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DIRECTORATE OF INTELLIGENCE

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South Korea: Foreign Investment Liberalization [redacted] 25X1

Summary

The impressive growth of foreign direct investment in South Korea reflects the success of a government liberalization program designed to attract advanced technology from abroad and reduce reliance on foreign borrowing. In the two years since the program began, investment approvals have doubled, while arrivals of funds have increased two-and-a-half times; last year foreign equity investment in South Korea also set new highs of $532 million in approvals and $250 million in arrivals. In launching the liberalization program, the South Koreans hoped to increase the flow of investment in areas they had selected for development, but they also eased restrictions on sectors of interest to Washington. Seoul remains disappointed that many foreign investors are focusing on the hotel and tourist services sector rather than the manufacturing sector, but we expect the government

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to continue to lower barriers to investment at a measured pace. [redacted] 25X1

Seoul Liberalizes Investment

South Korea's investment liberalization program, which has progressed steadily since it was unveiled in 1984, is in step with Seoul's broad effort to open the economy by reducing government intervention and relying increasingly on market forces. The program is designed to:

-- Obtain capital and advanced technology to develop South Korea's knowledge- and technology-intensive industries.

-- Alleviate some of the pressure on the economy caused by South Korea's $47 billion external debt--95 percent of cumulative foreign capital inflows to South Korea have been foreign loans rather than foreign investment. [redacted] 25X1

To accomplish these goals, Seoul has:

-- Scrapped a system that designated certain industries for foreign investment and precluded all others, in favor of a "negative list" that specifies only proscribed industries.

-- Increased the overall share of industrial sectors in which foreign investment is permitted from 44 to 80 percent.

-- Raised the ceiling for automatic approvals for foreign investment from $1 million to $3 million.

-- Replaced the requirement of prior approval for transfer of foreign technology into South Korea, when part of an investment package, with an after-the-fact notification system. [redacted] 25X1

The South Koreans clearly hoped the new program would ease growing trade frictions with the United States. Among the first areas opened for foreign investment when the plan took effect on 1 July 1984 were sectors that had been the focus of bilateral trade problems--the electronics, machinery, and transportation industries. [redacted] 25X1

The New Plan Gets Results

South Korean policymakers can point to the increased flow of foreign investment as proof that its "negative list" system is working. In the last two years, direct foreign investment has grown to $532 million, a 100 percent increase since 1983, the year before the new laws took effect. The planners have less

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cause for satisfaction in the direction investment is taking, however. Rather than focusing on manufacturing industries, foreign investors--primarily the Japanese--have concentrated on the hotel and tourist services sector with an eye toward the 1988 Olympics. A single Japanese tourism project ($300 million investment in the Lotte Hotel), for example, accounted for 56 percent of last year's total investment. Only 30 percent went to the manufacturing sector--well below its 63 percent share in 1984. [redacted] 25X1

Approvals of investment from Japan overtook those from the United States in 1985 for the second time in the past six years, but US investment is more closely tailored to Seoul's investment preferences. Investments in manufacturing industries that were approved through the end of 1985 accounted for 88 percent of total cumulative US investments in South Korea, or 43 percent of total investment in manufacturing from all sources. Major US investments in new projects in 1985 included General Motors's $25 million stake in the automotive parts industry, which came hard on the heels of its $150 million investment in a joint venture with Daewoo to produce automobiles for the US market. US firms also invested in the chemical and machinery industries. [redacted] 25X1

US investments in South Korea proved to be profitable for the companies involved. In contrast to the relatively lackluster performance of the overall South Korean economy last year (5.1 percent real GNP growth), an unofficial Finance Ministry analysis indicates firms backed by foreign investors far surpassed purely domestic businesses in growth, profitability, and dividend distribution. According to press reports, the profits of firms listed on the Seoul Stock Exchange dropped by 21 percent last year compared with 1984, but US firms, taking advantage of relaxed foreign exchange rules, were able to increase profit remittances by nearly 60 percent. Foreign investors earned greater profits in part because they went after only the most profitable areas, while the Seoul Stock Exchange includes a broad range of industries. Foreign firms also carry less debt than the average South Korean company. [redacted] 25X1

Outlook for Further Liberalization

The disparity in profits between foreign and domestic firms has exposed the government to criticism from protectionist elements within the country. The more radical student and labor groups oppose on political grounds any inflow of foreign capital, which they view as fostering dependency on foreign interests. Anti-American themes in particular have become a growing feature of their protests. In November 1985, students occupied and damaged the US Chamber of Commerce office in Seoul to protest the presence of US businessmen and capital that radicals insisted were a key prop for the "illegitmate" government of President Chun Doo Hwan. Moreover, powerful business interests oppose

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Seoul's economic liberalization program and resent having their profits reduced by competition from foreign firms. [redacted] 25X1

Despite such negative commentary, we believe US pressure, including the 301 process and the linking of continued Generalized System of Preferences (GSP) benefits to progress on economic liberalization, has had a significant impact on South Korean thinking and that relaxation of protective barriers will continue. The government's goal is to open 90 percent of South Korea's business sectors to foreign investment, bringing approvals to $1 billion by 1988. (Government and other services considered unsuitable for foreign investment, such as water works and education, make up the 10 percent that will remain closed.) Seoul has already opened new sectors it considers attractive to foreign investors, including the manufacturing of auto parts, optical fibers, biochemical, and synthetic fibers. [redacted] 25X1

The impending resolution of the intellectual property rights issue will probably also provide additional incentives for multinational corporations to invest in South Korea. Foreign firms have traditionally been reluctant to share advanced technologies with South Korean business partners in joint ventures for fear their proprietary processes will be pirated. Seoul's commitment to preserving the integrity of copyrights and patents will be seen as a positive development, especially by US investors. [redacted] 25X1

Although we expect South Korea to make continued progress in foreign investment liberalization, it will come at a measured pace.

-- Deputy Prime Minister and head of the Economic Planning Board Kim Mahn Je, South Korea's top economic policymaker, and his allies continue to favor economic liberalization. Nevertheless, the growing influence of more conservative ministries--including the Ministry of Trade and Industry, which has traditionally aligned itself with business interests against liberalization--will probably increase pressure on Seoul to demonstrate the net gains of direct foreign investment before moving to open new areas. In fact, interministerial squabbling has prompted Seoul to consider delaying until October the liberalization of 35 to 40 new areas scheduled for July.

-- We also expect Seoul will go slow on allowing investment in infant industries or other sensitive sectors, such as computers and telecommunications equipment. The South Koreans have repeatedly protected the industries on which they are staking future growth from direct foreign competition by restricting--or banning completely--the

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equity share owned by foreigners. Import restrictions complement rules limiting equity investment in firms producing key products. [redacted] 25X1

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