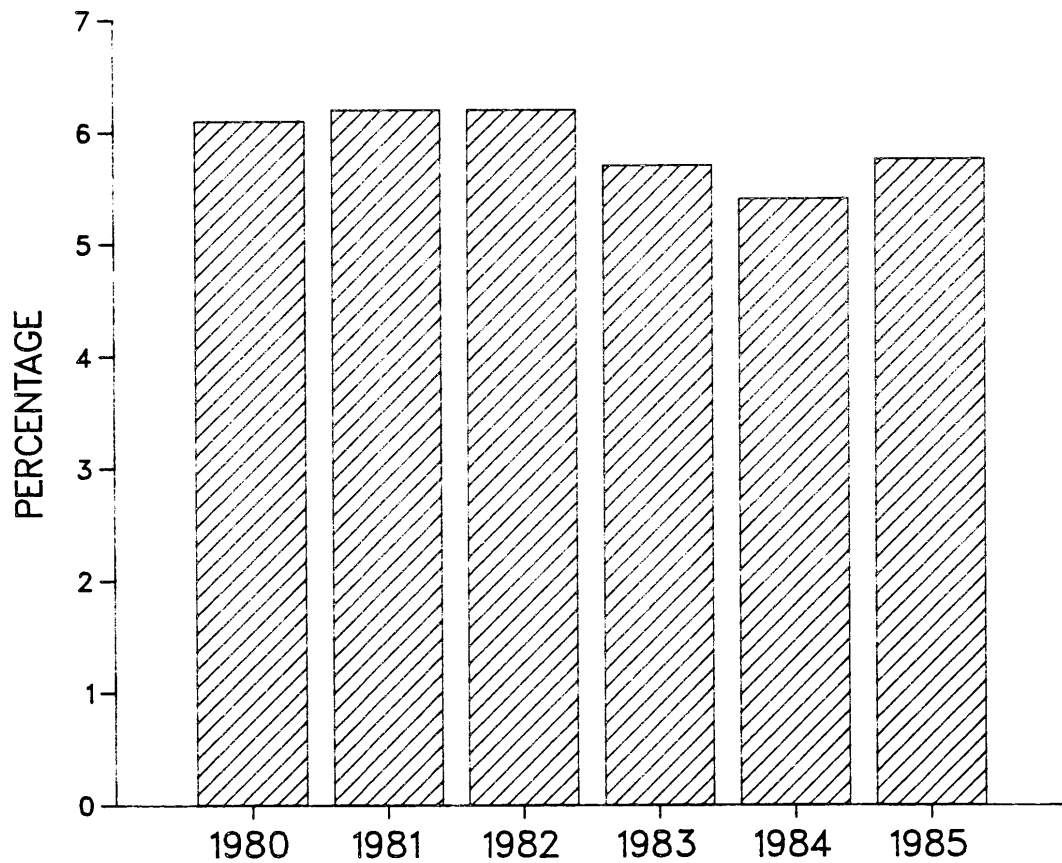
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South Korea's Foreign Debt 1980 - 1990

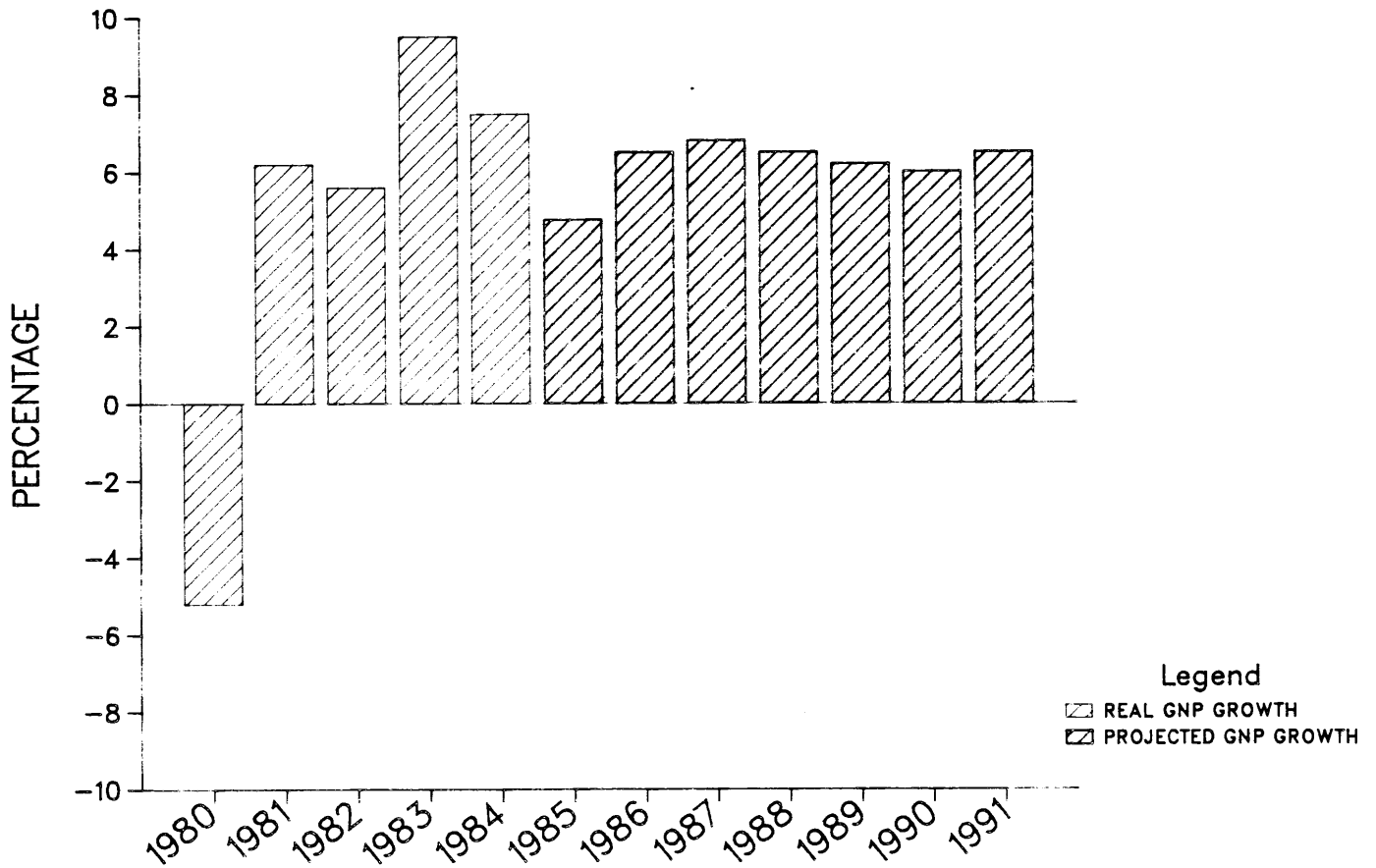


*Total debt service -- repayment of principle and interest on long and medium term debt plus interest on short term obligations -- divided by exports of goods and services.

SOUTH KOREA: SHARE OF GNP FOR DEFENSE SPENDING 1980-85



GROWTH OF SOUTH KOREA'S GNP 1980-91



**OUTLOOK FOR MAJOR SOUTH KOREAN INDUSTRIES
1985 TO 1995**

INDUSTRY	PERFORMANCE RATING			COMMENTS
	1985	1986-1988	1989-1995	
Steel		●	●	A turnaround in shipbuilding, coupled with strong growth in automobile manufacturing, will ensure strong domestic demand for steel...continued steel export restraints and excess world steelmaking capacity cloud the export outlook.
Shipbuilding	●	●	●	Demand forecast to pickup in late 1980s...Korean yards will be in good position to secure a big share of new orders.
Overseas Construction	●	●	●	Wage advantage eroding fast...lack technical expertise for complicated contracts...may bounce back if developing countries undertake large infrastructure projects.
Automobiles	●	●	●	Strong growth assured as Korea expands its role as an offshore production base for primarily US auto firms...state-of-the-art factories, coupled with wages one-tenth those in the United States, augur well for competitiveness and profitability.
Semiconductors	●		●	Lack of technical expertise and a strategy to leap-frog technology into 64K, 256K and 1-megabit chips will pose difficult challenges as the industry gears up.

LEGEND ● Poor
 ● Fair
 ● Good
 ● Excellent

Performance ratings are based on CIA projections of industry growth prospects, international competitiveness, and profitability. Greatest weight given to growth and competitive factors.

Computers	●	●	●	Capable of indigenous production of all but most sophisticated components...high value added and wages in electronics industry among lowest in Korea...dependent on US-Japanese-European technology.
Consumer Electronics	●	●	●	Near lowest wages for all manufacturing... highly skilled, disciplined work force well suited to detail work...large, recent investment in modern plants.
Heavy Machinery				Sinking along with overseas construction...poor export outlook.
Machine Tools	●	●	●	Growing in sophistication...Japan moving into higher end of machine tools and robotics...leaves possible niche for Korea.
Textiles and Apparel		●		Intense price competition from Asian LDCs will erode Korea's advantage in long run...recent investment will benefit producers in the medium term...protectionist moves could cripple industry ...successful move up market will forestall decline.
Footwear		●		Intense price competition from Asian LDCs will erode Korea's advantage in long run...protectionist moves could hasten decline.

