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South Korea and the Global Economy in Transition

Selected Working Papers

Edited by Byongwon Bahk and Gi-Wook Shin

FREEMAN SPOGLI INSTITUTE
FOR INTERNATIONAL STUDIES

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Preface

These working papers on the South Korean economy are the product of an annual conference series on Korean affairs hosted by Stanford University's Korean Studies Program (KSP), and made possible by the generous support of the Koret Foundation. KSP's 2009–2010 Koret Fellow, Byongwon Bahk, a former vice finance minister and chief economic adviser to Korean president Lee Myung-bak, played a leading role in organizing the 2010 conference, authored a major paper, and co-edited this volume.[1]

In March 2010 a score of top Korean and American experts convened at Stanford's Bechtel Conference Center for a two-day workshop exploring "South Korea and the Global Economy in Transition."[2] Duck-Soo Han, Korean ambassador to the United States, delivered the keynote address on "Economic Globalization and U.S.-Korean Relations."[3]

The editors believe that the study of the South Korean economy holds, or should hold, interest not only for Koreans but also for Americans and the international community as a whole. Korea has become *a major player in the global economy*, ranking thirteenth in GDP and seventh in exports among the world's nearly 200 countries.[4] This should no longer come as much of a surprise to consumers across the globe who use Korean cell phones, drive Korean cars, and, increasingly, enjoy Korean pop music and movies.

The Korean economy is also important as *a leading model of development*. In only two generations and despite national division and the devastation of civil war, South Korea has transformed itself from a largely agricultural economy to a world leader in manufacturing, which in turn facilitated its emergence as a dynamic democracy. The Korean experience holds many lessons for countries throughout the world as they also struggle to modernize in a highly competitive, globalized economy.

Korea's *success in navigating the turmoil caused by the global financial crisis* and recession of 2008–2009 is yet another reason for studying its economy. Despite its economy being an astounding 85 percent dependent on international trade, Korea has been among the world's leaders in recovering from the crisis.[5] Korea owes that success in part to the very hard lessons it learned from the Asian financial crisis of 1997–1998.

The five chapters selected for this compendium focus on some of the timeliest and most important issues involving the Korean economy.

Taeho Bark, a professor and former dean of the Graduate School of International Studies at Seoul National University, begins the volume with a review of "The Changing Global and Korean Economies." As he notes, the "fundamental issue" raised by the current economic and financial crisis is "whether the world economy can establish a new framework for sustainable and balanced growth." As one of Korea's leading economic experts and public intellectuals, he argues that the problems Korea faces due to globalization can only be resolved by embracing globalization more fully and effectively.

In his chapter on "An Odyssey of the Korean Financial System and the September 2008 Financial Shock," Thomas F. Cargill, professor of economics at the University of Nevada, Reno, examines the history of Korea's financial system and how the lessons Korea learned from the Asian financial crisis of 1997–1998 have contributed to its success in dealing with the current global financial crisis. Like Taeho Bark, Professor Cargill offers insightful, concrete recommendations to South Korean officials for dealing with Korea's long-term economic and financial challenges.

With South Korea's emergence as a leading economic power, it is also playing a larger role as a provider of official development assistance (ODA) across the globe. In their contribution, Professor Eun Mee Kim and Ji Hyun Kim of the Graduate School of International Studies at Ewha Womans University analyze "South Korea's Official Development Assistance Policy Under Lee Myung-bak: Humanitarian or National Interest?" They review Korea's history both as a recipient and as provider of ODA, and they seek to discover if Korea's ODA orientation changes significantly depending on whether the executive branch is led by progressives or conservatives. While their conclusions are perforce tentative, they point the way to further research that could make for increased, and more effective, Korean ODA.

In "Policy Recommendations for the Korean Economy," former Korean vice finance minister and 2009–2010 Koret Fellow Byongwon Bahk offers authoritative analysis and advice on dealing with the long-range challenges facing the Korean economy. He contrasts the modernization and globalization of Korea's enormously successful manufacturing sector with its still weak services sector. Based on a lifetime of economic and financial leadership experience, Bahk makes a powerful argument that Koreans can also succeed globally in the services sector, if they only believe in themselves.

Finally, Professor Gi-Wook Shin of Stanford's Walter H. Shorenstein Asia-Pacific Research Center and Dr. Joon Nak Choi of the Hong Kong University of Science and Technology argue in "Economic Globalization and Expatriate Labor in Korea" that Korea can help to overcome its weakness in the services sector by making use of global talent in the form of highly skilled expatriate workers. They offer rigorous analysis and detailed recommendations to the Korean government on how to use global talent to bolster Korea's engineering, finance, and general business sectors.

The editors hope that this volume will prove useful to officials, scholars, and business people in Korea, the United States, and throughout the world. They reiterate their gratitude to the Koret Foundation and to the staff members of Stanford's Shorenstein Asia-Pacific Research Center for conference and publication support; they also acknowledge the generous support of the Korea Development Institute (KDI) and express sincere appreciation to its president, Dr. Oh-Seok Hyun, who was a valuable participant in the 2010 conference.

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Notes

1 "Byongwon Bahk," http://aparc.stanford.edu/people/byongwonbahk/.

2 "South Korea and the Global Economy in Transition," http://aparc.stanford.edu/events/south_korea_and_the_global_economy_in_transition/.

3 "Economic Globalization and U.S.-Korea Relations," http://aparc.stanford.edu/events/economic_globalization_and_uskorea_relations/.

4 "CIA World Factbook: South Korea," https://www.cia.gov/library/publications/the-world-factbook/geos/ks.html.

5 "Rising Trade Dependency," *The Korea Times*, December 20, 2010, http://www.koreatimes.co.kr/www/news/opinon/2010/12/202_78330.html.

The Changing Global and Korean Economies[1]

Taeho Bark

In the aftermath of the global financial crisis, the world economy seems to be reaching a turning point as of mid-2010. With world GDP and global trade both in the process of recovering to pre-crisis levels, focus has turned to how long it will take the economy to fully recover. Meanwhile, reforms in global financial markets as well as in national regulatory and supervisory regimes are being carried forward. Based on the result of such reforms, the global financial system and national financial industries could face a dramatically new operating environment. Furthermore, the multilateral trading system is facing the biggest crisis since the launch of the World Trade Organization (WTO) in the mid-1990s. The Doha Development Agenda (DDA) negotiations, initiated in 2001, have not been finalized despite six years having lapsed since the original deadline. This lack of progress currently makes it very difficult to predict when the DDA negotiations will be completed. As a result, the multilateral trading system is giving way to regionalism and an ever-increasing collection of free trade agreements (FTAs).

The fundamental issue that has gained prominence in the current global financial crisis is whether the world economy can establish a new framework for sustainable and balanced growth. At the center of this question lies the long-discussed yet controversial issue of global imbalances; this debate is presently occurring in a number of guises, such as the current account imbalance between the United States and China, as well as the developmental gap between industrialized and developing countries. Such questions will not be answered in the short-term, but will instead require a comprehensive approach based on a longer-term perspective.

1 The author would like to acknowledge the assistance of Tae-Ho Cho and Joon Lee, graduate students at the Graduate School of International Studies (GSIS) at Seoul National University.

Recently, a great shift has occurred in the global leadership structure. As the G7 system, formed in the 1970s, lost its international status and legitimacy due to the rise of emerging economies, the G-20 emerged as a new international mechanism for dealing with the world's economic problems. Since its launch, the G-20 system has gained the world's trust by successfully leading efforts in coordinating and implementing stimulus packages. Though it is somewhat premature to predict the G-20's definitive position among global governance bodies, the system could become the de facto international body for managing the world economy.

The range of global issues that the world faces has greatly expanded and now includes matters as diverse as climate change, energy security, raw materials prices, and food security. The transnational nature of these problems means that adverse effects arising regionally will inevitably spread and impact the overall world economy. As such, there exists a significant degree of uncertainty among participants in the global economic system. Such uncertainty needs to be managed properly through international cooperation and, as evinced by the G-20's efforts, such cooperation is more essential now than ever.

Below I provide an overview of the state of the global economy and major issues affecting it; next, I evaluate the current state of the South Korean economy and analyze ongoing changes in South Korea's (hereafter simply Korea) external economic relations. Finally, I will interpret a new set of broad visions under the banner of a "Global Korea" recently promoted by the Korean government and propose a number of external economic strategies for Korea's future.

Global Economy: Current State and Major Issues

Current State of the Global Economy

The world economy seems to be recovering from the 2008 global financial crisis. As recently as October 2007 the International Monetary Fund (IMF) was projecting world GDP to record negative growth rates. However, thanks to coordinated stimulus measures and other cooperative efforts undertaken by major nations, negative growth was successfully avoided. Nevertheless, despite a positive improvement in GDP, growth rates have been the lowest since World War II and the aftershocks of the financial crisis will affect the world economy in the foreseeable future.

A full recovery will likely be a gradual process and, according to the World Bank and IMF, the appropriate response to the current state of world affairs is tempered optimism. Since mid-2009, stock markets worldwide have recovered approximately half their value, interbank lending rates have returned to normal, and stock market volatility has diminished. Moreover, signs of recovery are spread across both developed and emerging economies. Developing-country sovereign interest rate premiums have declined to around 300 basis points and developing-country stock markets have netted a more vigorous recovery than high-income ones.[2]

However, financial recovery is by no means a guaranteed outcome. Due to financial weaknesses in many institutions and growing deficits, the situation in many European countries such as Poland, Italy, Greece, and Spain remains precarious. The future of the American financial system, meanwhile, is under debate and scrutiny. Following serious losses by major companies like AIG and Citigroup, many are even investigating the possibility for government ownership of various financial institutions. As for developing countries, bond market and bank lending have only recently begun reopening to private-sector borrowers from developing nations and many uncertainties continue to plague the short-term forecasts for these economies. Though a majority of analysts do not expect a severe double-dip recession and return to negative growth rates, how private sector consumption and investment demand in emerging economies will respond to the recent influx of fiscal and monetary stimulus activity is unclear. Due to such uncertainties, the World Bank warns that developing-country growth could come in as low as 5.1 percent in 2010.[3] Although expansionary fiscal and monetary policies cannot be sustained indefinitely, it would be premature to implement exit strategies without ensuring that private sector activity meets baseline projections.

Alongside financial markets, the real economy is also exhibiting a subdued recovery. Global industrial production netted a growth of over 12 percent in the third quarter of 2009 and exports of developing countries were expanding at a 36 percent annualized pace in October 2009. Total volume of trade, however, remains 10 percent below the pre-crisis trend growth rate and, despite a more balanced recovery in developing and developed economies, output remains depressed worldwide.[4] In the United States and Europe, unemployment remains over 10 percent, and as unemployment rates continue to rise in many countries, private consumption has only shown weak signs of recovery.

2 World Bank, *Global Development Finance: Charting a Global Recovery* (Washington, DC: World Bank, 2009).

3 World Bank, *Global Economic Prospects 2010: Crisis, Finance, and Growth* (Washington, DC: World Bank, 2009).

4 World Bank, *Global Economic Prospects 2010*.

TABLE 1.1
Change in Projected Real GDP Growth (2010 and 2011; from previous year, %)

	2010	2011
World	2.7	3.2
High-Income Countries	1.8	2.3
Developing Countries	5.2	5.8
Developing Countries (excluding China and India)	3.3	4.0

Source: World Bank.

Perhaps more significantly, as positive contributions from stimulus packages and the inventory cycle wane, decreased spending by households and banks, as well as sluggish recovery in the U.S. housing market, is expected to slow growth. The IMF expects 0.5 percent GDP growth for 2009 and, assuming a 1 percent increase for advanced economies and 5 percent for newly emergent economies, a growth rate of 3 percent for 2010. World trade is also forecasted to show a modest 3 percent increase in 2010.[5] Meanwhile, the World Bank projects global GDP growth to be a modest 2.7 percent in 2010 and 3.2 percent in 2011, as shown in Table 1.1.[6]

Major Issues Facing the Global Economy

In subsequent post-crisis years, a variety of issues will likely test the capabilities and resolve of participants in the global economy. The importance of prudent macroeconomic policies was on display during the 2008 crisis as countries suffering the largest declines in output also had the largest current account imbalances. Moreover, global consensus has yet to be reached on how to resolve large current account imbalances between emerging and advanced economies. Redressing this imbalance will be especially significant for China and the United States, as many have cited America's trade deficit and China's equally formidable surplus as root causes behind the current financial crisis.

The multilateral trading regime, meanwhile, will also face a variety of challenges in years to come. Following the 1995 establishment of the WTO, trade ministers initially had high expectations for future rounds of trade liberalization. However, despite concerted efforts by various parties over several years, progress in the DDA negotiations has been excruciatingly slow. Reasons

5 International Monetary Fund, *World Economic Outlook*: *October 2009* (Washington, DC: IMF, 2009).

6 World Bank, *Global Economic Prospects 2010*.

behind Doha's failure are numerous. The proliferation of WTO members in recent years in conjunction with overreliance on consensus-based procedures in the WTO has led to stalemate, political brinksmanship, and even outright confrontation during trade talks. Moreover, a lack of leadership has plagued negotiations, and unless common ground can be reached between wealthier and poorer nations, the future of Doha does not seem bright.

The plight of multilateralism, however, has been accompanied by redoubled enthusiasm for regional and bilateral trade liberalization. Such rising regionalism shows little sign of abating. Since the WTO's inception, the number of reported regional trade agreements has dramatically increased, and as evinced by ASEAN and the discussions surrounding a potential ASEAN+3 FTA, nowhere has this trend been more pronounced than in East Asia. Regionalism is not without controversy, however, as some scholars have asserted that regional arrangements inherently discriminate against nonmember trading partners, thereby endangering the progress garnered from nearly 60 years of multilateral talks.

Alongside signs of recovery in financial markets, commodity markets staged a rally in 2009 after collapsing in late 2008. This rebound in commodity prices despite high inventories, which occurred earlier than in previous global downturns, reflects both renewed investment in commodity assets and changing fundamentals, with many believing the worst of the global recession had ended. The IMF's near-term outlook expects commodity prices to show modest upward movement as global demand, especially from emerging economies, will weigh against both above-average inventory and spare capacity.[7]

Nevertheless, as with global trade and finance, certain uncertainties remain. Particularly in regards to oil, while recession-related setbacks to capacity expansion are likely to be temporary and costs of oil investment have declined in recent quarters, prices are above the average for the past decade and could rise further as the dollar weakens or demand from emerging economies skyrockets. Rising oil prices, moreover, can not only threaten economic recovery but also destabilize related commodity markets. For instance, while food prices enjoyed a broad-based, albeit modest, recovery in 2009, higher oil prices will drive up farming costs and incentivize the diversion of food crops towards biofuel production.[8] Thus, to ensure continued post-crisis recovery, care should be taken to maintain an appropriate balance

7 International Monetary Fund, *World Economic Outlook Update: January 2010* (Washington, D.C.: IMF, 2010).

8 International Monetary Fund, *World Economic Outlook: October 2009*.

between supply and demand in all major commodity markets.

Just as international coordination of stimulus policies was critical in prompting recovery in 2009, such coordination will also be vital for the implementation of exit strategies in 2010 and beyond. But with differing policy environments and economic circumstances surrounding each economy, global cooperation between nations will be difficult to achieve. Through various forums such as the IMF, World Bank, and G-20, however, various parties are collaborating on resolving issues that affect the twenty-first century global economy, such as strengthening the post-crisis international financial regulatory system; reforming the mandate, mission, and governance structure of various international financial institutions; promoting energy security and sustainable development; and strengthening support for the world's poorest countries. Therefore, a major concern for advanced and emerging economies alike will not only be achieving mutually beneficial outcomes through these forums, but buttressing the forums in which these issues are discussed so they may continue to function as viable channels for coordination and recovery.

Korean Economy: Current State and Changes in Its External Economic Relations

Korean Economy at a Glance

From mid-2008 to early 2009, East Asian and Pacific economies were particularly affected by the collapse of global business investment and declines in trade. As dollar-based exports dropped 25 percent and production plummeted between 15 to 30 percent, high-income economies such as Japan, Singapore, Taiwan, China, and Korea were not immune from the downturn in capital goods demand.[9] (See trade volumes and percentage change in trade in Figures 1.1 and 1.2.) However, East Asia's rebound from the global recession in 2009 was also quicker and more robust than other regions, and Korea's economy has likewise successfully navigated the global economic crisis. GDP grew by 0.2 percent in 2009 and, along with Poland and Australia, Korea is expected to be only one of three OECD member countries that avoided economic contraction in 2009.[10] Moreover, the Korean won significantly recouped against the U.S. dollar.[11] These positive developments partly reflect

9 World Bank, *Global Economic Prospects 2010*.

10 Kim Jae-kyoung, "Korea's GDP Growth Ranks Third in OECD," *Korea Times*, March 8, 2010, http://www.koreatimes.co.kr/www/news/biz/2010/05/123_62032.html.

11 World Bank, *Global Economic Prospects 2010*.

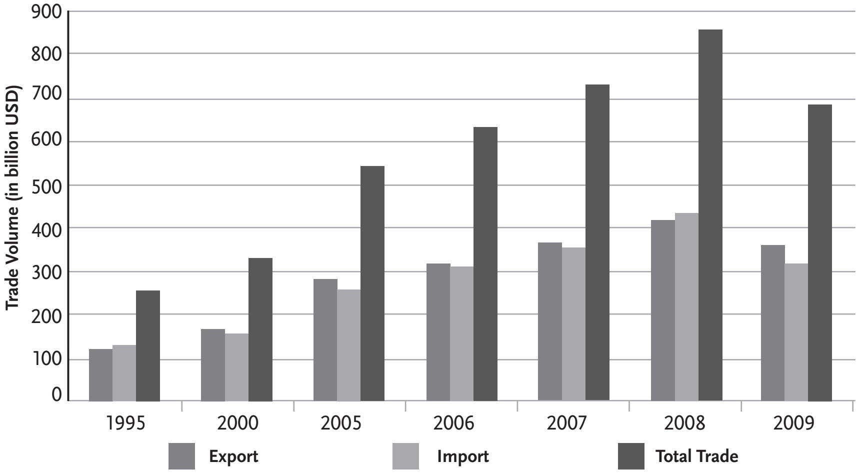

FIGURE 1.1 Korea's Trade Volume (1995–2009)
Source: Korea International Trade Association (KITA).

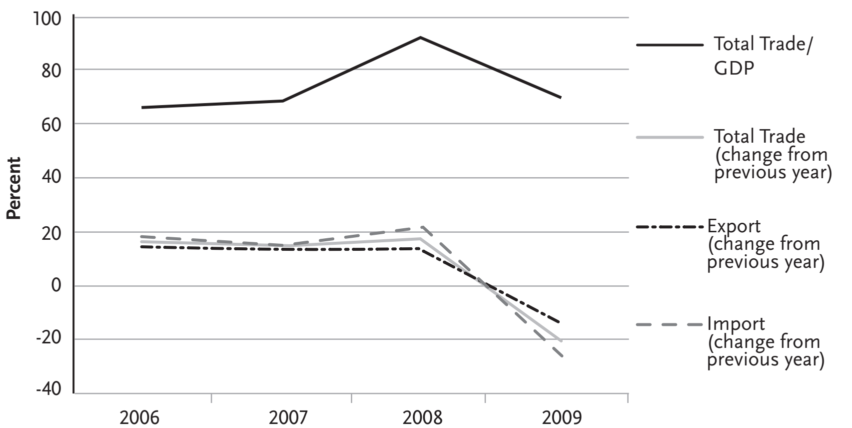

FIGURE 1.2 Changes in Korean Trade (2006–2009)
Source: Korea International Trade Association (KITA).

Korea's proactive participation in the G-20 process and, as per understandings reached with fellow members, the subsequent implementation of stimulus packages. Compared to the G-20 average of 2 percent, Korea's stimulus amounted to 3.6 percent of its GDP.[12]

12 IMF, "IMF Executive Board Concludes 2009 Article IV Consultation with the Republic of Korea," Public Information Notice (PIN) No. 09/103, August 9, 2009, http://www.imf.org/external/np/sec/pn/2009/pn09103.htm.

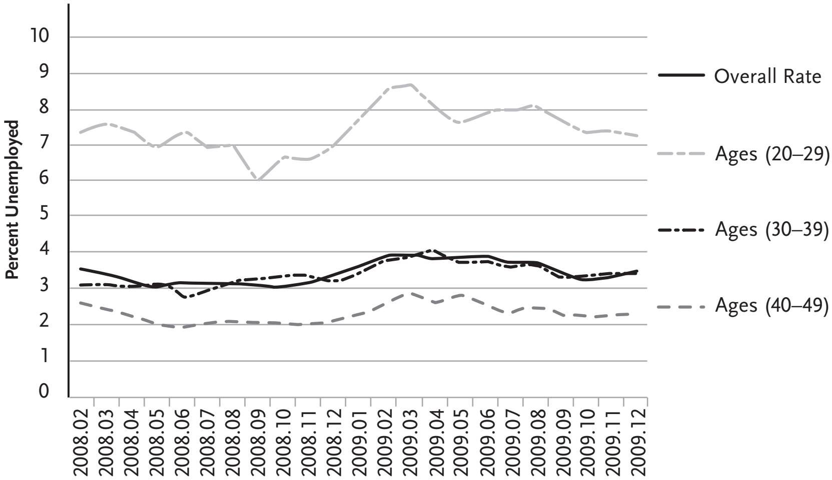

FIGURE 1.3 Korea's Unemployment Rate (2008–2009)
Source: Korean Statistical Information Services (KOSIS).

Korea's recovery, however, does not seem firmly entrenched, as private sector demand is not yet healthy enough to drive consumption and investments. Joblessness continues to be a problem as overall unemployment rose to 3.6 percent in 2009 while unemployment among twenty- to twenty-nine-year-olds jumped to 7.3 percent, as shown in Figure 1.3. Moreover, while Korea netted a trade surplus of $41 billion in 2009, both exports and imports declined by 13.8 percent and 25.8 percent respectively.[13] As exports to advanced economies are predicted to shrink and the Korean won is expected to strengthen versus the dollar, Korea's surplus will likely decrease, while trade levels in 2010 are not expected to recover to pre-crisis levels. These may prove to be significant barriers to recovery, as trade accounts for over 70 percent of the nation's GDP. Thankfully, Korea's economy is currently expected to improve in 2010 as a majority of government agencies, international organizations, global investment banks, and domestic research institutions are predicting a GDP growth rate of 4 to 5 percent, as shown in Table 1.2.[14]

13 Korea International Trade Association (KITA).

14 IMF, "IMF Executive Board Concludes 2009 Article IV Consultation with the Republic of Korea"; Kim Seyoon, "Bank of Korea Raises 2010 GDP Growth Forecast," *Bloomberg*, December 10, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aJMl79RbLwjI.

TABLE 1.2
Forecasts of Korea's GDP Growth Rate (2010)

Institution	GDP Forecast for 2010 (%)
IMF	4.5
OECD	4.4
Bank of Korea	4.6
Ministry of Strategy and Finance	5.0
KDI	5.5
Samsung Economic Research Institute	4.3

Source: 2009 reports from individual institutions listed.

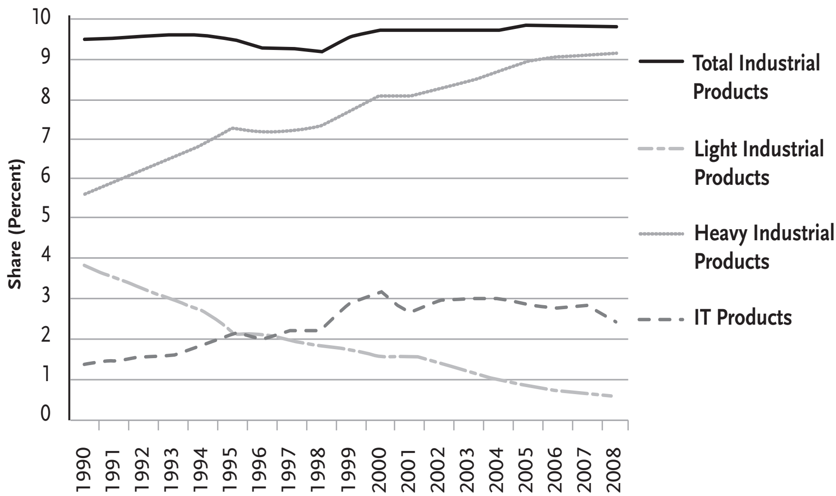

FIGURE 1.4 Korea's Share of Industrial Products in Total Exports (1990–2008)
Source: Korea International Trade Association (KITA).

Changes in Korea's External Economic Relations

In the past twenty years, Korea's international trade has changed dramatically in several respects. The dollar value of Korea's total trade grew almost 6.5 times, increasing from approximately $134.9 billion in 1990 to over $857.3 billion in 2008. This number took a noticeable dip in 2009 due to the global recession. Nonetheless, Korea ranks as the eleventh largest trading nation in the world and accounted for approximately 2.6 percent of total world trade in 2008. The composition of Korea's trading goods has also transformed and reflected the country's progression across various stages of

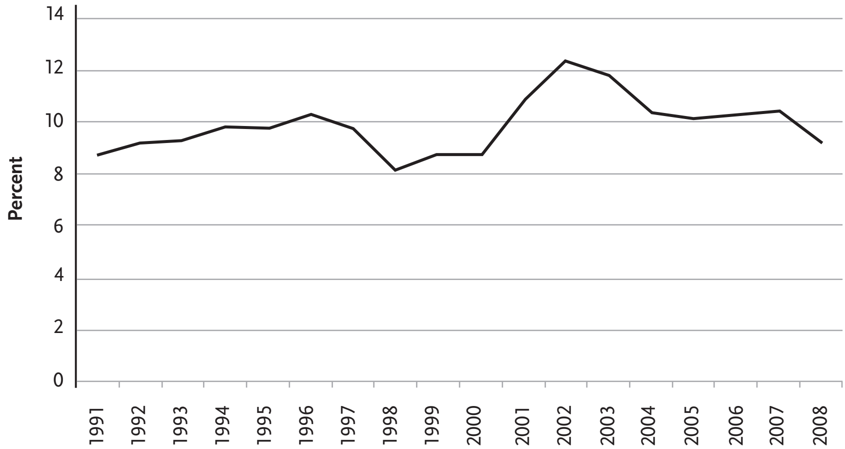

FIGURE 1.5 ROK Share of Consumer Goods in Total Imports (1991–2008)
Source: Korea International Trade Association (KITA).

TABLE 1.3

Korea's Top Ten Export Products (2000 versus 2009)

Top Ten Export Products (2000)					Top Ten Export Products (2009)				
	Volume (USD 100 millions)					Volume (USD 100 millions)			
Product	2000	2009	Change[a]	Weight[b]	Product	2000	2009	Change[a]	Weight[b]
Integrated circuit semiconductors	**246**	282	14.6	14.3	Ships	79	**423**	435.4	11.6
Cars	**119**	224	88.2	6.9	Integrated circuit semiconductors	246	**282**	14.6	7.8
Ships	**79**	423	435.4	4.6	Flat panel display	3	**251**	8266.7	6.9
Cordless phones	**56**	181	223.2	3.3	Cars	119	**224**	88.2	6.2
Computer parts	**52**	19	-63.5	3.0	Cordless phones	56	**181**	223.2	5.0
Synthetic resins	**50**	133	166.0	2.9	Synthetic resins	50	**133**	166.0	3.7
Monitors	**36**	22	-38.9	2.1	Car parts	21	**117**	457.1	3.2
Diesel oil	**32**	88	175.0	1.9	Wireless telecom.[b]	11	**106**	863.6	2.0
Polyester fabric	**31**	13	-58.1	1.8	Diesel oil	32	**88**	175.0	2.4
Computers	**29**	5	-82.8	1.7	Jet fuel / kerosene	19	**52**	173.7	1.4
Top Ten Subtotal	730	1390	90.4	42.4	**Top Ten Subtotal**	636	**1857**	192.0	51.1
2000 Total Exports	**1723**	3635	111.0	100.0	**2009 Total Exports**	1723	**3635**	111.0	100.0

Source: Korea International Trade Association (KITA).

Notes: a) "Change" is percent change from 2000 to 2009
b) "Weight" is weighted percentage
c) Wireless telecommunication equipment parts

TABLE 1.4

Korea's Top Ten Import Products (2000 versus 2009)

Top Ten Import Products (2000)					Top Ten Import Products (2009)				
	Volume (USD 100 millions)					Volume (USD 100 millions)			
Product	2000	2009	Change[a]	Weight[b]	Product	2000	2009	Change[a]	Weight[b]
Crude oil	**252**	508	101.6	15.7	Crude oil	252	**508**	101.6	15.7
Integrated circuit semiconductors	**179**	219	28.8	10.6	Integrated circuit semiconductors	170	**219**	28.8	6.8
Natural gas	**39**	139	256.4	2.4	Natural gas	39	**139**	256.4	4.3
SC equipment[c]	**34**	31	-8.9	2.1	Naphtha	34	**107**	214.7	3.3
Naphtha	**34**	107	214.7	2.1	Bituminous coal	20	**90**	350.0	2.8
Computer parts	**34**	24	-29.5	2.1	Synthetic material[d]	22	**48**	118.2	1.5
Gold	**23**	11	-52.2	1.4	Misc. plates	4	**41**	925.0	1.3
Synthetic material[d]	**22**	48	118.2	1.3	HR plate	15	**40**	166.7	1.2
Individ. device SC	**21**	34	61.9	1.3	Other plastic prod.	11	**39**	254.5	1.2
Bituminous coal	**20**	90	350.0	1.2	Iron	9	**35**	288.9	1.1
Top Ten Subtotal	**649**	1211	86.6	40.4	**Top Ten Subtotal**	576	**1266**	119.8	39.2
2000 Total Exports	**1605**	3231	101.3	100.0	**2009 Total Exports**	1605	**3231**	101.3	100.0

Source: Korea International Trade Association (KITA).

Notes: a) "Change" is percent change from 2000 to 2009
b) "Weight" is weighted percentage
c) Equipment for manufacturing semiconductors
d) Miscellaneous synthetic chemistry base material

economic development. In terms of exports, as shown in Figure 1.4, Korea used to be heavily concentrated in light manufacturing goods, which made up 38 percent of total exports as late as in 1990. In 2008, however, 90 percent of Korea's exports came from heavy industry and chemical goods. Exports from Korea's IT industry are also rapidly increasing, and products from the automobile, shipbuilding, semiconductor, home appliance, and mobile phone industries together account for close to 60 to 70 percent of exports. As for Korea's import composition, there have not been many noticeable changes. Petroleum accounted for 19.8 percent of imports in 2008, while imports of parts and components intended for the production of exporting goods accounted for 41 percent. Meanwhile, consumer goods accounted for less than 10 percent of imports (see Figure 1.5), a figure that decreases to approximately 4 percent if grains and foodstuffs are excluded.[15] Korea's top ten export and import products are shown in Tables 1.3 and 1.4.

15 Data from Korea International Trade Association (KITA).

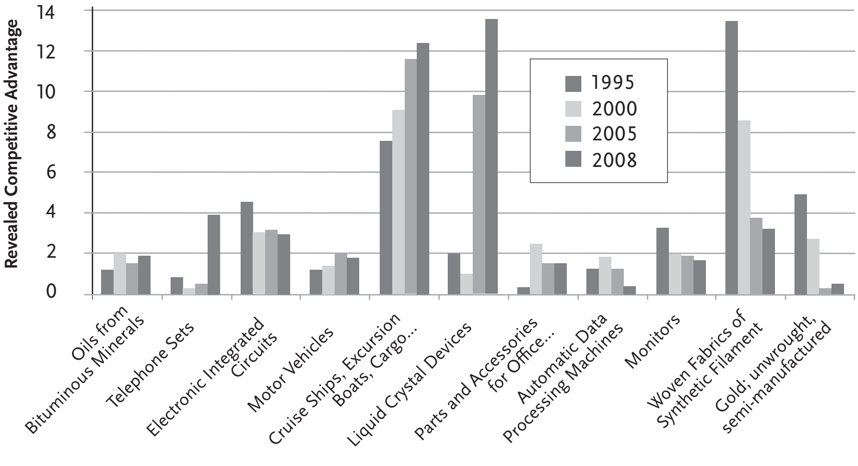

FIGURE 1.6 Changes in Korean Top Exports (1995–2008)
Source: Korea International Trade Association (KITA).

Korea's comparative advantages in relation to other international economies have evolved significantly in the past decade and a half, as shown in Figure 1.6. With economic development and the consequent movement toward higher value-added activities, Korea has increasingly specialized in the manufacture of high-tech devices (e.g., cellular telephone sets and LCD displays) as well as ships. At the same time, Korea's traditional advantage in automatic data processing machines, monitors and projectors (not including televisions), synthetic fabrics, and unwrought gold has diminished considerably. In fact, for automatic data processing machines and unwrought gold, the revealed comparative advantage has sunk below 1, which indicates these products have turned from comparatively advantageous products to comparatively disadvantageous products in the span of thirteen years. On the other hand, the revealed comparative advantages in oils from bituminous minerals (diesel) and motor vehicles have remained relatively constant.

The composition and relative importance of Korea's major trading partners have also changed over time. While Korea initially focused on the United States, Japan, and Europe as key destinations for its expanding exports, exports to China began increasing in the early 1990s, with China finally overtaking the United States as Korea's biggest export market in 2003. With the expansion of the European Union (EU) in recent years, Korea's major trading partners are now ranked in the following order: China, the EU, the United States, and Japan. In addition, trade with emerging economies has also dramatically increased, with Korea having trade relations with over 220

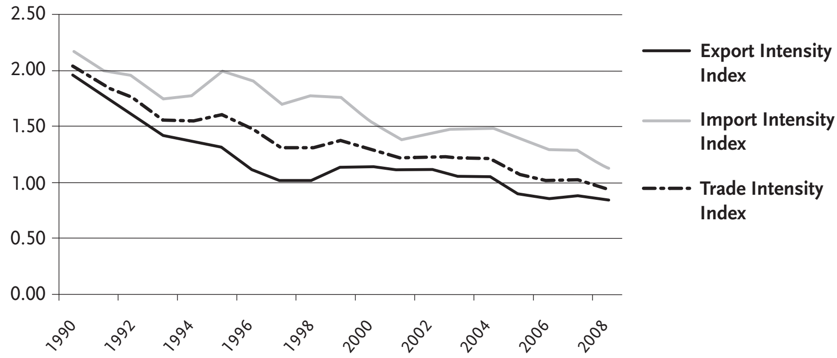

FIGURE 1.7 Korea-U.S. Trade Intensity Index (1990–2008)
Sources: Korea International Trade Association (KITA); UNCOMTRADE.

countries in 2008.[16]

Trade with the United States

Total trade between the United States and Korea amounted to approximately $84.7 billion in 2008, through which Korea netted a trade surplus of $8.6 billion. The trade intensity index (see Figure 1.7) between the two countries has shown a notable decrease every year since the early 1990s.[17] In particular, Korea's export intensity index to the United States has fallen below 1, which signifies that Korea is now exporting less to the United States relative to world exports to the United States. Meanwhile, the import intensity index is hovering barely above 1, which demonstrates that Korea is not importing much more from the United States compared to the rest of the world. At its current pace, Korea's import intensity index may even fall below 1 in the near future. In 2008, Korea mainly exported globally-competitive products such as road vehicles, telecommunication and sound recording equipment, and electrical machinery to the United States while importing electrical machinery, specialized machinery, transportation equipment, and organic chemicals. The Korea-U.S. trade composition consequently shows a high level of intra-industry trade between the two economies.[18]

16 Korea International Trade Association (KITA).

17 We have calculated the trade intensity index between countries *i* and *j* in the world *w*, using the following formula: $T.I.I. = \frac{(X_{ij}/X_{iw})}{(X_{wj}/X_{ww})}$ where *X* stands for import, export, or total trade values depending on which intensity we were looking at. The index value of 1 means that the relative importance of country *j* for country *i*'s trade is the same as it is for the rest of the world.

18 Data from Korea International Trade Association (KITA).

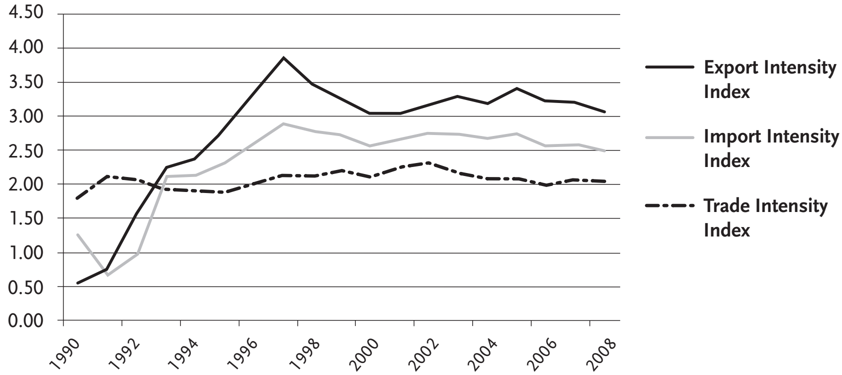

FIGURE 1.8 Korea-China Trade Intensity Index (1990–2008)
Sources: Korea International Trade Association (KITA); UNCOMTRADE.

China

Since the normalization of diplomatic relations between Korea and China in 1992, the volume of trade between the two nations has expanded at an extremely rapid rate. The total trade value between Korea and China in 1992 amounted to $2.8 billion. By 2008, that figure had increased by nearly sixty-fold to over $168 billion and Korea recorded a trade surplus of near $14.5 billion. Trade volume growth of such magnitude is hard to find anywhere else in the world, and the Korea-China bilateral relationship has been lauded as a substantial achievement by both countries. Reflecting recent developments in total trade, Korea's export and import intensity indices scored well above the world average: in 2008, Korea's export intensity index was over 3 while import intensity was above 2, as shown in Figure 1.8. These figures suggest that Korea's reliance on China as an export market is more than three times as heavy as the rest of the world's level of reliance, while Korea's dependence on China as a source of imports is more than double the rest of the world's dependence on China. Geographical proximity of the two countries as well as significant "complementarities" of the two countries' economic capabilities are two possible reasons for such intensive trade between Korea and China.[19]

In 2008, Korea's main exports to China consisted of electrical machinery, professional and scientific apparatus, organic chemicals, and telecommunication and sound recording equipment. In the same year, Korea's main imports from China included products such as iron and steel, electrical ma-

19 Data from Korea International Trade Association (KITA).

chinery, telecommunication and sound recording equipment, apparel, coal, and textiles. This trade composition shows that intra-industry trade is quite active between both nations; furthermore, the overall pattern of trade indicates that Korea currently exports more capital goods to China while importing more raw materials. It has been reported that a considerable portion of Korean exports are accounted for by firms of Korean origin located in Chinese territory, for purposes of importing capital goods, parts and components from Korea. These firms, furthermore, export finished products mostly to the United States or Europe. Therefore, most of Korea's exports to China never reach China's domestic consumption markets. [20]

Japan

Total trade between Korea and Japan recorded a historical high of $89.2 billion in 2008 and Korea netted a trade deficit of nearly $32.7 billion in the same period. This deficit was the largest recorded since the two countries began serious bilateral trading relations in the 1960s. This almost-lopsided trading pattern is also reflected in trade intensity indices: the export intensity index is steadily falling (from approximately 2.7 in 1990 to below 1.5 in 2008) while the import intensity index remains extremely high (at around 3), as shown in Figure 1.9. These numbers speak directly to Korea's heavy reliance on Japanese imports. Due to geographic proximity, even if the actual trade volume is not remarkable, the proportion of Korea's exports to Japan is moderately higher than the corresponding average proportion of exports from rest of the world. Between Korea and Japan, intra-industry trade in electric machinery, iron and steel, and general industrial machinery industries was most prominent.[21]

Aside from intra-industry trade, Korea exported telecommunication and sound recording equipment, and petroleum and related products to Japan, while importing chemical materials and products, plastic, and road vehicles. Korea also imported sizeable volumes of high quality materials, parts and components from Japan and currently relies heavily on such imports to produce its export goods. Thus, structurally, Korean exports depend on Japanese imports and as Korea's exports to the world increase in the foreseeable future, its imports from Japan will also likely increase. In 2009, Korea registered a $27.7 billion trade deficit against Japan.[22]

20 Data from Korea International Trade Association (KITA).
21 Data from Korea International Trade Association (KITA).
22 Data from Korea International Trade Association (KITA).

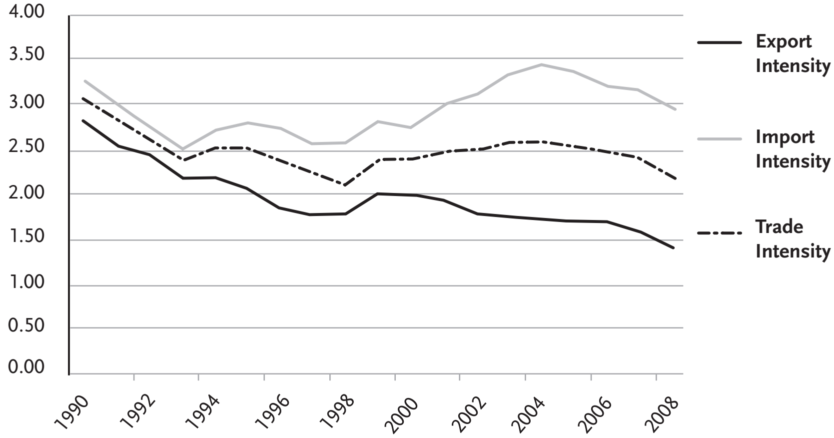

FIGURE 1.9 Korea-Japan Trade Intensity Index (1990–2008)
Sources: Korea International Trade Association (KITA); UNCOMTRADE.

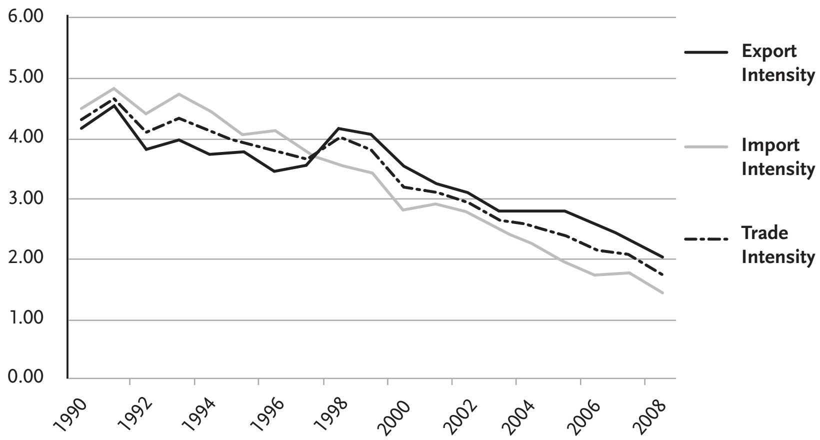

FIGURE 1.10 Korea-EU Trade Intensity Index (1990–2008)
Sources: Korea International Trade Association (KITA); UNCOMTRADE.

Europe

In 2008, Korea and the EU recorded a total trade of $98.4 billion from which Korea recorded a trade surplus of $18 billion. Trade intensity between Korea and European nations was very high in the early 1990s, yet both export and import intensity indices have steadily declined since, as shown in Figure 1.10. Currently, both numbers are higher than the world average, yet it is unclear whether the figures will remain above unity considering the downward trend of the last twenty years. Between Korea and Europe, there

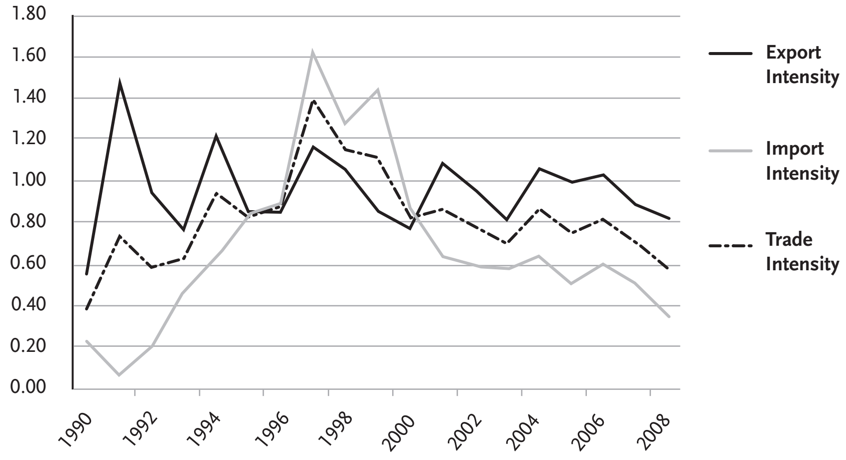

FIGURE 1.11 Korea-Africa Trade Intensity Index (1990–2008)
Sources: Korea International Trade Association (KITA); UNCOMTRADE.

is active intra-industry trade in automobiles and related parts, and semiconductors. Meanwhile, Korea exported comparatively more products from the shipbuilding, flat screen display, and wireless phone industries while European economies exported more pharmaceutical goods, equipment necessary to produce semiconductors, and chemicals.[23]

Rest of the World

Korea has been rapidly expanding and intensifying trade with more minor trading partners, a diversification that has led the nation to establish bilateral trading relations with countries and regions as diverse as ASEAN, India, Latin America, and Central Asia. However, Korean trade with the African continent has remained minimal compared to trade with other parts of the world (see Figure 1.11). Korea's level of trade with Latin America is also low, although both absolute trade volume and the export intensity index have been increasing in recent years, as shown in Figure 1.12. Total value of trade with Latin America amounted to less than $4 billion in 1990. In 2008, however, Korea-Latin American trade amounted to $47.0 billion—a leap of almost twelve times the original amount. Moreover, the export intensity index from Korea's perspective reached 1.27 in 2008, compared to 0.94 in 1990, demonstrating that an increasing portion of Korean exports are targeting Latin America as a final destination.[24]

23 Data from Korea International Trade Association (KITA).
24 Data from Korea International Trade Association (KITA).

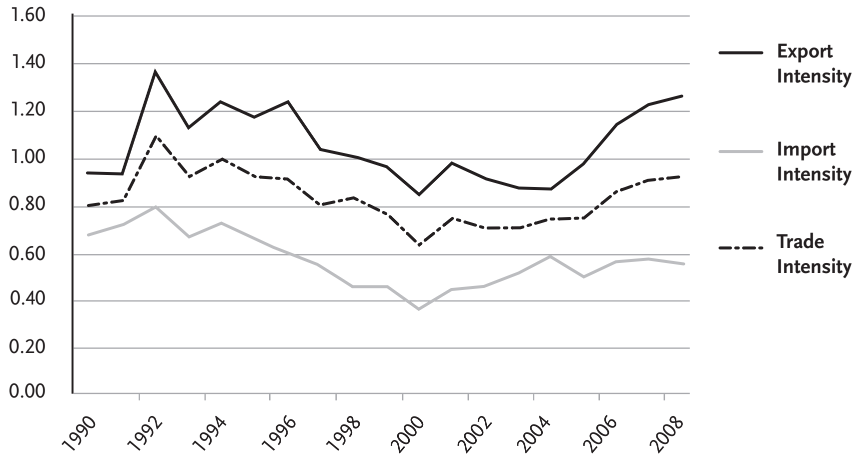

FIGURE 1.12 Korea-Latin America Trade Intensity Index (1990–2008)
Sources: Korea International Trade Association (KITA); UNCOMTRADE.

Within this "rest of the world" category, Korea's relationship with India has demonstrated remarkable jumps in terms of absolute volume of trade. In 1990, trade with India was worth approximately $0.7 billion, but by 2008 the figure had increased by almost 22 times to $15.6 billion. Similar magnitudes of increase were experienced in both exports and imports: Korean exports to India leaped from $0.44 billion to $9.0 billion while imports from India swelled from $0.28 billion to $6.6 billion. This impressive increase in trade occurred smoothly over the last twenty years. Trade in 1993 was the single outlier year to this overall trend, when imports increased moderately (by about 9.4 percent) from 1992 while exports more than quadrupled, going from $0.44 billion to $1.8 billion. This hike was also reflected in the trade intensity indices as Korea's export intensity index in 1993 spiked from 0.92 to 3.84, thereby pulling the total trade intensity index up from 1.04 to 2.49, as seen in Figure 1.13. Beyond this singular anomaly, trade intensity indices have remained fairly stable around 1, except for a recent surge that may reflect the free trade agreement between the two countries taking effect.[25]

External Economic Strategies for a Global Korea

Korea has recently made concerted efforts to raise its status in the international community. Reflective of such efforts, the government recently proposed a new set of broad visions under the banner of a "Global Korea."

25 Data from Korea International Trade Association (KITA).

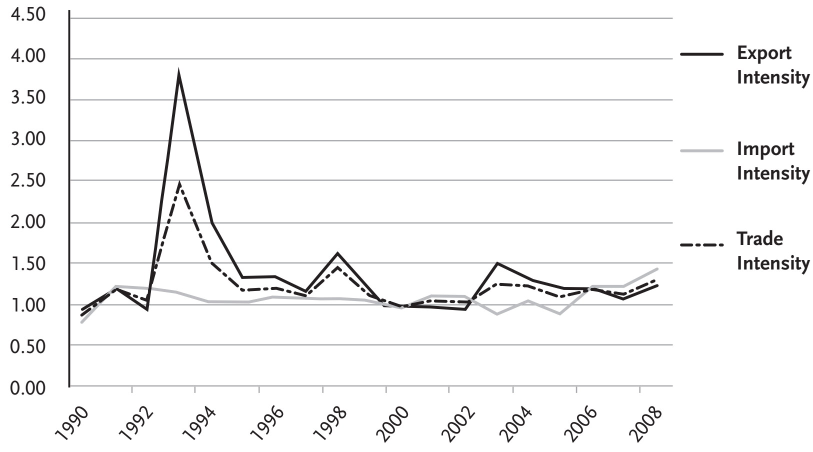

FIGURE 1.13 Korea-India Trade Intensity Index (1990–2008)
Sources: Korea International Trade Association (KITA); UNCOMTRADE.

There have not been many details revealed at this point in time. Nonetheless, here I recommend three objectives that should be pursued in order to realize such a global Korea. First, the nation should liberalize domestic markets and integrate its economy with the global environment in order to become globally competitive; second, Korea should fulfill the responsibilities and duties that correspond to its rising economic status; and, finally, Korea should exert appropriate leadership on issues in which it has expertise. In this area, Korea must play a proactive role in bridging the interests of industrialized and developing countries. To achieve these three objectives, the following external economic strategies should be undertaken.

Further Liberalize the Economy

If Korea's developmental past is any indication, its future lies in proactively liberalizing markets as opposed to protecting domestic industries and firms. Thus, Korea's current liberalization rate is nearly 100 percent while the average tariff rate is 12.4 percent. However, while Korea's policy has been primarily export-driven and outward-looking, with trade-distorting substitutions subsidies having been largely phased out in past decades, one glaring exception is in agricultural products. Moreover, despite regular praise from the GATT/WTO review mechanism, Korea's policies need to be harmonized with internationally-recognized intellectual property protections, sanitary and phytosanitary measures, technical standards, and safety standards that befit an advanced economy. The opening of trade in goods and services through multilateral, regional, and bilateral arrangements, as well as facilitation of foreign investment and upgrading of domestic measures to global standards, will ultimately induce competition, improve the competitiveness of domestic firms abroad, and strengthen the nation's overall economic performance.

A larger problem for Korea, meanwhile, is market liberalization's effect on consumer welfare. Thus far, despite significant lowering of barriers for trade, Korea's preponderance of raw materials, intermediary, and capital goods imports for production purposes has meant that final consumer goods from abroad have failed to effectively penetrate the domestic market. Furthermore, such disparity between production-oriented versus consumer-oriented imports is aggravated by the fact that affiliates of Korean conglomerates are monopolizing production, importation, and distribution, which additionally blocks competitors from entry and allows for price-discriminating strategies. Thus, protectionism should be disavowed and Korea's domestic focus should be oriented towards enhancing consumer welfare.

The liberalization policies outlined above will, of course, entail costs for certain industries. Therefore, reasonable compensation schemes and governmental support programs will be required to pave the way for troubled sectors and firms during industrial restructuring. Such policies, if appropriately designed and implemented, will go a long way towards persuading the private sector to support market liberalization.

Improve Korea's Business Environment

Since the advent of globalization and proliferation of transnational corporations, a nation's economic health is no longer tied to conventional notions of national borders and competition. Increasingly, growth and development will depend on a nation's ability to maintain an attractive business environment and invite constructive investment from abroad.

For a variety of reasons, foreign direct investment (FDI) inflows into Korea remain unimpressive compared to the rest of East Asia. High real estate prices, uneasy relations between labor and management, and a lack of intellectual property protections and enforcement have all contributed to a relatively unattractive business environment. Businesses are often hampered by excessive government regulations related to Korea's trade and investment regimes, an underdeveloped financial services sector and capital and foreign exchange markets, and market access restrictions. Finally, Korea's developmental policy has traditionally been focused on promoting trade rather than investment. In the future, however, the nation needs to take bold steps in resolving these problems or risk being left behind by competitors.

Diversify Korea's International Economic Relations

To both reflect and adapt to the coexistence of multilateralism and regionalism in the world trading environment, Korea's trade strategy should adopt a two-pronged approach that includes maintaining healthy relations within the WTO as well as balancing individual regional relations. While proactively participating in DDA negotiations and supporting the existing multilateral trading regime, Korea needs to pay special attention to strengthening trade with the U.S., EU, and East Asian economies.

This strategy, at least in the foreseeable future, will necessitate the successful completion of current FTA negotiations along with ratification of the United States-Korea Free Trade Agreement (KORUS FTA) and finalization of the Korea-EU FTA. Furthermore, Korea should seriously investigate the possibility of integrating bilateral FTAs into regional ones such as the proposed China-Korea-Japan FTA, ASEAN+3 FTA, ASEAN+6 FTA, or APEC FTA. Until such regional arrangements are realized, Korea should actively promote and participate in functional cooperation among neighboring economies in various fields such as currency swaps, energy security, and environmental protection.

Increase Korea's ODA

Korea's status as a large economy based on nominal GDP cannot sufficiently explain its unique potential to assist developing countries. As a newly-industrialized nation that transitioned from official development assistance (ODA) recipient to donor nation in 1987, Korea has firsthand experience in navigating the precarious evolution from less-developed to advanced-nation status. Thus, Korea not only has the international capacity to aid less fortunate countries, but also has the requisite knowledge to serve as a guide to developing economies and the credibility to serve as an intermediary between developed and less-developed nations.

Korea's present commitments, however, remain woefully small and as of 2008 Korea's ODA was only .09 percent of gross national income (GNI). Although Korea officially joined the OECD Development Assistance Committee (DAC) in January 2010, the nation's ODA/GNI ratio remains far below the DAC average of .3 percent. Moreover, according to the OECD Special Review from 2008, 98 percent of Korean bilateral aid is either tied or partially tied, an extremely high proportion at odds with key DAC recommendations. However, there has been progress: Korea has steadily increased its ODA since 2000 and set an explicit target of increasing ODA/GNI to .25 percent by 2015, representing a six-fold increase in aid in just seven years; furthermore, Korea has presented a *Roadmap on Untying*, a positive step towards untying its aid.[26]

Promote Green Growth at Home and Abroad

Like many newly-developed Asian economies, Korea has a mixed record in regards to promoting environmental protection and such neglect has adversely affected its international rankings. The 2010 Environmental Performance Index, assembled by Yale and Columbia Universities in conjunction with the World Economic Forum, recently ranked Korea 94th out of 161 nations based on internationally recognized environmental health and resource indicators. While its score on this index approximated the average for East Asian and Pacific countries, the country lagged behind the average for Korea's income group.

Recent developments, however, indicate a greener future for Korea. The Presidential Commission on Green Growth, established in February 2009 in hopes of transforming Korea into a "Model Green Nation," announced a Five-Year Plan for Green Growth (2009-2013) that includes programs to combat climate change, secure energy independence, create sustainable growth engines based on green technologies, and annually invest 2 percent GDP into green projects.[27] Additionally, Korea has taken initiative on a global scale. As a non-Annex I nation, it notified the Secretariat of the United Nations Framework Convention on Climate Change (UNFCCC) of its intent to participate in the Copenhagen Accord. Meanwhile, Korea's leadership made a unilateral pledge to reduce greenhouse gas emissions by 30 percent below its 2020 business-as-usual emissions[28] and proposed to raise $200 million for an East Asian Climate Partnership Program that will encourage green ODA abroad.[29]

Enhance Korea's Role in the International Community

Korea is now a mature economy and ready to assume a more proactive leadership role on the world stage. In a global context, befitting its special position as a newly-developed economy with a post-war developmental success story, Korea's future role lies in being a constructive mediator between advanced and developing nations on contentious issues. In G-20 Summit meet-

26 OECD, *Development Co-operation of the Republic of Korea,* DAC Special Review (Paris: OECD, 2008).

27 Xavier Leflaive, *Eco-Innovation Policies in the Republic of Korea* (Paris: OECD, 2008).

28 Ramstad Evan and Jung-Won Shin, "South Korea Sets Its Own Carbon Goal," *Wall Street Journal*, November 18, 2009, http://online.wsj.com/article/SB125842928229651665.html.

29 Korea International Cooperation Agency.

ings, President Lee Myung-bak indicated Korea's willingness to play such a role as he emphasized the need to guard liberalization against protectionism while simultaneously advocating currency swaps and expansion of the IMF Short-term Liquidity Fund to help less developed economies during the financial crisis.

Korea's newfound willingness to be a leader is also evident in the nation's increasingly dynamic presence on the world stage. The country chaired the 2009 OECD Ministerial Council Meeting in June and is host of the G-20 Summit in 2010, the Bureau International des Expositions (BIE) Expo in 2012, and the 22nd World Energy Congress in 2013.[30] These activities are complemented by Korea's continual active participation in numerous international forums such as ASEAN+3, APEC, ASEM, OECD, and the WTO.

Hold a Successful G-20 Summit

When President Lee Myung-bak spoke at the January 2010 World Economic Forum in Davos, he highlighted the importance of the Seoul G-20 Summit. As the first meeting where post-crisis international cooperation will be the focal point of discussion, the Seoul gathering is an opportunity for the G-20 to establish itself as an independent global governance body. While the implementation of exit strategies will unquestionably be one of the central issues surrounding discussions, delegations can be expected to debate a broader range of topics based on mid to long-term perspectives.

President Lee also underscored the need for parties to faithfully implement agreements reached in previous meetings. These include reforming financial regulations and the supervision system, strengthening early warning and surveillance capabilities of key financial institutions, restructuring governance structure of international financial organizations such as the IMF and World Bank, supporting an early conclusion to the DDA negotiations, and combating protectionism worldwide. Upon these preexisting initiatives, however, Lee also promised to develop agenda items to help bridge the developmental gap between countries. Specifically, the president mentioned the construction of a "global financial safety net," through, for example, strengthening bilateral financial cooperation between advanced and developing economies, and establishing regional financial cooperation mechanisms. In addition, Lee also pledged to work towards a more inclusive summit and has invited input from non-member states, regional cooperation bodies, international organizations, and even the private sector. In particular, the president foresaw creative contributions from world business leaders to be

30 Ministry of Foreign Affairs and Trade, *Diplomatic White Paper 2009* (Seoul: MOFAT, 2008.

especially vital in producing post-crisis sustainable growth and employment.

Concluding Remarks

The world economy is at a crossroads and the most important task is finding a new framework to promote sustainable and balanced growth. The current global financial crisis illustrates that international cooperation and policy coordination are the only means of successfully achieving this goal. History shows that financial crises can be averted or effectively managed when parties achieve international coordination, and that lacking such cooperation, crises are more likely to be accompanied by a prolonged recession. Therefore, it is hoped that the newly established G-20 can sustain the world's trust and play a vital role in managing the world economy. The first steps towards this end will be successful outcomes in the 2010 G-20 Summit Meetings to be held in Canada and Seoul.

Due to Korea's heavy reliance on foreign markets, some have argued that it should expand its domestic market to decrease the nation's vulnerability to external shocks. However, there is a limit to the Korean domestic market; for Korea's economy to grow further, the nation's leadership must continue implementing externally-oriented economic strategies. It is therefore commendable that the current government has proposed the new set of globally-minded visions to achieve a so-called Global Korea. However, Korea's future economic direction cannot be interpreted under this banner as simply increasing exports, as has been the case in the past. A true global Korea will entail the opening of domestic markets, the diversification of trade to different regions, the upgrading of domestic policies, institutions, and customs to global standards, and the expansion of Korea's scope of responsibilities in the international community.

An Odyssey of the Korean Financial System and the September 2008 Financial Shock[1]

Thomas F. Cargill

In late 2008, the U.S. financial system appeared to be at the abyss. The collapse of securities markets in general, and mortgage-backed securities in particular, was the result of an accumulation of stress caused by over two years of declining residential house prices, deteriorating household and financial sector balance sheets, and reduced availability and increasing cost of credit. The sudden collapse of securities markets and bankruptcy of Lehman Brothers on September 15, 2008, led to unprecedented lender of last resort policies by the Federal Reserve and public injection of funds by the U.S. Treasury directed toward large financial institutions (banks, investment companies and insurance companies) in an attempt to avoid another 1930s Great Depression. The financial shock occurred in an already declining real economy that had turned from expansion to contraction in December 2007. The economic and financial distress spread rapidly to the rest of the world through international linkages and because many countries had large amounts of dollar-denominated assets, especially securities backed by residential mortgages. As a result, the period from late 2008 through 2009 is referred to as the "great recession" in the United States, while from the international perspective the period is known as the "global financial crisis" of 2008.

The 2008 global financial crisis profoundly impacted and tested South Korea's (hereafter simply Korea) financial system; the "September shock" generated a sense of panic throughout it, rekindling memories of the 1997 crisis that had brought Korea close to economic and financial collapse as

1 This paper was prepared for the OECD as a background paper for the *2009 Economic Survey of Korea*, and some elements of it form part of the financial chapter in the *2009 Survey* and an OECD working paper authored by Randall Jones, Masahiko Tsutsumi, and myself. The author expresses appreciation to Randall Jones for comments on the paper. All errors remain the responsibility of the author, however.

a result of capital flight and the collapse of the export sector. News media accounts in September and October anticipated the worst, and suggested Korea was on the verge of another 1997-type crisis.[2] The financial shock occurred as Korea was already dealing with a slowing economy, downward trending profitability, rising housing prices, and increasing debt in the household and small and medium-sized enterprise (SME) sectors.

The government reacted rapidly by: (1) injecting public funds into banks; (2) requiring banks and other financial institutions to increase capital; (3) guaranteeing foreign debt owed by banks and providing some banks with dollar reserves; (4) decreasing the policy interest rate and expanding the Bank of Korea's lending facilities; (5) increasing credit guarantees and other support for SMEs, and; (6) providing frequent and transparent information through the Bank of Korea, Financial Services Commission, and Financial Supervisory Service about the government response to the crisis. At the same time, the government affirmed its commitment to continue corporate governance reform, liberalization of financial markets, and the institutional redesign of government financial and regulatory institutions.

The dire predictions in the news media proved incorrect, however. A number of indicators reported by the Bank of Korea[3] suggest that the financial system stabilized by March 2009 and continued to improve throughout the year, in tandem with the real economy. By the end of 2009, the financial sector still had not achieved its pre-crisis levels of performance, but appeared to be on the road to recovery; however, the financial system remains weaker than in the pre-crisis period in terms of nonperforming loans (NPLs) and delinquency rates for banks and non-bank financial institutions.

As of the first quarter of 2010, Korean financial policy discussion was progressing in a calmer environment and focused on seven areas:

- Improve financial regulation and supervision to limit imprudent risk-taking by financial institutions in general.
- Limit risk-taking by both financial institutions and the household sector in mortgage lending and borrowing, to limit potential housing bubbles.
- Increase the ability of financial institutions to absorb declines in asset values.
- Monitor and implement policies to restrain and improve the quality of household and SME debt.

2 "South Korea–Second time around," *The Economist*, October 25, 2009, 52–53.

3 Bank of Korea, *Financial Stability Report: November 2009*, http://www.bok.or.kr/broadcast.action?menuNaviId=737.

- Improve the foreign exchange demand-supply structure to reduce the susceptibility of banks to capital flight and internalize this risk into the bank decision-making process.
- Improve corporate governance at both financial and non-financial entities to improve efficiency.
- Design exit strategies for public injections of capital and purchases of nonperforming assets to limit moral hazard.

As an export-oriented and non-reserve currency country, like many Asian countries, Korea is relatively sensitive to external shocks, whether financial or real. The economy remains susceptible to capital flight and rapid currency depreciation; hence, establishing a transparent and sound financial system is a necessary condition for sustained economic growth. Like the 1997 Asian crisis, the September 2008 global financial crisis revealed how vulnerable Korea was to capital flight. Korea's foreign investment portfolio declined by 173.9 hundred million won in the fourth quarter of 2008, but returned to an upward trend from January 2009 and increased to 219.9 hundred million won in the third quarter of 2009, reflecting the rapid restoration of confidence. This vulnerability to external shocks presents policy makers with both short- and long-run problems.

In the short run, Korea needs to establish policies and make institutional changes to enable the financial system to absorb external shocks. Judged by the response to the September 2008 shock, Korea has made significant progress in this regard compared to the 1997 crisis. At the same time, longer-run issues remain. In the long run, Korea would benefit from reorienting its export-based development strategy from manufacturing-oriented exports to service/information-based exports as well as relying more on domestic demand. Moreover, it should reduce its reliance on foreign currency financing and provide greater incentives for internal sources of funding by increasing the household saving rate and focusing more on domestic investment. However, the policy discussion of the longer-run problem has not progressed much beyond a general recognition there is a problem. The majority of the policy effort is directed toward the short run. While Korea is successfully dealing with the short-term issue, the financial system will remain excessively susceptible to external developments if Korea's economic structure remains unchanged; despite its relative size, as long as Korea stays committed to an export-growth strategy, it will be vulnerable to capital flight risk.

In this paper I examine the impact of the September 2008 shock on Korea's financial system in 2009 from several perspectives. First, I discuss the evolution of the Korean financial system in three stages (1953–1980; 1980–

1997; and 1997–present) to provide a historical perspective on the September 2008 shock and rapid recovery of the financial system. Next, I consider pre-September 2008 issues in the Korean financial system. The attention of regulatory authorities was occupied by the increasing levels of household and government debt, housing price developments, and continued weak condition of SMEs. In the next section I look at the impact of the September 2008 shock on the financial system, its recovery and stabilization. Then, I identify those factors that enabled Korea's financial system to absorb the shock and review the response of the Korean government to the September 2008 shock. I continue with a discussion of continuing concerns and challenges and conclude with a broad overview of the past decade.

Placing the September 2008 Crisis in Historical Context

To properly understand the accomplishments of Korean financial reform, as manifested by the events since September 2008, it is important to place them in the context of Korea's financial evolution from 1953 up to the September 2008 crisis. The financial system (defined to include private depository institutions, private markets, government regulatory agencies, and central banking institutions) has experienced three major transitions[4] since 1953.

Phase 1: 1953–1980

The first phase covers Korea's nondemocratic and interventionist government period. The industrial structure was dominated by large business groups (*chaebŏl*) with close ties to the government that controlled the financial system. Industrial policy was directed toward heavy industry and chemicals. Korea grew rapidly, although unevenly, during this phase, accompanied by high and variable inflation and the accumulation of unsustainable imbalances in both the real and financial sectors. Korea's NPL problem was large long before it emerged as a problem in the United States (1980s) and Japan (1990s). The financial system was an instrument of government-directed industrial policy subject to extensive credit allocation and interest control policies directed toward favored sectors of the economy. Policy conflicts between the government and the central bank on occasion resulted in

4 These three periods are also used to review the development of Bank of Korea policy in the postwar period. Thomas F. Cargill, "The Bank of Korea in Historical and Comparative Perspective," *Academic Paper Series on Korea* 3 (2010), Korea Economic Institute and the Korea Institute of International Economic Policy.

dismissal of Bank of Korea governors.[5] Price stability and prudential policies took second place to government industrial objectives. The Bank of Korea, under the administration of the government, contributed to wide swings in the rate of inflation, supported financially weak corporations by making policy loans to specific sectors of the economy, and operated its discount window with the objective of preventing failures of financial institutions (mainly banks) and markets. The effects of unstable prices, support of financially weak corporations, and the moral hazard implicit in Korea's industrial policy were masked by rapid economic development through the 1970s; however, by 1980 economic and financial distress accumulated to a point whereby regime change was necessary.

Phase 2: 1980–1997

Poor macroeconomic performance and international pressure to liberalize led to the second phase, commencing in the 1980s, which included a major shift in political structure from authoritarian to more democratic institutions. Gross domestic product (GDP) declined in 1980, trade and current account deficits increased, foreign borrowing increased, and the consumer price index (CPI) inflation rate reached 28.6 percent. At the same time, Korea was being advised and pressured to liberalize its real and financial sectors to establish a more sustainable base for economic and financial stability. The Korean government officially adopted a liberalization policy in its Fifth Five-Year Plan (1982–1986) and implemented it in two steps: first, to stabilize macroeconomic performance and second, to commence liberalization. The banking system was denationalized followed by interest rate deregulation and the initial development of money and capital markets. The Presidential Commission for Financial Reform, established in January 1997 on what would turn out to be the eve of the Asian financial crisis, released reports in April, June, and November of that year. The pace of financial liberalization up to this point had been slow and most observers regarded the government's commitment to liberalization weak. Liberalization was pursued more in response to external pressure, and many government officials found it difficult to understand why regime change was required when GDP growth was high and inflation moderate. The Presidential Commission was critical of the slow pace and recommended a much bolder policy to modernize Korea's financial system. At the time the Commission's reports were released there was little impact, with only one exception: an intense debate emerged

5 Bernhard Seliger, review of *The Bank of Korea: A History of Fifty Years*, by Myung-Chang, Chung, ed., *Korean Studies Review* 1 (2002), http://koreaweb.ws/ks/ksr/ksr02-01.htm.

in summer 1997 between the Bank of Korea and the Ministry of Finance and Economy over moving bank supervision from the central bank to the ministry. However, this debate had more to do with labor union politics than financial reform. The impact of the 1997 Asian financial crisis on Korea dramatically changed both the context of the debate on financial liberalization and the attitudes of the Korean government on the need for regime change.

Phase 3: 1997 to September 2008

The 1997 crisis begins the third phase. The swiftness and magnitude of the economic and financial distress starting in late 1997 and the need to seek a $58 billion credit line from the IMF made the weakness of the financial system, the inadequacies of past liberalization efforts, and the need for regime change apparent to the Korean authorities. The government launched a series of major structural reforms in the financial system, including: (1) a major injection of public funds into the banking system; (2) a dramatic decline in the number of financial institutions, achieved through closures and mergers; (3) increased capital requirements; (4) the purchase of NPLs by the Korea Asset Management Corporation (KAMCO); (5) institutional redesign of the financial and regulatory regime to consolidate oversight, reduce political influence, and enhance transparency; and (6) institutional redesign of the Bank of Korea to reduce political pressure and increase transparency. Financial-sector reforms were accompanied by industrial restructuring to make large corporations and the *chaebŏl* system more market oriented and reduce their control over financial institutions, while reducing the role of government credit allocation policies. The bold approach recommended in early 1997 by the Presidential Commission on Financial Reform was made politically feasible by the crisis that erupted later in the year. Korea's wide range of policy responses was followed by a return to rapid economic growth by late 1998. The nation's aggressive efforts to resolve the NPL problem, close insolvent institutions, devote significant financial resources, and make significant institutional redesign of its financial system are remarkable.

Resolving the nonperforming loan problem

KAMCO played the major role in resolving Korea's large NPL problem in the wake of the 1997 crisis, as shown in Table 2.1. KAMCO's purchases rapidly reduced NPLs, both as a share of total loans and GDP for both banks and non-bank financial institutions, between March 1998 and December 2002. KAMCO's success was due to the fact that it was a "garage sale" institution rather than a warehouse. This provided an important signal the government's response to the crisis would not be based on forgiveness and

TABLE 2.1

NPLs and KAMCO Purchases of NPLs (1997–2002)

	Mar-98	Dec-99	Dec-00	Dec-01	Dec-02
NPLs as Percentage of Total Loans	17.7	14.9	10.4	5.6	3.9
Banks	16.8	12.9	8.0	3.4	2.3
Nonbanks	20.5	23.0	23.6	13.7	9.8
NPLs as Percentage of GDP	26.6	18.2	12.4	7.2	5.3
	Nov-97 to Mar-98	**Mar-98 to Dec-99**	**2000**	**2001**	**2002**
KAMCO Purchases of NPLs (won trillions)	13.9	48.3	33.0	6.0	9.0
Banks	8.4	44.1	4.4	4.9	0.2
Non-banks	5.5	4.2	28.6	1.1	8.8

Source: He Dong, "The role of KAMCO in Resolving NPLs in the Republic of Korea," IMF Working Paper, no. 04/12 (September 2004).

forbearance, an approach pursued in some countries, including Japan. Instead, public funds would be used for a rapid resolution of the problem. KAMCO disposed the NPLs by bulk or pooled asset-backed securities (ABS) sales, individual sales, foreclosure and public auction, and joint partnerships. The pooled or ABS sales not only disposed of the NPLs, but also helped establish a secondary financial market that contributed to Korea's increasingly sophisticated money and capital markets.[6]

Institutional redesign

Four institutional reforms of the regulatory and central banking institutions occurred that rendered the government's role in the financial system and economy more transparent and less subject to political interference as in the past.

The establishment of the Financial Supervisory Commission in 1998 and the Financial Supervisory Service in 1999 provided prudential regulation over the financial system by increasing capital standards, reducing NPLs, introducing a meaningful system of classifying NPLs, reducing politicization of bank credit allocation, and increasing overall financial system transparency. The Financial Supervisory Service now provides timely and transparent

6 He Dong, "The role of KAMCO in Resolving NPLs in the Republic of Korea," IMF Working Paper, no. 04/12 (September 2004).

information on the financial performance of the most important financial institutions. These regulatory institutions established a prompt correction action framework to move aggressively against troubled financial institutions; established an asset quality rating system for financial institutions; imposed a variety of prudential regulations regarding loans to individuals and business groups; improved corporate governance by requiring an outside director system for many financial institutions (including permitting foreigners to serve as directors); and enhanced accounting standards to provide a meaningful disclosure system.

The formal independence of the Bank of Korea was enhanced in 1998 and 2003, and central bank policy became more transparent.[7] The introduction of an inflation-targeting framework established a firmer foundation for anchoring inflation expectations in the economy and reduced political influence on central bank credit allocation policies. The 2003 changes also provided the Bank of Korea with greater flexibility to support the payments system and be a lender of last resort.

The Korea Deposit Insurance Corporation (KDIC), established in 1996, was given the task of insuring deposits of banks, securities companies, insurance companies, merchant banks, and savings banks, thereby limiting systemic risk. This explicit form of government deposit guarantees is more transparent and less sensitive to political pressures than the previous implicit system.

KAMCO was originally established in 1962 to remove nonperforming assets from the Korea Development Bank and its role was expanded to other financial institutions in 1966. In November 1997, KAMCO was reorganized to deal with the NPL problem, which increased significantly as a result of the 1997 crisis. KAMCO is classified as a public nonbank financial corporation under the supervision of the Financial Supervisory Commission. It has been elevated to important safety-net position in the Korean financial system.

Recapitalization and restructuring financial institutions

The Korean government devoted significant public funds to restructuring financial institutions, increasing prudential regulation, and increasing capital adequacy (see Table 2.2). According to the Bank of Korea,[8] five banks that did not meet the eight percent Bank for International Settlements (BIS)

7 Thomas F. Cargill, "Central Bank Independence in Korea," *Journal of the Korean Economy* (Spring 2001): 1–33; and Thomas F. Cargill, "The Bank of Korea in Historical and Comparative Perspective," *Academic Paper Series on Korea* 3 (2010), Korea Economic Institute and the Korea Institute of International Economic Policy.

8 "Recent Changes in the Financial System," Bank of Korea, accessed November 1, 2011, http://www.bok.or.kr/broadcast.action?menuNaviId=647.

TABLE 2.2
Capital Adequacy and Profitability of Financial Institutions

		1995	1997	1999	2001	2003	2005	2006
Banks	BIS Capital Ratio	9.3	7.0	10.8	10.8	10.4	12.4	12.3
	NPL Ratio	5.2	6.0	13.6	3.3	2.7	1.3	0.9
	ROA	0.3	-0.9	-1.3	0.8	0.1	1.2	1.1
	ROE	4.2	-14.2	-23.1	15.9	2.2	20.3	15.6
Insurance Companies	Capital Ratio	0.1	-0.1	-5.4	1.2	6.5	8.3	8.3
	NPL Ratio				5.3	4.1	3.4	3.0
	ROA	-0.1	-0.1	-4.4	-0.5	1.8	1.1	0.9
	ROE	-114.8	91.2	122.3	-111.4	34.1	13.7	12.9
Securities Companies	Capital Ratio	45.7	36.3	33.3	20.5	17.8	30.9	36.8
	NPL Ratio					29.4	11.9	5.6
	ROA	2.0	2.0	2.1	-0.8	-1.7	0.1	3.4
	ROE	5.0	-5.7	9.3	-3.3	-7.3	0.3	14.3

Source: Joon Ho Hahm, "Ten Years after the Crisis: Financial System in Transition in Korea," in *Ten Years after the Korean Crisis*, eds. Meral Karasulu and Doo Yong Yang (Korea Institute for Economic Policy, 2008), 64–97.

capital adequacy standard were closed in 1998, nine banks were merged into four banks in 1999, and two of these were merged into one bank in 2000. Eight banks were nationalized, some were sold, and the equity of some still remains with the KDIC. Even among the healthy banks, the government encouraged mergers. In the case of non-bank financial institutions, the government closed 29 merchant banks, 15 securities companies, 15 asset management companies, and 22 insurance companies from 1998 to June 2007. The total injection of public funds from November 1997 through June 2008 was 168.5 trillion won (32 percent of GDP), of which 38.6 trillion won was the purchase of NPLs by KAMCO. The bulk of this injection was made from 1997 to 2000.

Significant Commitment of Public Funds

He in 2004 compared the fiscal costs of resolving the Korean banking crisis with nine other countries, including Japan and the United States.[9] Of the four OECD economies, Korea's fiscal response over the period from 1997 to

9 He Dong, "The role of KAMCO in Resolving NPLs in the Republic of Korea," IMF Working Paper, no. 04/12 (September 2004).

2000 was the largest as a share of GDP. Korea's fiscal response was 32 percent of GDP; in comparison, over the same period Japan's fiscal response was 7 percent of GDP, and the U.S. response to the 1984–1991 savings and loan crisis was 4 percent. As of 2004, the recovery rate of the public injection of funds (32 percent) compares favorably with Japan (16 percent) and is not far below the recovery rate in the United States (43 percent). Korea's recovery rate as of early 2010 is estimated to be about 51 percent; however, recovery rates of other countries considered by He are not available for comparison.

As a result of the aggressive resolution of the NPL problem, restructuring of the banking system, institutional redesign of regulatory and central banking institutions, and commitment of significant public funding, the Korean financial system emerged from the 1997 crisis more balanced and more reliant on commercial-based models. Moreover, foreign banks under foreign control have become a permanent and competitive part of the Korean financial system.[10] The return to a stable financial and monetary environment, as illustrated in Table 2.2, was accompanied by recovery of the real sector. Korea's GDP increased 12.8 percent in 1999 and 4.8 percent in 2000. By 2005, most observers concluded that Korea had made significant progress in financial and corporate reform, especially in comparison with the limited progress before 1997.

Korea and Japan

Korea's progress after 1997 stood in sharp contrast to Japan's slow response to the collapse of asset prices in 1990/1991 that generated a "lost decade and a half" of economic and financial development;[11] Korea's recovery from the September 2008 shock likewise contrasts strongly with Japan's. The comparison between these two countries is important because many regarded Korea as being in the shadow of Japan, partly because so many of Korea's economic institutions were strongly influenced by that nation. Korea was often referred to during the 1980s and 1990s as "Asia's next giant," with the current giant being Japan. That comparison is no longer relevant. Korea in many respects is on a different and more sustainable development path, partly because of its greater willingness to make significant institutional changes and adapt more international perspectives than Japan.

Cargill and Patrick in 2005 attributed the differential response to the

10 Thomas Byrne, "The Post-Crisis Transformation of Korea's Banking System," in *Korea's Economy 2005* (Seoul: Korea Economic Institute and the Korea Institute of International Economic Policy, vol. 21, 2005), 9–12.

11 Thomas F. Cargill and Takayuki Sakamoto, *Japan Since 1980* (New York: Cambridge University Press, 2008).

1997 crisis to five factors: (1) the Bank of Korea established price stability in contrast to the Bank of Japan, which permitted deflation after 1994; (2) Korea relies more on external borrowing and has lower international reserves than Japan, giving it more incentive than Japan to reform its financial institutions to prevent capital flight; (3) the national consensus to end the reliance on an IMF bailout as soon as possible provided the Korean government with not only the will to make significant structural changes but the political power to overcome entrenched interests in the old regime; (4) Korea benefited from more effective leadership while Japan's political distress in the 1990s matched its economic and financial problems; and (5) the macroeconomic decline in Korea was larger than in Japan and its geopolitical position relative to North Korea generated more intense pressure to reestablish stability.[12]

Additional factors now seem relevant. Japan lacked political leadership during the first few critical years of the crisis starting in late 1997 until early 2001 when Junichiro Koizumi became prime minister. Politicians in Japan were focused more on adapting to a new electoral system (introduced in 1994) than resolving the nation's economic and financial problems. In contrast, Korea possessed a more stable political leadership. Japan, except in 1997 and 1998, did not believe its economy to be in crisis, whereas Korea's attitudinal change was remarkable after 1997 and has been more permanent. Japan was not as willing as Korea to devote public funding to resolving NPLs and recapitalizing the banking system, nor was Japan as willing to set off a "garage sale" for NPLs, but more inclined to rely on forgiveness and forbearance. Japan already had a large amount of accumulated government debt, and conflicts between the Bank of Japan and Ministry of Finance over monetary policy reduced policy coordination; whereas Korea's regulatory and central banking institutions cooperated to a high degree while at the same time enhancing the formal independence of the Bank of Korea. Koizumi provided the leadership, but not until 2003 did signs of recovery begin in Japan; however, the recovery was weak, deflationary trends continued through 2005 and were dependent on exports to China. After the departure of Koizumi in September 2006, political distress returned to Japan; the new Japan Democratic Party appears willing to reduce the pace of structural reform and, in the case of Japan's large postal savings system, to reverse the direction of structural reform that had been the hallmark of Koizumi's reform program.

The different responses to the 1997 crisis are clearly apparent in how each country was impacted by the September 2008 crisis. Korea's "V" shaped

12 Thomas F. Cargill and Hugh Patrick, "Response to Financial and Economic Distress: South Korea and Japan," in *Korea's Economy 2005* (Seoul: Korea Economic Institute and the Korea Institute of International Economic Policy, vol. 21, 2005), 17–22.

recovery is impressive, while Japan continues to struggle with political and economic distress, and most recently the impact of the March 2011 tsunami.

Continuing Financial Concerns after the 1997 Crisis up to the September 2008 Shock

Korea's economy and financial system recovered rapidly after the 1997 crisis and meaningful institutional redesign of the financial system continued. Nevertheless, new problems emerged in the financial system, including rising household consumer and mortgage debt, increasing housing prices, and higher government debt.

The government encouraged domestic credit expansion, especially for consumer spending, to replace foreign borrowing as a demand driver after 1999 (see Table 2.3). It encouraged banks to expand credit to SMEs and consumers, and provided tax incentives to consumers making payments by credit cards.[13] Consumer credit card use and credit card debt expanded rapidly, contributing to the run-up in household debt from 40 percent of GDP at the beginning of 2000 to more than 70 percent by the end of 2002. Moreover, the household saving rate fell sharply. Household loans increased at an average annual rate of 28.4 percent from 2001:1 to 2002:4 (see Table 2.3). The credit expansion bubble burst in 2003 in response to a rising rate of personal bankruptcy, financial problems in many credit card companies, and the rise in the central bank's policy interest rate in May 2002 from 4 to 4.25 percent. GDP growth slowed to 3.6 percent in 2003 and the government bailed out a number of credit card companies, while allowing others to fail.

Although the financial distress resulting from the collapse of the credit card bubble was relatively minor compared to the 1997 crisis, it demonstrated the need for greater prudential regulation over household and business credit. It illustrated the risk of credit-led expansion and heightened concern over increasing mortgage debt and rising housing prices (shown in Figures 2.1 and 2.2). Nationwide house prices in real terms began to increase in 2000, though with considerable volatility, after falling during most of the 1990s. The increase after 2000, however, was moderate relative to the rapid increase in real housing prices in the late 1980s. Prices stabilized by 2005 and have declined only slightly in the two-year period 2008–2010.

Nevertheless, the government became increasingly concerned in light of Japan's experience with real estate prices in the second half of the 1980s

13 Diego Valderrama, "After the Asian Financial Crisis: Can Rapid Credit Expansion Sustain Growth?" FRBSF *Economic Letter* (Federal Reserve Bank of San Francisco, no. 2004–38, December 24, 2004), http://www.frbsf.org/publications/economics/letter/2004/el2004-38.pdf.

TABLE 2.3
Household Debt (2001–2009)

Date	Loans to Households (won billions)	Change from previous quarter (%)	Housing-related loans (won billions)	Change from previous quarter (%)
2000 1	199,399			
2000 2	215,189			
2000 3	227,073			
2000 4	241,069			
2001 1	249,491	25.12		
2001 2	265,020	23.16		
2001 3	283,213	24.72		
2001 4	303,519	25.91		
2002 1	328,829	31.80		
2002 2	354,400	33.73		
2002 3	379,940	34.15		
2002 4	391,119	28.86		
2003 1	396,754	20.66		
2003 2	402,566	13.59		
2003 3	409,558	7.80		
2003 4	420,938	7.62		
2004 1	425,689	7.29		
2004 2	433,759	7.75		
2004 3	441,197	7.73		
2004 4	449,398	6.76		
2005 1	453,111	6.44		
2005 2	468,678	8.05		
2005 3	480,650	8.94		
2005 4	493,469	9.81	208,422	
2006 1	500,846	10.53	212,139	
2006 2	516,662	10.24	222,091	
2006 3	529,453	10.15	228,607	
2006 4	550,431	11.54	240,951	15.61
2007 1	555,278	10.87	243,569	14.82
2007 2	564,723	9.30	242,979	9.41
2007 3	578,496	9.26	244,044	6.75
2007 4	595,397	8.17	245,764	2.00
2008 1	604,981	8.95	244,820	0.51
2008 2	622,895	10.30	248,748	2.37
2008 3	637,708	10.24	251,990	3.26
2008 4	648,327	8.89	254,736	3.65
2009 1	647,689	7.06	260,444	6.38
2009 2	661,514	6.20	266,485	7.13
2009 3	675,584	5.94	270,049	7.17

Source: Bank of Korea, Economic Statistics System (ECOS).

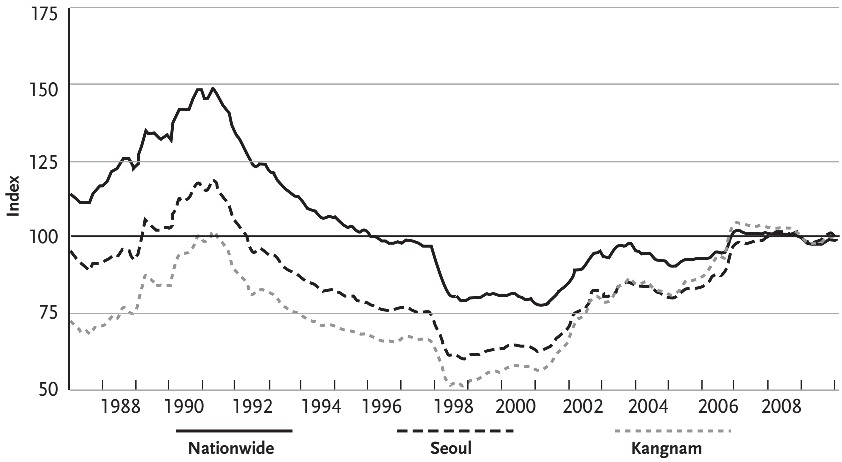

FIGURE 2.1 Korean Housing Prices Index (1988–2008)
Notes: 1. Data includes single-family homes and apartments. The index is deflated by the overall consumer price index 2. December 2008=100 3. Kangnam is an area of Seoul.

Source: Kookmin Bank, National Housing Price Survey, and *2009 Economic Survey of Korea*, OECD.

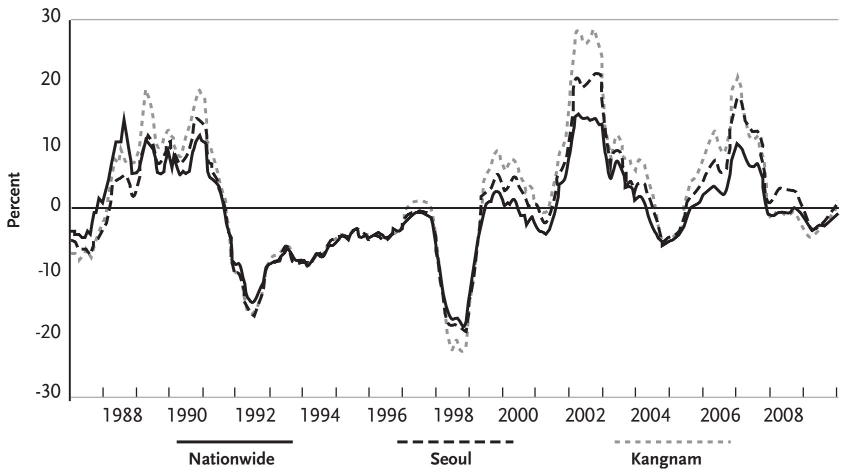

FIGURE 2.2 Percentage Change in Korean Housing Prices (1988–2008)
Notes: 1. Data includes single-family homes and apartments. 2. Percentage change is year-on-year, adjusted for inflation 3. Kangnam is an area of Seoul.

Source: Kookmin Bank, National Housing Price Survey, and *2009 Economic Survey of Korea*, OECD.

and the more recent concern about housing price developments in a wide number of countries, including the United States. The trends shown in Figures 2.1 and 2.2, when compared internationally, suggest that housing price developments in Korea were not as troubling as in other countries.[14] In addition, Korea's housing price increases cannot be attributed directly to monetary policy,[15] as was the case in Japan during the second half of the 1980s, or in the United States during the first half of the 2000s. Instead, they are more the outcome of fundamentals shaped by the government's housing policy. The Bank of Korea "leaned against" the credit expansion starting in late 2005 when it increased the base rate from 3.25 to 3.5 percent in October 2005 and continued to increase the base rate until it reached 5.25 percent in August 2008. In addition, regulatory authorities adopted a large number of policies, aimed at both the demand and supply sides of the housing market, to limit price increases.[16]

Along with the growth of household debt, there was concern over the significant increase in government debt. Before the 1990s, there was little government debt, but by the end of 2005 it had reached 31 percent of GDP. Much of the increase resulted from the infusion of public funds into the banking system in 1998 and 1999. Although the ratio was low compared to the OECD average of 77 percent, the increase prompted a major change in the role of government debt in the financial system. Much of the debt accumulation was the result of recapitalizing the banking system, assisting in closures and mergers, and purchasing NPLs. A total of 168.5 trillion won of public funds were injected into the financial system from November 1997 through June 2008: 63.5 trillion won for recapitalization, 38.6 trillion won for purchases of NPLs, and 30.3 trillion won for deposit insurance claims.[17] These funds were distributed mainly through the KDIC and KAMCO.

Although the major *chaebŏl* adopted more commercial-based corporate governance structures and have improved in productivity and profitability, there is continued concern over the financial condition and sustainability of SMEs. They have not been as aggressive as the *chaebŏl* in reforming their business model, and government subsidization of the SME is deep and increasing. In addition, the labor union relationship with the SMEs makes struc-

14 OECD, "Reforming housing and regional policies in Korea," in *Economic Survey of Korea, 2007* (Paris: OECD, 2007), 61–89.

15 Song Joonhyuk, "House Prices and Monetary Policy: A Dynamic Factor Model for Korea," *Journal of the Korean Economy* 9 (December 2008): 467–496.

16 OECD, *Economic Survey of Korea*, 2007.

17 Bank of Korea, "Recent Changes in the Financial System," accessed November 1, 2011, http://www.bok.or.kr/broadcast.action?menuNaviId=647.

tural reform difficult. This is an issue not only for the SMEs but also for the banking system, as banks have a large exposure to SME loans. The share of banks' loans to large companies has steadily declined since the early 1990s as corporations took advantage of expanding money and capital markets and reduced their reliance on bank credit. More recently, large companies relied on internal sources of funds. At the same time, the share of banks' loans to SMEs has steadily increased.

The September 2008 shock, recovery and stabilization

Korea's economy was already slowing prior to the September 2008 shock as a result of the recession that had begun in the United States in December 2007, increasing oil prices, and tighter monetary policy as the Bank of Korea "leaned against" housing price increases. There was little evidence of financial stress, however, and little advance warning the U.S. financial system would unravel so quickly following the September 2008 shock. The September shock dramatically impacted Korea's financial system with spillover effects on the macro economy that continue to the present. The immediate effect on Korea's financial system included: (1) an increased spread between corporate and Treasury bond yields as investors shifted to safer assets; (2) capital flight and rapid depreciation of the won; (3) the reduced ability of Korean banks to borrow in the London Interbank Offered Rate (LIBOR) market; (4) reduced availability and increased cost of bank credit; and (5) increased bankruptcy risk for households and SMEs. A mild depreciation of the won in the first half of 2008 accelerated, and between September 2008 and March 2009 the won depreciated rapidly. Bond and stock prices also fell significantly and bank risk increased dramatically, as measured by the LIBOR-OI spread and the TED spread.

Despite fears of a repeat of the 1997 crisis, the Korean financial system stabilized by March 2009 and by the end of the year had overcome the September 2008 shock without the type of damage resulting from the 1997 crisis. Nonetheless, the condition of the financial system at the start of 2010 remained weaker than before September 2008, and there is a risk of moral hazard problems because of the large government injection of funds and guarantees to stabilize financial markets and institutions. In spite of this, 2009 is a success story for the Korean financial system, demonstrating the effectiveness of the extensive set of financial reforms enacted in response to the 1997 crisis. Considering Korea's financial system in the 1960s and how it responded to the September 2008 shock, the evolution is an odyssey from an unsustainable to sustainable financial and monetary environment.

TABLE 2.4
Loans, Loan Quality and BIS Capital Adequacy Ratio for Nationwide Banks

Date	Total Loans (won trillions)	Change (%)	Substandard or Below to Total Loans (%)	Loan Loss Reserves to Substandard Loans or Below (%)	BIS Capital Adequacy Ratio (%)	After-Tax Profit (won trillions)
2002	432.2		2.40	83.50	10.46	2.90
2003	463.9	7.33	2.80	82.10	10.34	0.20
2004	473.0	1.96	2.00	96.60	11.31	5.90
2005	503.0	6.34	1.30	115.40	12.51	8.60
2006	591.3	17.55	0.90	160.40	12.41	8.10
2007	670.9	13.46	0.70	191.80	12.00	9.40
2008	784.7	16.96	1.20	151.60	12.75	5.20
Jun-09	778.5	-0.79	1.60	125.40	14.29	1.50

Source: Ministry of Strategy and Finance, December 2009.

The Bank of Korea's November 2009 *Financial Stability Report* concluded:

> The Korean financial system, which had suffered severe instability following the global financial crisis in the latter half of 2008, regained stability at a rapid pace from the beginning of 2009. Stability returned to the financial markets and there was an overall improvement in foreign exchange soundness against the background of the reduction of systemic risk in the international financial markets. There was also an improvement in the soundness of financial institutions' management.[18]

The official conclusion is supported by a wide range of indicators, notably the condition of financial institutions in general and banks in particular. The greatest concern was the condition of the banking system, which by 2008 had reemerged as the primary source of indirect finance. Despite significant growth in bond and commercial paper markets, Korea's financial system remains "bank-centered" and the banking system has become more concentrated over the past decade.[19] Non-bank financial institution share in indirect financing peaked at a little over 50 percent prior to the 1997 crisis. As a result of closings, mergers, and acquisitions, non-bank financial insti-

18 Bank of Korea, *Financial Stability Report: November 2009*.

19 Joon Ho Hahm, "Ten Years after the Crisis: Financial System in Transition in Korea" in *Ten Years after the Korean Crisis*, eds. Meral Karasulu and Doo Yong Yang, (Korea Institute for Economic Policy, 2008), 64–97.

TABLE 2.5
Loans, Loan Quality and BIS Capital Adequacy Ratio for Specialized Banks

	Total Loans (won trillions)	Change (%)	Substandard or Below to Total Loans (%)	Loan Loss Reserves to Substandard Loans or Below (%)	BIS Capital Adequacy Ratio (%)
Sep-08	417.2		0.83	184.77	11.24
Dec-08	432.9	3.76	1.11	147.78	11.59
Mar-09	453.0	4.64	1.34	135.46	12.16
Jun-09	451.6	-0.31	1.41	131.61	12.91
Sep-09	447.2	-0.97	1.41	131.87	13.51

Source: Bank of Korea, ECOS—Economic Statistics System.

TABLE 2.6
Total Loans, Loan Quality and Net Profit of Non-Bank Financial Institutions

	Loans (won trillions)	Change (%)	Substandard Loans or Below to Total Loans	Net Profit (won billions)
2002	189		5.2	3,280
2003	177	-6.50	6.2	9,905
2004	180	1.86	5.3	198
2005	202	12.20	5.2	3,056
2006	230	13.64	4.1	5,096
2007	266	15.57	3.4	5,380
2008	278	4.63	3.6	3,765
Jun-09	297	6.94	4.0	2,310

Source: Ministry of Strategy and Finance, Korea.

tutions' share in indirect finance declined to a little over 30 percent by 2005. The share of bank finance increased to its pre-crisis level.

Total loan growth of nationwide banks, which account for about 90 percent of total bank deposits and loans, declined sharply between the end of 2008 and June 2009 (Table 2.4). The ratio of substandard or below loans to total loans had increased as of June 2009, although it is still lower than 2002–2004. The ratio of loss reserves to substandard or below has declined since 2007 but remains 25 percent above substandard loans as of June 2009,

TABLE 2.7
Net Income, Delinquency Ratio and BIS Capital Adequacy Ratio

	Jun-08	Jun-09
Savings Banks		
Net Income (Won Billions)	3,782	725
Delinquency Ratio	14.00	15.80
BIS Ratio	9.16	9.80
Nonbank Credit Card Companies		
Net Income (Won Billions)	11,133	9,806
Delinquency Ratio	3.43	3.10
BIS Ratio	25.40	28.20

Source: Ministry of Strategy and Finance, Korea.

thanks to the upward trend in reserves from 2002 to 2007. The Bank for International Settlements (BIS) capital adequacy ratio has generally increased in recent years and, as of June 2009, was higher than at any time since 2002. This reflected the government's infusion of public funds to ensure public confidence in the banking system, government pressure for banks to strengthen their capital base, and the slower growth of loans. After-tax profits declined in 2008–2009, but remain positive.

The two largest specialized banks, Korea Development Bank and Industrial Bank of Korea,[20] have performed much the same as nationwide banks in 2009 with respect to loans and loan quality, as seen in Table 2.5. Capital adequacy has increased and profits have remained positive. The performance of non-bank financial institutions is much the same with the exception of the savings bank sector (see Tables 2.6 and 2.7). The savings bank sector and nonbank credit card companies have been the weak sectors of nonbank financial institutions. After the collapse of credit companies in 2003 and the subsequent reforms, credit card companies improved and were in a better position to absorb the September 2008 shock. However, savings banks remain a problem. Net income for savings banks declined by 81 percent and the already-high delinquency rate increased further after September 2008.

20 Korea has four specialized banks: Korea Development Bank, Industrial Bank of Korea, National Agricultural Cooperative Federation, and the National Federation of Fisheries Cooperatives. The Korea Development Bank and Industrial Bank of Korea are by far the largest of the specialized banks. These are policy banks supported by the government to target certain sectors of the economy to achieve specific policy objectives. These banks are regulated separately from commercial banks because of the policy loan objectives, although they are subject to the general application of the Banking Act.

Savings bank delinquency rates are higher than at banks because many of their customers (households and SMEs) are unable to secure credit from the banking sector.

In sum, the September 2008 shock reduced loan growth at all types of Korean financial institutions and in general lowered loan quality. However, bank capital adequacy increased, reserves exceeded substandard or below loans at banks, and institutions were profitable by end of 2009. While these institutions will need to deal with reduced loan quality, they appear financially sound and, in the absence of another shock, should continue to improve their performance in 2010. The weak financial condition of the savings banks is the exception.

Accounting for Korea's Success

There are three factors accounting for the Korean financial system's success in absorbing the September 2008 shock. First, the policies and institutional redesign of Korea's regulatory and central banking institutions in response to the 1997 crisis rendered the financial system more efficient, transparent, flexible, and stable. Second, large corporations and financial institutions were sound at the time of the September 2008 crisis in terms of NPLs, loan loss reserves, and profitability. Third, the government response was rapid, substantial, and in most cases, transparent. Each will be discussed in turn.

The elements of the first factor have been covered above and they provided the foundation for the second factor in Korea's success. Corporations, banks, and non-bank financial institutions were sound and well positioned to absorb the shock in late 2008. The numerous reforms of the financial system, corporate governance, and institutional redesign of government regulatory and central banking institutions established a more sound, transparent and flexible financial structure. At the time of the September 2008 shock, profitability, return on assets, ratio of substandard or below loans, delinquency rates for SME and household loans, and BIS capital adequacy all indicated a sound financial system. Although the government was concerned about housing price increases, there was little probability of a rapid decline in prices, and any decline would not have the effect on the financial or real sectors as occurred in some OECD countries because of government-imposed prudential regulations on mortgage lenders since 2002, in the form of loan-to-value (LTV) ratios of 40 to 60 percent and debt-to-income ratios of about 40 percent. Some news accounts suggested Korean banks had funded domestic lending with foreign borrowing[21] as in 1997; however, this was not correct, according to government officials.[22] The loan-to-deposit ratios at year-end 2007 and year-end 2008 were 104.4 and 101.6 percent, respectively, if deposits include CDs. Excluding CDs, the respective ratios were 123.9 and 118.8 percent. In addition, Korean officials pointed out that foreign currency liabilities are balanced with foreign currency assets. However, these statements were misleading and masked a serious problem discussed below.

The risk of prolonged won depreciation in 2008 appeared smaller than a decade earlier, given the improved foundation of the Korean banking system and larger holdings of international reserves.[23] At the end of June 2008, Korea's external debt was $420 billion, of which almost one-third was not subject to repayment burdens (pre-foreign direct investment funding, foreign exchange forward hedging of pre-contracted future cash flows, and advanced receipts for shipbuilding contracts). In 1997, international reserves were small relative to the size of external debt and much of the international reserve holdings were of low quality and difficult for outsiders to evaluate. The situation in September 2009 was different. The size of reserves—at about $250 billion—was large relative to external debt, most reserves were held in bonds rated AA or above, and the government was transparent about its holdings of international reserves. At the same time, Korea's financial system remained sensitive to foreign borrowing. Finally, fiscal and monetary policy instruments were in a strong position to respond to the adverse impacts of the shock. While the position of fiscal policy was similar to that in 1998, monetary policy during the decade had matured and become a more flexible instrument of policy. The institutional redesign of the Bank of Korea toward greater formal independence and transparency rendered it better able to response to the crisis than in 1998.

The Korean government response was rapid, aggressive and, in contrast to the 1997 crisis, transparent.[24] Stabilization of the financial system and the

21 Martin Fackler, "Financial Crisis Spreads to Emerging Nations," *New York Times*, October 24, 2008, http://www.nytimes.com/2008/10/24/business/worldbusiness/24won.html.

22 Financial Services Commission and Financial Supervisory Service, "Domestic Banks' Loan to Deposit Ratio," October 13, 2008.

23 Financial Supervisory Service, "Text of Governor Kim Chang's Conference Call with Institutional Investors," October 14, 2008; and Financial Services Commission, "Korea's Financial Market and Economy: Resilience Amid Turbulence," December 2008.

24 Reports, news releases and conferences with market participants by high ranking regulatory officials of the Financial Supervisory Service, the Financial Supervisory Commission, and the Bank of Korea provided detailed information to the public and especially the foreign sector to assess the condition of the financial system and economy.

real sector was achieved by a combination of fiscal policy, monetary policy (including unorthodox measures) and financial-regulation policy.

The Bank of Korea sharply eased monetary policy by cutting the policy interest rate six times from 5.25 percent in September 2008 to the current 2010 level of 2 percent. In addition, it increased open market operations, broadened the range of assets eligible for open market operations, raised the ceilings on their credit ceiling program, paid interest to banks on their required reserve balances and contributed to the Bond Market Stabilization Fund and the Bank Recapitalization Fund. To support the won, the Bank of Korea entered into dollar swaps with the U.S. Federal Reserve and yuan swaps with the People's Bank of China in November 2009, and expanded the yen swap arrangement with the Bank of Japan. The Bank provided a $100 billion guarantee on foreign bank liabilities in October 2008, when they were estimated to be about $80 billion. In May 2009 this guarantee was extended to cover newly acquired foreign liabilities through the end of the year.

Financial and regulatory policy was designed to remove NPLs from the balance sheets of financial and non-financial institutions, and achieve recapitalization of banks and stabilization of capital markets. The most noteworthy elements of this policy are programs to assist SMEs. The Korean government instructed banks to automatically roll over existing loans to SMEs. In October 2008, the government increased the loan guarantee percentage for SMEs from 85 to 95 percent, provided 100 percent guarantees for targeted sectors (exports, green growth, start-ups and high technology), and introduced a Fast Track system for SME access to bank credit. As of July 2009, nearly 18 trillion won (2 percent of GDP) had been provided to almost 10,000 SMEs under the Fast Track system.[25] Finally, the government established a "win-win guarantee program" in January 2009. The program involves contributions by large corporations or local governments to the Korea Credit Guarantee Fund and other funds that guarantee loans to SMEs. The government's policies toward SMEs were intended to prevent large-scale bankruptcy by encouraging continued bank lending.

The government established a 40 trillion won (4 percent of GDP) Corporate Restructuring Fund to address the NPL problem. KAMCO will play a leading role in purchasing nonperforming assets from financial institutions and companies through this fund.[26] As of October 2009, KAMCO and the

25 Financial Services Commission and Financial Supervisory Service, "SME Loans & Credit Guarantees in the First Half of 2009," July 17, 2009.

26 Financial Services Commission, "Bank Recapitalization Fund: Timetable and Operational Plan," February 25, 2009; and "Notice of Amendments to the Korea Asset Management Corporation (KAMCO) Act's Enforcement Decree," May 4, 2009.

fund had spent 4.1 trillion won, of which half was to purchase NPLs (1.2 trillion won by KAMCO and 0.8 trillion won by the fund) with the remainder for purchases of physical assets and to support corporate restructuring. In December 2009, the government established a 20 trillion won (2 percent of GDP) Bank Recapitalization Fund to purchase subordinated bonds, preferred stock, etc. Banks, holding companies, the Industrial Bank of Korea, National Agricultural Co-operative Federation and the National Federation of Fisheries Co-operatives can apply for funds. One of the goals of the fund is to support SMEs by extending new credit lines, rolling over existing loans, and expanding credit guarantee schemes. The Korean government created the Stock Market Stabilization Fund and the Long-term Corporate Bond Fund as temporary measures to support the capital markets. The two funds are relatively small and were a waste of resources given the size of the markets.

Assessment and Areas of Concern

Despite Korea's success story in responding to the 2008 financial crisis, a number of longer-run issues continue to present challenges to the Korean government. These include: housing and mortgage debt; non-mortgage consumer debt; SME credit risk; susceptibility to capital flight; and the need to develop an exit strategy to minimize moral hazard.

After falling in late 2008, housing prices resumed their upward trend in nominal terms by mid-2009; however, in real terms housing prices have stabilized. Mortgage debt continues to increase, supported by the expectation of higher housing prices and the liquidity injected into the financial system by the government response to the September 2008 shock. The pace of house price increases is moderate compared to the rates seen during housing bubbles in other OECD countries. The housing situation is not as unstable or unsustainable as in Japan in the late 1980s or in the United States in the 2000s, but for different reasons.[27] The Bank of Korea "leaned against" upward pressure on housing prices and the government reacted in 2005–2006 to limit the demand for housing and to stimulate the supply.

The most important step toward reducing the potential of a housing bubble was the introduction of regulations on LTV and debt-to-income (DTI)

27 In Japan, the housing (and equity) bubble was supported by the close relationship between bank capital, bank lending, equity prices and land prices combined with easy monetary policy and weak regulatory oversight. In the United States, the housing bubble was supported by the social contract to support housing through government sponsored agencies (Freddie Mac and Fannie Mae) combined with easy monetary policy and weak regulatory oversight.

TABLE 2.8

LTV ratio on Bank Lending (February 2010)

<table>
<tr><th>Type of district</th><th>Type of collateral</th><th colspan="2">Loan maturity and amount (Korean won)</th><th>LTV ceiling (%)</th></tr>
<tr><td rowspan="5">Speculative area</td><td rowspan="3">Apartment</td><td colspan="2">10 years or less</td><td>40</td></tr>
<tr><td rowspan="2">More than 10 years</td><td>> 600 million</td><td>40</td></tr>
<tr><td>≤ 600 million</td><td>60</td></tr>
<tr><td rowspan="2">Non-apartment home</td><td colspan="2">3 years or less</td><td>50</td></tr>
<tr><td colspan="2">More than 3 years</td><td>60</td></tr>
<tr><td rowspan="4">Non-speculative area</td><td rowspan="2">Apartment</td><td colspan="2">3 years or less</td><td>60</td></tr>
<tr><td colspan="2">More than 3 years</td><td>60</td></tr>
<tr><td rowspan="2">Non-apartment home</td><td colspan="2">3 years or less</td><td>60</td></tr>
<tr><td colspan="2">More than 3 years</td><td>60</td></tr>
<tr><td rowspan="5">Seoul Metropolitan area (excluding speculative area)</td><td rowspan="3">Apartment</td><td colspan="2">10 years or less</td><td>50</td></tr>
<tr><td rowspan="2">More than 10 years</td><td>> 600 million</td><td>50</td></tr>
<tr><td>≤ 600 million</td><td>60</td></tr>
<tr><td rowspan="2">Non-apartment home</td><td colspan="2">3 years or less</td><td>50</td></tr>
<tr><td colspan="2">More than 3 years</td><td>60</td></tr>
</table>

Source: Ministry of Strategy and Finance, Korea.

TABLE 2.9

Korean Government SEM Support Programs

Year	Won Billions
1997	3,073
1998	5,163
1999	6,248
2000	5,005
2001	5,031
2002	5,567
2003	6,245
2004	6,322
2005	6,172
2006	6,104
2007	5,698
2008	5,680
2009	10,120

Source: Ministry of Strategy and Finance, Korea.

TABLE 2.10
SME Bank Loans and Percent Guaranteed by Public Institutions

	SME Bank Loans (won trillions)	Guaranteed (%)
December-03	238.0	
June-04	247.9	
December-04	244.1	
June-05	250.0	
December-05	256.5	14.1
June-06	279.1	13.0
December-06	301.8	11.1
June-07	339.8	10.4
December-07	370.0	9.4
June-08	405.2	9.0
December-08	422.4	9.1
March-09	432.2	10.6
June-09	438.6	11.8

Source: Ministry of Strategy and Finance, Korea.

ratios. In 2002, the government imposed LTV ratios for bank mortgage lending in both speculative and non-speculative zones. Speculative zones were areas where housing price increases were the most rapid and appeared to be driven more by expected price increases than fundamentals. There were 92 speculative zones covering 37 percent of Korea's regional districts in 2002; by 2010, this had shrunk to only three speculative zones within Seoul representing 1.2 percent of regional districts. The LTV ratios for banks and insurance companies (shown in Table 2.8) are identical, ranging from 40 percent in speculation zones to 60 percent in other areas. However, savings banks and other financial institutions operate with lower restrictions. The LTV ratios are enforced by a combination of regulatory oversight and self-regulation for some sectors. The LTV and DTI ratios were the most stringent in the OECD area, thus explaining why housing prices in Korea have been relatively stable compared to other OECD countries. Self regulation may have contributed to a stable housing market; however, self regulation is a weak reed for prudential policy in the future.

Thus, while housing and mortgage credit will be a continuing concern to the Korean government, this is not a major long-run issue that threatens the stability of the financial system as it did in Japan or the United States.

Nonetheless, this does not reduce the growing concern over the general indebtedness of the average Korean household. Household debt is about 150 percent of disposal income and growing relative to income.

SME credit risk is a more serious problem than housing and mortgage debt. Korean SMEs have long been supported by the Korean government and recent policy actions have extended that support. They are a major part of Korean's industrial structuring, accounting for up to 50 percent of manufacturing output and 32 percent of exports.[28] Table 2.9 indicates the amount of government spending on SME support programs from 1997 to 2009. Table 2.10 indicates the total bank loans to SMEs and the percent guaranteed by public institutions from December 2003 through June 2009.

Despite extensive government support even before the September 2008 shock, SMEs in Korea did not perform as well as large corporations, as is the case for SMEs in many countries. Their limited access to finance and lack of economies of scale make it more difficult to compete; however, the situation is somewhat unique in Korea. SMEs have long received government support and despite post-1997 crisis reforms, support has not declined significantly—in fact, it increased in 2009. The large corporations which were part of the *chaebŏl* structure were the focal point of corporate reform after 1997 because the *chaebŏl* were at the center of a credit allocation system that had weakened Korea's financial system and generated an inefficient allocation of credit. In order to prevent widespread bankruptcy among SMEs and potential labor union problems at that time, the government essentially bailed out these institutions rather than requiring the aggressive restructuring applied to the large corporations.[29] This differential approach, combined with generous support from the government for the SME sector, generated a moral hazard problem that continues to the present. One of the reasons for the relatively poor performance of SMEs is their dependence on government guarantees that have been extended in response to the September 2008 shock.

Korea continues to be susceptible to currency flight, and Deputy Governor Kyungsoo Kim of the Bank of Korea recently summed up Korea's problem in this regard.[30] After the 1997 crisis, Korea's foreign debt problem

28 Stijn Claessens and Dongsoo Kang, "Corporate Sector Restructuring in Korea: Status and Challenges," in *Ten Years after the Korean Crisis*, ed. Meral Karasulu and Doo Yong Yang (Korea Institute for Economic Policy, 2008), 103–148.

29 Ibid., 125.

30 Kyungsoo Kim, "Global Financial Crisis and Korean Economy" (paper, presented at the Federal Reserve Bank of San Francisco Asia Economic Policy Conference, October 2009), http://www.frbsf.org/economics/conferences/aepc/2009/09_Kim.pdf.

TABLE 2.11

External Debt and Assets (period end, USD billions)

	2005	2006	2007	2008:2	2008	2009:1
External Debt	187.9	260.1	382.2	419.8	381.3	369.3
(Short Term)	65.9	113.7	160.3	176.2	151.1	148.1
Banks	83.4	136.5	194.0	210.5	171.7	161.9
(Short Term)	51.3	96.1	134.0	146.7	113.0	103.8
External Assets	308.6	366.7	417.7	422.5	348.2	345.6
(Short Term)	212.4	242.8	266.3	261.8	279.6	278.8
Banks	53.0	63.2	76.4	84.5	83.0	77.3
(Short Term)	39.0	39.9	45.5	51.9	52.4	47.2
External Debt to External Assets	0.61	0.71	0.92	0.99	1.10	1.07
External Debt to External Assets (Short Term)	1.32	2.41	2.95	2.83	2.16	2.20
External Debt to External Assets Held by Banks	1.57	2.16	2.54	2.49	2.07	2.09

Source: Kyungsoo Kim, "Global Financial Crisis and Korean Economy" (paper, presented at the Federal Reserve Bank of San Francisco Asia Economic Policy Conference, October 2009), http://www.frbsf.org/economics/conferences/aepc/2009/09_Kim.pdf. Ratios computed from original data.

was not one of balance between external debt and external assets (shown in Table 2.11), but one of asymmetry in that the majority of assets were held by the monetary authority and the majority of debt held by the banking system. This situation has remained much the same since 2005 and was the reason some viewed the Korean banking system at the edge of the abyss because the risk of foreign debt was concentrated there. As I suggested earlier, this is one case in which the Korean government's news releases were less than transparent. As Korea's economy expands, banks become increasingly dependent on foreign borrowing but lack the foreign assets to offset the debt. As a result there is a tendency for bubble and burst cycles. The foreign debt supports domestic spending, which manifests itself in outlets like increasing housing prices, and when the inevitable decline comes because of some external or internal shock, the reversed capital inflow causes financial distress. External liberalization in Korea has increased its economy's sensitivity to sudden capital outflows.

Deputy Governor Kim indicated three possible solutions: increase holdings of international reserve assets by the monetary authority; use capital controls; or internalize the risk of foreign borrowing to the banking system to provide incentives to monitor this source of funds more carefully. The first two would be ineffective, while the third option has potential: much like risk-based deposit insurance premiums or capital asset requirements, imposing a risk premium on bank foreign debt would provide incentives for banks to manage foreign borrowing more prudently.

The large injection of public funds, guarantees, government purchases of bank-subordinated debt and, especially, expanded support of the SMEs, present Korea with a difficult policy problem. History has shown there is a tendency for governments in the face of financial distress to first deny the problem; after denial is no longer possible, to understate the problem with creative accounting, etc.; and, after understatement is no longer credible, to engage in policies of forgiveness and forbearance. This scenario has been repeated many times in the past three decades; even the United States, with one of the world's most transparent and open financial systems, presented a classic example of this sequence during the savings and loan crisis. The scenario describes a common response to financial crisis in many countries, including Korea's own response up to the 1997 crisis. The September 2008 crisis demonstrated a major change in Korean policy: Korea clearly recognized the crisis, in most cases did not understate the crisis, and took aggressive and transparent action to support the financial system. It would be a mistake to characterize the extensive government support of banks, non-bank financial institutions, and SMEs as forgiveness and forbearance as practiced in the past; however, there is a moral hazard problem. The greater the government role in supporting the financial system, the less likely institutions will adopt market principles. Bankruptcy plays an important role in the allocation of real and financial resources and the more extensive the government effort to prevent or limit bankruptcy, the longer the period of distress. This is a difficult position for Korean authorities (and Asian governments in general) where the financial system is seen more as a social matrix of participants as much as it is an economic matrix.[31]

Conclusion

The transition of the Korean financial system from the early years of postwar development to a mature system that capably responded to the September 2008 shock and returned to stability after only a few months is a remarkable odyssey. The response of Korea's financial system to the U.S. September 2008 crisis demonstrated the success of the policies and institutional redesign of

31 Chang Lee, "The State and Institutions in East Asian Economic Development," *Journal of the Korean Economy* 3, no. 1 (2002): 1–17.

Korea's financial and monetary institutions following the 1997 crisis. The institutionally-stronger financial system was a conducive environment for the aggressive and generally transparent government reaction in terms of regulatory, fiscal, and monetary policy. Korea's financial system in the year following the crisis has in general been a success story.

Korea has turned from crisis management to dealing with more longer run issues. On December 16, 2009, the Financial Services Commission announced an agenda for financial policy in 2010 consisting of five objectives: funding economic revitalization; establishing a robust financial system; improving competitiveness of the financial sector; increasing support for low-income households and making financial markets more accessible to mid- to low income households; and increasing Korea's recognition in the global financial market.[32]

The Korean government is clearly continuing the liberalization of financial markets. This is a positive sign. Korea has not been part of the backlash against liberalized financial markets in the United States or Japan. It is notable the Korean government recognizes the need to reduce and internalize to banks the risk of reliance on foreign sources of funds; to improve transparency in reporting by financial institutions; to enhance prudential regulation over lending such as LTV and DTI ratios; and to encourage continued corporate governance reforms in both the real and financial sectors.

At the same time, Korea, like many Asian economies, views the financial system more than just a market for funds but, just as importantly, as a social matrix of support for businesses and households as part of the social contract between the people and the government—hence, the willingness of the Korean government to subsidize lending and provide loan guarantees as aggressively as pursued in late 2008 and early 2009. The greater government support, however, the more pervasive moral hazard and less incentive to rationally allocate resources. The Korean government recognizes the need for an exit strategy and appears to be making tentative steps in that direction.

Overall, the odyssey of the Korean financial system is impressive, but at the same time, the continuing support of the rather extensive SME sector and large expansion of liquidity in response to the September 2008 shock expose Korea to serious moral hazard problems. Continued reliance on export-led economic growth exposes Korea to shocks and limits the nation's flexibility to respond to shocks. Reducing the support system and changing development strategy have been a challenge and to date, Korea has made little progress on these issues.

32 Financial Services Commission, "2010 Financial Policy Agenda," December 16, 2009.

South Korea's Official Development Assistance Policy Under Lee Myung-bak: Humanitarian or National Interest?[1]

Eun Mee Kim and Ji Hyun Kim

South Korea was admitted as the twenty-fourth member to the Development Assistance Committee (DAC) of the Organization for Economic Co-operation and Development (OECD) in 2010, a milestone that symbolized South Korea's entry into the ranks of advanced industrialized countries as an important donor of development assistance. Further evidence of South Korea's rising global status is its role as host of two important global meetings, the G-20 meeting in November 2010 and the fourth and final High Level Forum on Aid Effectiveness (HLF-4) in fall 2011.

For a nation that emerged from the ashes of the Korean War in the 1950s and was a major recipient of worldwide aid totaling $12.7 billion between 1945 and 1995, this indeed was a sea change. Once one of the poorest nations in the world with a gross national product (GNP) per capita of less than $100, in 2010 South Korea boasted the thirteenth largest economy in the world, with the fastest projected recovery from the global financial crisis that began in the United States in 2008. However, when President Lee Myung-bak announced in his 2008 Independence Day speech the plan to honor the Roh Moo-hyun administration's commitment to increase South Korea's official development assistance (ODA)[2] as a share of gross national income (GNI) to the OECD/DAC average of 0.25 percent and increase the volume of ODA threefold by 2015, it didn't seem to resonate with his adminis-

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2 ODA is defined as grants or loans provided to developing countries and multilateral agencies undertaken by the official sector with the purpose of promoting economic development and welfare of the recipients. ODA consists of (1) grants; (2) concessional loans with at least a grant element of 25 percent; and (3) technical cooperation (OECD/DAC Glossary of terms and concepts).

tration's other policies. Some members of Lee's presidential transition team had openly criticized the preceding decade under presidents Kim Dae-jung and Roh Moo-hyun as the "lost decade." The Lee administration was even criticized by political analysts for the number of policies and programs it overturned that had been set in place by the Roh administration. Thus, it seems out of place that the Lee administration would promote the rapid increase of ODA, itself a hallmark of the more liberal Roh regime.

In this paper we attempt to compare the Lee administration's ODA policies and activities with those of the Roh administration, using aid determinants studies. The realist view on foreign aid argues that donor governments use aid to enhance their national interests (Black 1968; Eberstadt 1988). The humanitarian perspective on ODA, on the contrary, refers to aid more focused on humanitarian assistance for poverty reduction and development of the recipient nations (Kegley 1993; Lumsdaine 1993; Cigranelli 1993).

This paper asks two questions: what is the nature of the publicly-proclaimed ODA policies of the Roh and Lee administrations—i.e., are they for national interest or humanitarian goals—and does ODA data actually realize proclaimed ODA policies and reflect the Lee government's recent humanitarian-leaning ODA policies?

We will begin by reviewing different studies on the determinants of ODA and suggest how we may proceed with an empirical analysis of South Korea's ODA; next we provide a brief overview of South Korea as a recipient of ODA, to shed light on how South Korea's ODA may provide a different modus operandi to the global ODA community. Following that will be a comparative analysis of the ODA policies of the more liberal Roh Moo-hyun administration (2003–2008) and the more conservative Lee Myung-bak administration (2008–present). We will present findings from a comparison of ODA activities from 2000 to 2010 in order to examine whether the policies are borne out with ODA data. In our conclusion we provide a summary of the findings and suggest directions for further research.

Different Perspectives on the Determinants of ODA

There is a growing body of studies on poverty pointing to its myriad causes and its resolution (Birdsall 2001; Narayan 1999; Sachs 2005; Sen 1999). Reflecting a more comprehensive understanding of poverty and its resolution, 189 world leaders signed the Millennium Declaration at the United Nations (UN) in 2000, agreeing to meet the Millennium Development Goals (MDG) and uniting in the fight to halve the population living under extreme poverty by 2015. The OECD as well has played a critical role in working with the largest donor countries to formulate guidelines for ODA.

While international organizations such as the UN, the World Bank, and the OECD have participated in the fight against poverty and have urged ODA donors to respond from a humanitarian and global perspective, donors have often provided aid for their own national interests, whether it is to help support their previous colonies and private business interests, enhance their geopolitical influence, or secure energy and other natural resources. Thus, many studies have attempted to analyze the determinants of donors by examining their aid activities.

Studies on foreign aid started in the 1950s after WWII, primarily focusing on the U.S. and Western European cases. These studies can be grouped into two categories: those that focus on the effects of aid on recipient countries, and those that examine the determinants of aid in donor countries. It is beyond the scope of this chapter to provide a full review of the myriad studies on aid allocation; we will instead examine a few key studies that analyzed aid determinants using aid allocation data of donor countries and were influenced by international relations theories.

We can divide the studies into two groups according to the researchers' à priori assumptions about aid: those belonging to the realist perspective, and another group in the idealist perspective. The former gained support during the Cold War when researchers assumed that aid policies were driven by strategic interests of nation-states (Black 1968; Eberstadt 1988). The realist perspective argued that nation-states exist in a Hobbesian state in which the primary objective of international relations is survival. Thus, realists prioritize security and assume that foreign aid serves the strategic interests of the donor. Classical realists associate national security with relative advantages in military power and opportunistic alliances (high politics) while they minimize or dismiss the economic or humanitarian motives behind aid (low politics). However, neorealist scholars have underscored the importance of the economic dimension of national security (Gilpin 1987).

The idealist perspective on aid and the neoidealist spin-offs interpret international relations in a more cooperative way. They criticize the realist perspective's assumption that interstate behavior is characterized primarily by competition and pursuit of security (Kegley 1993; Lumsdaine 1993; Cigranelli 1993). The idealists argue that foreign aid is provided largely by humanitarian concerns, and its purpose is to promote economic development and reduce poverty of recipient nations—i.e., the recipient's needs take precedence over the donor's needs. Thus, measuring the effectiveness of aid is a matter of examining economic development and poverty reduction in the recipient nation, rather than looking at the donor's interests. Although there are many ways to measure the recipient nation's needs, the most widely used variable is per capita income. The reasoning is that the poorer the country, the more it is in need of aid.

The labels of "realist" and "idealist" are innately biased and favor the former; below, in an effort to avoid à priori assumptions about the determinants of aid, we will use the terms "national interest" to refer to the realist perspective, and "global and humanitarian" to refer to the idealist perspective.

More recently, studies on ODA have identified multiple determinants for aid, including economic interests (such as promotion of trade and foreign direct investment), foreign relations (political interest; the international prestige of being a donor; enhancement of national security; influence over the recipient nation's political and institutional systems), and humanitarian concerns. In addition, relationships derived from past colonial ties often have a positive influence on aid flows (Alesina and Dollar 2000, 34). Many studies have found that either economic or political interest has played a critical role in the early phase of foreign aid programs of many donor nations (Stirling 1981; Nester 1992; Grilli and Riess 1992; Neumayer 2003).

A revisionist perspective on aid was developed after a series of studies by McKinlay and Little (1977, 1978a, 1978b, 1979) examined how aid was allocated in Germany, France, the UK and the United States. McKinlay and Little's studies have been credited for providing a logical framework for aid analysis. These studies empirically demonstrated that donors often provide aid from both national interest as well as humanitarian perspectives, although there are discernable shifts in their policy direction over time. It has now become standard in aid allocation studies to include both types of variables that control for donor's national interests as well as recipient nation's needs (global and humanitarian). The rationale is that donors will naturally have mixed interests in terms of ODA; ODA is not provided based solely on one set of interests.

Many empirical studies have been conducted to identify the determinants of ODA in developed countries, i.e., OECD/DAC member countries. McKinlay and Little (1977) divided the targets of the United States' ODA during 1960–1970 and developed two models: the recipient needs model, and the donor interest model. For the former, they used variables such as GDP per capita, per capita calorie consumption, number of doctors per 100,000 people, and real growth rate of GDP per capita; for the donor interest model, they used variables such as profits from development, international political-economic relations, security, political interest, and stability of the domestic political system. In their subsequent work on the ODA of the United States, they concluded that political and security interests were more important determinants than humanitarian consideration for the recipients (McKinlay and Little 1979).

McGillivray and Oczkowski (1991) introduced the Tobit model to test the ODA activities of the UK, with an emphasis on UK's former colonies. Gounder and Doessel (1997) tested the motives of Australian overseas aid to Indonesia using GNP per capita, trade deficit, aid per capita, military assistance per capita, outward foreign direct investment, and export.

Other studies compared ODA allocation and selectivity based in many donors. Berthelemy and Tichit (2004) tested the bilateral ODA activities of OECD/DAC member countries for the period 1980–1999 by using the variables of real GDP per capita, population, economic growth rate, level of primary education, infant mortality rate, export, import, FDI, and the democracy index. Their study showed that at the end of the Cold War, the tendency to favor former colonies was reduced when trade alliance with recipient countries increased (Berthelemy and Tichit 2004, 272–273). Dollar and Levin (2004) examined ODA selectivity of OECD/DAC member countries and multilateral aid organizations for 1989–2003 focusing on population, GNI per capita, the democracy index, the economic freedom index, distance, export, a dummy variable for colonial experience, and emergency relief.

Many studies on ODA determinants have utilized both the national interest and global and humanitarian perspectives, and have found that ODA determinants tend to comprise both elements and often change over time. In this study, we present a summary comparison of ODA data between 2000 and 2010 in order to capture how South Korean ODA policies and activities have changed.

South Korea as a Recipient of ODA: 1945–1995

In order to understand the symbolic significance of South Korea as a donor, it is important to understand its longer history as a recipient of ODA. The nation holds a unique position in OECD/DAC as one of the poorest countries in the world that has joined the most advanced industrialized economies as an emerging donor. When OECD/DAC was established in 1961, South Korea's GNP per capita was $61, making it one of the least developed countries (LDCs) in the world.

South Korea's history as a recipient of ODA began in 1945 after it was liberated from Japanese colonial rule (1910–1945). The southern part of the Korean Peninsula was governed by the United States until 1948, and the United States provided aid from the Government Appropriations for Relief in Occupied Area (GARIOA) and Economic Rehabilitation in Occupied Area (EROA) programs (Lee 2004: 35). GARIOA was emergency relief aid to assist with U.S.-occupied areas in need of basic subsistence including food, medicine, and fuel, while EROA was for infrastructure in U.S.-occupied areas (35). U.S. aid during its occupation period totaled $409.4 million under the two programs (35). In addition to grant aid, the United States also provided concessional loans from the Office of the Foreign Liquidation Commissioner (OFLC) with a total of $24.9 million, thus bringing the total ODA provided by the United States to $434.3 million (35–37). The United Nations Relief and Reconstruction Agency also provided emergency relief aid as well as infrastructure (37).

The Republic of Korea (ROK, or South Korea) was officially established in August 1948, but it continued to receive grant aid as military and economic assistance (Lee 2004, 32; Kim 1997). The Korean War (1950–1953) devastated over 80 percent of the Korean Peninsula, and South Korea became an important recipient of military and economic aid during the war period as well as in the post-war reconstruction period. About 70 percent of all grant aid South Korea received from the world was concentrated between 1945 and 1960; the United States was the largest donor, with aid totaling $3.1 billion, worth about $60 billion in current prices (ODA Korea 2010).

Between 1961 and 1975, South Korea experienced a period of rapid economic development and foreign capital was provided more in concessional loans, graduating from grant aid, which decreased substantially by the end of the 1950s. The newly-pronounced aid policy of President Kennedy in 1961 transformed the focus of U.S. aid from stabilizing economies to economic development and growth (Macdonald 1992, 290). This policy shift meant that grant aid would be replaced by concessional loans requiring more responsibility and ownership from the recipients. The shift coincided with South Korea's new push for economic development in the early 1960s, and the nation utilized concessional loans for its development plans (Kim 1997; Lee 2004, 55). In the first half of South Korea's economic development (1961–1975), 50.7 percent of ODA was provided in grant aid versus 49.3 percent in concessional loans (Lee 2004, 59). More importantly, while the United States provided 63.6 percent of ODA to South Korea in 1961–1975, it became a much less important provider of ODA during 1976–1990, when it provided only 14.6 percent of ODA. During this period Japan provided 57.4 percent and other nations provided 28 percent of ODA (Lee 2004, 57). ODA to South Korea totaled $3.94 billion in 1961–1975 and decreased to $3.51 billion in 1976–1990 (Lee 2004, 57). Table 1.1 presents the total ODA to South Korea from 1945 until the late 1990s.

TABLE 3.1
South Korea as a Recipient of ODA (1945–1999)

	1945–1960	1961–1975	1976–1990	1991–1999	Total
Grants (USD millions)	$3,045.6	$1,999.0	$750.4	$1,202.5	**$6,997.5**
Grants/ODA (%)	98.3	50.7	21.4	54.0	**54.8**
Concessional loans (USD millions)	$52.3	$1,942.4	$2,760.4	$1,023.7	**$5,778.8**
Concessional loans/ ODA (%)	1.7	49.3	78.6	46.0	**45.2**
Total (USD millions)	**$3,097.9**	**$3,941.4**	**$3,510.8**	**$2,226.2**	**$12,776.3**
Total (%)	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Lee 2004, 74.

By 1975, South Korea's GNP per capita reached $574, and it was thus no longer eligible for a low-income economy classification by the International Development Association and could no longer receive soft loans (Lee 2004, 66). In 1995, South Korea finally graduated from recipient status when it paid off the structural adjustment loan to the World Bank.

Grant aid and concessional loans provided to the South Korean government acted almost like domestic capital, allowing the ROK government to utilize these funds to support its industrial policies (Kim 1997). It would therefore be difficult to understand South Korea's remarkable economic development from the 1960s without examining the role of ODA.

Analysis of South Korea as a Donor of ODA: 1967–present

South Korea as an Emerging Donor of ODA

South Korea first participated as a donor in 1963 when it worked with USAID on a training program, but it was not until the late 1980s when South Korea emerged as a donor of ODA. In 1987, the South Korean government established the Economic Development Cooperation Fund (EDCF) to handle concessional loans, placing it under the Export-Import Bank of Korea (also known as Korea Eximbank). In 1991, the Korea International Cooperation Agency (KOICA) was established to handle grant aid. Table 3.2, total ODA provided from 1987, shows that South Korea's ODA increased very rapidly since the early 1990s after the establishment of its two main aid-implementing agencies.

TABLE 3.2

South Korea as a Donor of ODA (1987–2010, USD millions)

	Total ODA	Bilateral ODA Subtotal	Grant	Loan	Multilateral ODA	ODA/GNI (%)
1987	23.50	1.42	1.42	--	22.08	0.02
1988	34.00	2.10	2.10	--	31.90	0.02
1989	33.80	5.04	3.27	1.78	28.75	0.02
1990	61.16	12.25	3.26	8.99	48.91	0.02
1991	57.47	31.52	25.04	6.48	25.96	0.02
1992	76.80	45.22	30.99	14.23	31.59	0.02
1993	111.56	60.12	32.68	27.44	51.44	0.03
1994	140.22	60.07	38.45	21.62	80.15	0.03
1995	115.99	71.46	50.11	21.35	44.53	0.02
1996	159.15	123.31	53.41	69.90	35.84	0.03
1997	185.61	111.34	54.77	56.57	74.27	0.04
1998	182.71	124.70	37.21	87.48	58.01	0.05
1999	317.49	131.35	38.95	92.40	186.14	0.07
2000	212.07	131.18	47.78	83.41	80.89	0.04
2001	264.65	171.54	52.97	118.57	93.11	0.06
2002	278.78	206.76	66.70	140.06	72.02	0.06
2003	365.91	245.17	145.46	99.71	120.74	0.06
2004	423.32	330.76	212.09	118.68	92.56	0.06
2005	752.32	463.30	318.00	145.30	289.01	0.10
2006	455.25	376.06	258.95	117.11	79.19	0.05
2007	696.11	490.52	358.33	132.19	205.59	0.07
2008	802.34	539.22	368.67	170.55	263.12	0.09
2009*	1,094.1	791.8	441.8	350.0	302.3	0.11
2010*	1,341.1	990.5	520.5	470.0	350.6	0.13

Sources: 1987-2008: Export-Import Bank of Korea; 2009: 17-20; 2009-2010: Office of the Prime Minister 2009.

Notes: Figures for 1987-2008 are based on net disbursements.

* 2009 and 2010 figures are based on estimates and are in Korean won billions.

TABLE 3.3
Configuration of Bilateral versus Multilateral Aid (2000–2010, %)

	South Korea		OECD/DAC Average	
	Bilateral	Multilateral	Bilateral	Multilateral
2000	61.86	38.14	67.08	32.92
2001	64.82	35.18	66.97	33.03
2002	74.17	25.83	69.93	30.07
2003	67.00	33.00	71.99	28.01
2004	78.13	21.87	68.42	31.58
2005	61.58	38.42	76.87	23.13
2006	82.61	17.39	73.72	26.29
2007	70.47	29.53	70.43	29.57
2008	67.21	32.79	71.14	28.86
2009	72.37	27.63	69.70	30.03
2010	73.86	26.14		

Sources: 2000-2008: Export-Import Bank of Korea 2009; 2009-2010: Office of the Prime Minister's Office 2009; OECD/DAC database on web.

Notes: 2000-2008 figures are based on net disbursements; 2009-2010 figures are based on estimates.

South Korea's ODA began with multilateral aid, primarily consisting of its contribution to international organizations devoted to development assistance (see Table 3.3). This gradually changed to bilateral aid, which by 1991 was twice the size of the contribution made as multilateral aid. In 1993, South Korea's ODA volume reached over $100 million for the first time, and it continued to grow quite rapidly throughout the 1990s, reaching $200 million by the year 2000.

Since LDCs and low-income countries lack the capacity to repay loans, in keeping with the OECD/DAC guidelines for assistance most large donors tend to provide ODA as grant aid (OECD various years). Therefore it is interesting to note that South Korea's ODA configuration in bilateral aid changed from more in grant aid to a higher percentage of aid in concessional loans during 1996–2002. While there are many countries that provide concessional loans, they tend not to count it toward their ODA contribution. We should examine more carefully in future research why a larger share of bilateral ODA was in concessional loans during the administrations of Kim Young Sam (1993–1998) and Kim Dae-jung (1998–2002).

In 2003, there was a rather abrupt shift in favor of grant aid within bilateral ODA. In 2002, concessional loans were at one of their highest shares with 67.74 percent while grant aid was at 32.26 percent (see Table 3.4). This

TABLE 3.4
Configuration of Bilateral Aid (2000–2010, %)

	Grant Aid	Concessional Loan
2000	36.42	63.58
2001	30.88	69.12
2002	32.26	67.74
2003	59.33	40.67
2004	64.12	35.88
2005	68.64	31.36
2006	68.86	31.14
2007	73.05	26.95
2008	68.37	31.63
2009	55.80	44.20
2010	52.55	47.45

Sources: 2000-2008: Export-Import Bank of Korea 2009; 2009-2010: Office of the Prime Minister's Office 2009.
Notes: 2000-2008 figures are based on net disbursements; 2009-2010 figures are based on estimates.

changed in 2003 to 59.33 percent in grant aid versus 40.67 percent in concessional loans, changing the pattern of bilateral ODA established 1996–2002. This clear turning point in South Korea's ODA activities reflects the more progressive Roh administration's foreign policy. Although the Kim Dae-jung administration was also perceived as more liberal than earlier regimes, the Roh administration was freer to pursue more liberal global aid policies than Kim, who from the beginning of his tenure had to focus on rebuilding the South Korean economy after the devastating Asian financial crisis (1997–1998). This pattern of more grant aid versus concessional loans in bilateral ODA has continued to 2008, but as we will see has been reversed when we examine projection data for 2009–2010.

Although South Korea's ODA/GNI is still at about 0.09–0.1 percent, far below the OECD/DAC average of 0.25 percent, its ODA volume reached over $1 billion, enabling it to accede to the OECD/DAC as of January 2010.

Comparison of ODA Policies of the Roh Moo-hyun (2003–2008) and Lee Myung-bak administrations (2008–present)

As the South Korean economy expanded, its role in the world grew, and its ODA volume increased as well. South Korea's pattern of ODA disbursement began to change towards a greater percentage of grant aid versus concessional loans, and its ODA volume continued to increase rapidly from 2003. The Roh administration (which took office in February 2003) began to push for more aggressive ODA policies including creating a policy framework for ODA (2005); increasing ODA volume; shifting geographical orientation of South Korea's ODA from Asia to Africa (2006); and applying for membership in OECD/DAC (2007).

In a September 2005 keynote speech to the UN General Assembly, President Roh announced that South Korea would fulfill its global responsibility in addressing poverty and hunger in the world, and pledged to expand its ODA to Sub-Saharan Africa (MOFAT 2005a). Not long after, in November 2006, current Secretary-General of the UN and then-ROK Minister of Foreign Affairs and Trade Ban Ki Moon gave the keynote speech at the first Korea-Africa Forum, in which 27 African countries and five heads-of-state participated (MOFAT 2005a).

The first Policy Framework for ODA was presented in November 2005, in line with the MDGs and the OECD/DAC donor guidelines. South Korea's ODA strategy was to provide support for the MDGs' poverty eradication and sustainable development. Grants were to be used as important tools for foreign policy, and LDCs were to be selected based on humanitarian goals (MOFAT 2005b). On the other hand, the EDCF focuses on supporting "developing countries with strong economic ties with South Korea or those with a great potential for the economic cooperation in order to enhance the national economy of Korea and developing countries" (EDCF 2008, 2011). Since South Korea's exports to developing countries account for about 70 percent of its total exports, the EDCF suggests that concessional loans to these countries can be mutually beneficial. Thus, while grants focus more on the poverty eradication of developing and least developed countries, the EDCF focuses more on countries with considerable export relations with South Korea, which are often more developed than those being supported by grants.

This bifurcated ODA policy reflected South Korea's ODA system at a time in which the Ministry of Foreign Affairs and Trade (MOFAT) was in charge of grant aid with KOICA as the main implementing agency, while the Ministry of Finance was in charge of concessional loans, controlling the Export-Import Bank of Korea as the primary implementing agency. Many

TABLE 3.5
ODA Classification and Major Institutions (2008)

<table>
<tr><th colspan="3">ODA by Type</th><th>Coordinating Ministry</th><th>Implementing Agencies</th></tr>
<tr><td rowspan="7">Bilateral ODA (67.2%)</td><td rowspan="6">Grant (68.4%)</td><td>Bilateral grants</td><td rowspan="6">Ministry of Foreign Affairs and Trade (MOFAT)</td><td rowspan="6">Korea International Cooperation Agency (KOICA); Various ministries; Local governments</td></tr>
<tr><td>Technical cooperation</td></tr>
<tr><td>Food aid</td></tr>
<tr><td>Humanitarian/ Emergency relief aid</td></tr>
<tr><td>Debt forgiveness</td></tr>
<tr><td>Support through NGOs</td></tr>
<tr><td>Concessional Loan (31.6%)</td><td>Economic Development Cooperation Fund (EDCF)</td><td>Ministry of Strategy and Finance (MOSF)</td><td>Korea Eximbank</td></tr>
<tr><td rowspan="2">Multilateral ODA (32.8%)</td><td>Grants and capital subscriptions to International organizations (100%)</td><td>UN and other international organizations</td><td>MOFAT</td><td>MOFAT</td></tr>
<tr><td>Concessional lending to international organizations (0%)</td><td>IMF and other international organizations</td><td>MOSF</td><td>MOSF</td></tr>
</table>

Source: Official Development Assistance Korea, http://www.odakorea.go.kr.
Note: Figures based on 2008 net disbursement.

other ministries and local governments were engaged in their own grant aid programs, which in 2008 led the OECD/DAC Special Review team to conclude that South Korea's aid system was not only bifurcated between grant aid and concessional loans without a strong and clear coordinating mechanism, but was also a fragmented system of grant aid agencies involving over thirty institutions (OECD 2008). Table 3.5 presents how ODA is managed in South Korea with different ministries and aid implementation agencies. Under the Roh administration, the Ministry of Finance was substantially strengthened when it was given the added responsibility of budgeting and became the Ministry of Strategy and Finance (MOSF). This important difference between the Roh and Lee administrations has made coordination difficult between MOFAT and the MOSF, with the MOSF in control of the budget, and MOFAT not on equal footing to negotiate and coordinate aid activities. These difficulties are exacerbated by the two ministries' disagreement on South Korea's aid goals and policies—MOFAT tends to favor grant aid and untied aid, while the MOSF tends to favor concessional loans and tied aid. Thus, it is not surprising with the added influence of the MOSF that we have seen a shift toward more concessional loans with the 2009 and 2010 projection data.

The Roh administration, already aware that South Korea's ODA institutions were too numerous and fragmented, in 2006 established by presidential decree the Committee for International Development Cooperation (CIDC). Located in the prime minister's office, its membership ranged from ministers of ODA-related ministries to civilian experts, and its objectives were to establish the larger vision of South Korea's ODA policy, and more importantly, to coordinate its bifurcated and fragmented ODA system. However, lacking both personnel and budget, the committee could only play a minor role. This changed later in 2010 after the National Assembly passed the Basic Law on ODA in December 2009, stipulating that the coordinating mechanism should be solidly established in the prime minister's office to support the CIDC's function.

At the second CIDC meeting in July 2007, chaired by the prime minister, the ODA Mid-term Strategy (2008–2010) was discussed and confirmed. This strategy laid out the South Korean government's goal to increase the volume of ODA; to build a foundation for maintaining policy coherence; and in particular, to build more trust in South Korea's ODA policy in the international community by presenting its ODA goals and directions, e.g., its wish to join the OECD/DAC (MOFAT 2009).

The Roh administration made it clear that ODA was an important foreign policy goal, and that it would provide more ODA commensurate with its economic prowess in the world. The series of ODA policies created by the Roh administration appear to be in line with the public image of this administration as more progressive than its predecessors. The progressive stance in the domestic arena seemed to have resonated with Roh's liberal stance in foreign policy, including ODA.

In sum, the most important achievements of the Roh administration for ODA include recognition of ODA as an important foreign policy goal; alignment of South Korea's ODA vision with MDGs and support for LDCs and Sub-Saharan Africa; declaration of its intent to join the OECD/DAC; an increase

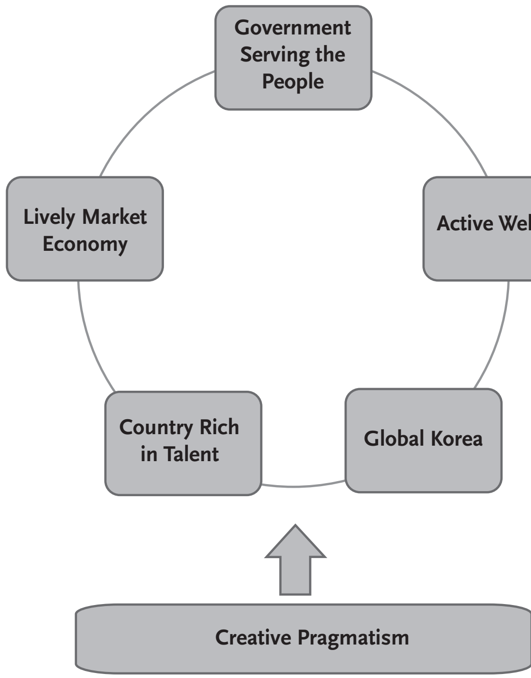

FIGURE 3.1 Lee Myung-bak Administration's Overall Policy Framework
Source: Office of the President 2009a.

in ODA volume; and improvement of the domestic ODA system, including an improved coordination mechanism among different ministries and implementing agencies of ODA, in line with global standards as recommended in the OECD/DAC guidelines.

The Lee Myung-bak administration, which took office in February 2008, has been seen as more conservative in many aspects of its domestic and foreign policies. It has been dubbed as a "pro-business" government, reflecting President Lee's long career in the construction business and his pro-growth economic policies. This administration announced that "creative pragmatism" was its key modus operandi, and defined it as an emphasis on substantive results, the promotion of realistic problem-solving methods, and the use of creative methods to implement policy goals (Presidential Transition Committee 2008). The overall policy framework included the elements shown in Figure 3.1; its emphasis on a market economy differed from the Roh administration, which was more focused on distributional welfare policies and programs. It was a signal that the Lee administration would have pro-business economic growth policies.

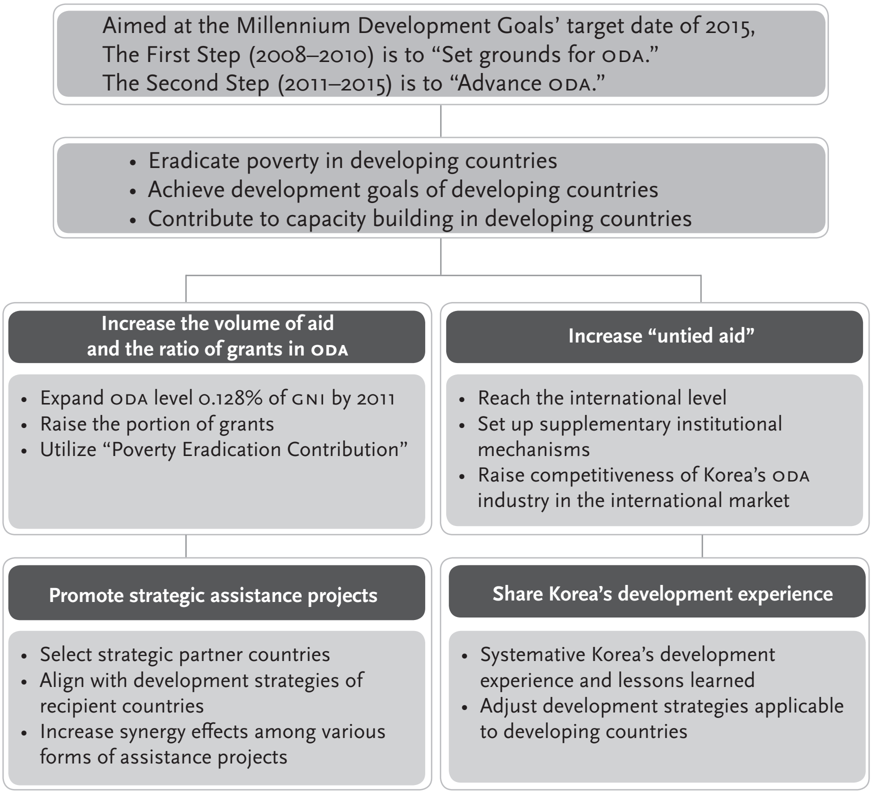

FIGURE 3.2 South Korea's Mid- to Long-term ODA Policy Framework
Source: Office of the President 2009a.

In spite of the apparent differences between the Roh and Lee administration's policy frameworks, the ODA policies seemed to be consistent. ODA was seen as a vital element in the Lee administration's vision for "Global Korea." In his inauguration address, President Lee laid out the vision for South Korea as a responsible and contributing member of the global community committed to playing an important role for world peace and sustainable development. Global Korea includes four key agendas: energy, free trade agreements (FTA), peace-keeping operations (PKO), and global development efforts, including ODA (MOFAT 2009).

It is interesting and noteworthy that ODA Korea[3], the official home page maintained by MOFAT, has a Mid-Term ODA Strategy almost identical to that

3 The Ministry of Foreign Affairs and Trade opened this home page on October 1, 2007 as one of the ministry's important outlets for publicity for ODA. This site provides updated information about South Korea's ODA and aims to encourage the participation of the public (MOFAT 2008).

of the Roh administration, thus attesting to the continuity of ODA policies between the two administrations (see Figure 3.2).

As noted above, in 2007 the Roh administration requested that the OECD conduct a special review of South Korea in preparation for its ascendance to OECD/DAC (OECD 2008). The review was conducted in 2008 and the results presented late that year (OECD 2008). It concluded that South Korea's fragmented aid architecture was the main barrier to enhancing aid effectiveness. In spite of the creation of the CIDC in the prime minister's office, it was clear that having over thirty ministries, agencies and municipalities involved in ODA without a clear coordinating mechanism was seen as a major obstacle in improving South Korea's aid activities. Thus, the OECD/DAC recommended that South Korea create a legal framework that could provide a solid basis for ODA goals and system, and that the fragmented aid system should be consolidated into one system or at least should develop a functioning coordinating mechanism (OECD 2008).

The OECD/DAC also noted that a relatively large share of tied and partially tied aid was a problem. OECD/DAC member countries had already reduced the share of tied aid to 0.14 percent by 2006 (OECD 2007), so the OECD/DAC noted with alarm that South Korea's concessional loans reached 31.6 percent of all bilateral aid in 2008, compared to DAC members' average of less than 10 percent. Immediately prior to Lee's 2008 Independence Day address, the CIDC was convened, and the goal to join the OECD/DAC by 2010 and to increase its ODA volume by three times and its ODA/GNI to the OECD/DAC average of 0.25 percent by 2015 was approved, in spite of resistance from the MOSF.[4] The MOSF was cautious about increasing South Korea's ODA volume and advancing South Korea's ODA system with the global financial crisis looming large and projections for economic recovery unclear. Nonetheless, the ODA policies set in place by the Roh administration were reaffirmed by the CIDC and announced by Lee in his address. This set the tone for his administration's overall ODA strategy and policies.

In March 2009 the Presidential Council on Korea's Nation Branding (PCNB) announced ten action plans (PCNB 2009), about half of which were related to boosting South Korea's role in the global community; the plans

4 The Ministry of Finance during the Roh administration was expanded to the Ministry of Strategy and Finance (MOSF) in the Lee administration, which put the budgeting function into the Ministry of Finance. This new ministry's functions resemble those of the Economic Planning Board of the 1960–70s. This has meant that the other ministries have to seek approval from the MOSF for their budgets. In regards to ODA, this has made it very difficult for MOFAT to negotiate the terms of ODA with MOSF on an equal level.

included enhancing its ODA, dispatching 3,000 aid volunteers around the world, and promoting the Knowledge Sharing Program (KSP), the Korea Development Institute's hallmark program for sharing South Korea's economic development know-how with developing countries (PCNB 2009; Office of the President 2009b).

The Lee administration has promoted several action plans, including ones aimed at improving the ODA system, increasing the share of untied aid, and expanding KOICA overseas volunteers. The administration established the Roadmap on Untying Aid, and aimed at untying all grant aid and fifty percent of concessional loans by 2015 (Office of Prime Minister 2009).

In his 2010 New Year's address, President Lee made a strong plea for an increase in South Korea's ODA and for the nation to pursue an ODA policy that reflects and builds upon its own experience as an aid recipient. In particular, he stressed that South Korea must be respectful of recipient nations and provide aid without being motivated by national interests—such as energy, resources and commerce—and thus clearly uphold OECD/DAC principles.

In sum, the Lee administration's ODA policies were very much in line those promoted by the Roh administration, and in keeping with the recommendations made by OECD/DAC in its special review. Lee has argued that South Korea should play an important global role in poverty reduction by sharing its economic development and democratization experience. After the "Basic Law on ODA" was passed in the National Assembly in December 2009, the prime minister's office created a new Director General's office in charge of ODA. Thus, at least in its rhetoric, the Lee administration's policy direction regarding ODA has been consistent with the Roh administration, and the administration has reaffirmed its commitment to fulfill a South Korean global role commensurate with its global economic ranking.

The OECD/DAC special review of South Korea highlighted four key aspects of a globally-responsible donor (OECD 2008); we have summarized the ODA policies and programs of the Roh and Lee administrations in respect to those four aspects in Table 3.6. The findings show that there is consistency between the two administrations in terms of top leadership commitment toward ODA. Important differences are in the legislation and ODA system. As discussed earlier, the ODA system in South Korea has been fragmented into a large number of implementing agencies and bifurcated at the policy level into two main ministries—MOFAT and MOSF. The Basic Law on ODA, which was passed in the National Assembly in 2009, stipulated that all grant aid should be coordinated by MOFAT and all concessional loans by the MOSF. Since concessional loans are only administered by the Export-Import Bank of Korea, it is MOFAT that is left with the massive coordination task of orga-

TABLE 3.6

Comparison of ODA Policies: Roh and Lee Administrations

Roh Moo-hyun Administration (2003-2008)	Lee Myung-bak Administration (2008-present)
Political Will of the President	
South Korea will fulfill its global role to address poverty and hunger (UN General Assembly Meeting Keynote speech, September 2005). South Korea's ODA will be in line with MDGS and OECD/DAC guidelines for donors. Triple South Korea's ODA to Sub-Saharan Africa (First Korea-Africa Forum, 2006). Declared South Korea's wish to join OECD/DAC by 2010.	Reaffirm South Korea's commitment to join OECD/DAC, and triple its ODA volume and increase ODA/GNI to 0.25% by 2015 (August 15, 2008 Independence Day Speech). South Korea's ODA and PKO will be commensurate with its economic ranking in the world (August 15, 2008 Independence Day Speech, National Brand 2009, etc.) Re-double ODA to Sub-Saharan Africa by 2012 (Second Korea-Africa Forum, November 2009) South Korea's ODA should be humanitarian and not seeking national interests such as energy and other natural resources (New Year's Speech 2010).
ODA Legislation	
No overarching legal framework. National Assembly fails to pass the ODA law. KOICA (grant aid implementing agency under MOFAT), and Economic Development Cooperation (concessional loan implementing agency in the Export-Import Bank of Korea under MOSF) each have separate/independent laws.	Basic Law on ODA was passed in the National Assembly (December 2009).
ODA System: Ministries and Implementing Agencies	
Committee for International Development Co-operation (CIDC) created in the Prime Minster's Office to help coordinate aid policies and system. Policy Level: MOFAT (grants), MOSF (concessional loans). Implementing Level: KOICA (grants, technical cooperation), EDCF (concessional loans) and over 30 ministries and municipalities in grant aid.	CIDC strengthened with a Director-General's office (2010). Policy Level: MOFAT (grants of all ministries and municipalities), MOSF (concessional loans). Implementing Level: KOICA (grants, technical cooperation), EDCF (Concessional Loan) and over 30 ministries and municipalities. MOFAT to coordinate all grants implementing agencies. MOST to coordinate all concessional loans.
ODA Vision and Policy Objectives	
Align with MDGS. Align with OECD/DAC guidelines for donors. South Korea's comparative advantage and development experience will be the basis of South Korean ODA. South Korean model of ODA is sought.	Promote South Korea's global image as a responsible and humanitarian player in terms of ODA and PKO activities commensurate with its economic ranking. Separate ODA policy from resource diplomacy. South Korean model of ODA is developed.

Sources: Compiled by authors based on data from the Ministry of Foreign Affairs (various years); Office of the President 2009a, 2009b; Office of the Prime Minister 2009.

nizing highly-fragmented grant agencies, as noted earlier.

A more fundamental coordination is called for between MOFAT and the MOSF, one that will be handled by the newly-enhanced CIDC. The latter will now have an office, personnel, and requisite budget to help with the coordination of grant aid and concessional loans. It will have to find a common vision and set of objectives for grant aid and concessional loans, which had up to now acted more or less independently from each other. The CIDC will now have to produce one common vision and strategy for all ODA, one list of major recipient countries, one Country Assistance Strategy for each recipient country, and so on.

However, even with an enhanced CIDC in the prime minister's office, this coordination will not be easy; with the MOSF's upgraded status as a super agency wielding budgetary oversight, MOFAT will need to seek its approval for its budget, including ODA. Even though the global aid community has deemed that grant aid is more helpful to recipients, and in particular to LDCs, and that a bifurcated aid system hinders delivery due to duplication of administration and lack of coordination, and increase in transaction costs, and that it hinders economies of scale needed in large programs, the MOSF has been steadfast in its opposition to many of these recommendations. This is partly due to South Korea's own experience of utilizing concessional loans for its industrialization and partly to protect its own institutional raison d'être. Although a unified ODA system is recommended by the OECD/DAC and backed by many civil society organizations in South Korea, the MOSF has so far rejected this type of system, which it fears in the long run will undermine itself and its control over ODA.

The remaining task is to determine if these policies have actually been realized—if the Lee administration's professed intent to have a more humanitarian goal-based ODA is supported by an examination of the empirical aid data.

Comparison of South Korea's ODA Activities, 2000–2010

To understand to what extent actual ODA activities have changed between the Roh and Lee administrations and whether South Korea's ODA has moved more in line with that of advanced industrialized donor countries, we compared ODA implementation statistics in two categories: multilateral aid versus bilateral aid, and grant aid versus concessional loans.

In terms of the former, OECD/DAC recommends that donor countries provide as much multilateral aid as possible to reduce the number of bilateral donors recipient countries must face, and thus reduce coordination complications as well as the multiple conditionalities that can accompany each bilateral donor. Thus, the OECD/DAC recommends that donors work with other donors for trilateral aid, and most importantly, utilize international organizations that are well organized and have a proven track record. On average, OECD/DAC member countries provided about 29 percent in multilateral aid and 71 percent in bilateral aid in 2008 (OECD 2008). Table 3.3 above shows that, except for the years 2004 and 2006, South Korea's bilateral versus multilateral aid composition was quite similar to the OECD/DAC average. However, that appears to be changing with the 2009–2010 projected figures, which tend to show that South Korea's multilateral commitment is slowly falling behind that average. Furthermore, by examining the sub-categories of South Korea's multilateral aid, it clearly is primarily going into paying South Korea's dues to international financial organizations where the nation has a membership and in which said organization has a share in any development assistance activity. Thus, a careful examination of South Korea's multilateral aid reveals it is not yet sufficiently devoted to multilateral organizations with strong development cooperation activity in developing nations. This drop in the ratio of multilateral versus bilateral aid may be a sign that the Lee administration is turning back the clock on progress in this aspect of ODA effectiveness.

In the second category of comparison, in terms of grant aid versus concessional loans, the OECD/DAC and advanced donor nations have strongly recommended that South Korea move away from concessional loans and provide more in terms of grant aid (OECD 2008). A comparison of the composition of bilateral aid data shows an alarming trend: South Korea's concessional loans have begun to rise sharply since 2009 estimates (see Table 3.4). Our empirical analysis shows a significant shift in South Korea's ODA allocation starting 2007, one which became more pronounced in 2008. The findings for 2007 and 2008 reflect ODA activities of the Roh administration, although the Lee administration came into office in early 2008. The findings show that the earlier ODA activities from 2000 to 2006 reflect stronger national interests although the governments—the Kim Dae-jung and Roh Moo-hyun administrations—were more progressive than the current Lee administration. Since the data we have for 2009 and 2010 are projections, we need to closely monitor the actual implementation data to examine whether concessional loans have indeed risen sharply since the Lee administration took office. This would be directly contrary to the president's public proclamation that South Korea's ODA will be more aligned with global standards, moving away from concessional loans and more toward grant aid. Further hard evidence on the pattern of ODA allocation will be required to assay if the Lee administration has indeed honored its rhetoric for more humanitarian-based ODA.

Although we do not yet have the ODA data for 2009, we examined the aid estimates for 2009 and 2010 in order to shed light on the possible direction ODA activities are taking in the Lee administration. Figures in Table 3.3, albeit limited, show an interesting shift in trend in bilateral aid. They show that while the share of grant aid was consistently higher during the Roh administration, the difference has begun to decrease since the Lee administration; in particular the estimate figures for 2009 and 2010 show that a reversal of grant aid versus concessional loans has occurred. This is both alarming and contrary to what President Lee has announced as his administration's ODA policy—i.e., one that is humanitarian and separates South Korea's national interests from its ODA. If these professed policies were to be realized, we would have expected to see that grant aid would be increased, or at minimum, kept constant relative to that of the Roh period. This is admittedly only one indicator given the limitation of empirical data for 2009–2010, but it reveals a disparity between the administration's stated policies and actions. Once the aid data from 2009 becomes available a more in-depth analysis will be required in order to fully examine whether the Lee administration's ODA policies are borne out with its aid activities.

Concluding Remarks

Studies on ODA and its determinants have focused primarily on U.S. and Western European cases. Using theories advanced in international relations, social scientists have examined whether aid is provided in the national interest of the donor nation, and whether it is provided with the professed goal of aid—i.e., humanitarian and based on global needs for poverty reduction and sustainable development. South Korea has recently been accepted to the OECD/DAC as its twenty-fourth member, which signals that it is now joining the ranks of advanced industrialized countries as a globally responsible nation.

The Lee Myung-bak administration (2008–present) has in most respects been considered more conservative than its preceding two administrations, and has overturned a few key policies of the Roh Moo-hyun administration. Thus, it came as a surprise when President Lee himself spoke very forcefully that South Korea must provide greater assistance to the world to fight poverty from a humanitarian perspective. In his 2010 New Year's address, he made it clear that South Korea's ODA policies and aid disbursement must be separated from its energy diplomacy and other national interests.

In this chapter we have attempted to understand the Lee Myung-bak administration's ODA policy, one that seems anomalous vis-à-vis the administration's other domestic and foreign policies. We examined the extent to which the ODA policies of the Lee administration are consistent with those of the preceding Roh administration. The comparative analysis showed that there appears to be quite a bit of consistency in the ODA policies. Furthermore, in some areas such as legislation and ODA system, the Lee administration was able to improve what had existed or had been lacking in the Roh administration. In sum, the policies regarding ODA have advanced beyond the Roh administration, and have shown a consistent pattern of policy development.

However, the linear regression results show a different pattern. While the data for 2000–2006 supported the hypothesis that South Korea's ODA activities are more in line with national interests, it started to show a more humanitarian trend by 2007, and was more pronounced in 2008. Thus, we can conclude that South Korea's ODA activities were more narrowly focused on national interests during the early part of the Roh administration, until that began to change around 2006.

What is not clear is how to interpret the Lee years. Although the policies and the president's stated commitments tend to favor the humanitarian perspective, there are some alarming signs that ODA activities (based on 2009 and 2010 estimates) may be turning the clock back to more national interest-based activities. In particular, the share of concessional loans as compared with grant aid started to increase in 2009, a reversal of the pattern we have witnessed since about 2003. Although this is just one indicator, it suggests that contrary to what the administration has touted, South Korea's ODA is not oriented toward LDCs or for real poverty reduction and economic development of the poorest countries in the world, but headed toward lower-middle and upper-middle income countries, which have a better capacity to repay the loans, and consequently to Asia, where many of these countries are concentrated. If these trends are found with empirical evidence, they run counter to Lee's declaration that South Korea's ODA will be provided for humanitarian purposes to LDCs and that its aid allocation to Sub-Saharan Africa would be increased. We do not have yet have the empirical data for the Lee years, so it is probably premature to conclude that the ODA activities are based more on national interests. However, the limited estimates we have seen suggest there is a gulf between professed policies and actual aid practices.

Examination of South Korean ODA policies and activities provides an interesting glimpse of ODA issues for an emerging donor, one that must also harness public support in order to continue with its ODA programs. South

Korea struggles to find its global image amidst the tension between being an aggressive economic power versus a globally responsible citizen. The analysis here shows that South Korea is at a crossroads in terms of how it should uphold the global paradigm of humanitarian aid in contrast to its need to work for domestic constituents who may not yet be ready to embrace its new role in the world.

As mentioned above, further 2009 data is needed to fully examine ODA activities as compared to policies under the Lee administration. There is also a need for more in-depth studies about how ODA decisions are made in South Korea in order to shed light on how an emerging donor—one without a history of being a colonizer, and with a nascent humanitarian vision of aid—can carve out its own model of ODA.

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Policy Recommendations for the Korean Economy

Byongwon Bahk

Ever since I was appointed Director General for Economic Policy in 2001 and put in charge of South Korea's overall economic policy, I have consistently emphasized that *job creation* and *management of the balance of payments* should be the main criteria for formulating and evaluating economic policies.

The former would not seem unusual in many countries, but in South Korea (hereafter simply Korea) steady improvement in employment has long been taken for granted; unemployment became an issue in Korea only for a brief period after the 1997–98 Asian financial crisis. The balance of payments, or how to secure sufficient foreign currency to import capital goods and natural resources, has been the Korean economy's Achilles' heel. The recent worldwide crisis clearly showed that the current account balance is the final source of creditworthiness, especially when there is turbulence in the capital account.

Below I shall demonstrate that the most efficient and effective way to simultaneously achieve these two goals—job creation and management of the balance of payments—is to make the services industry internationally competitive.

Bleak Prospects for Job Creation

As we all know, growth and job creation both depend upon investment. After the Asian financial crisis, and coincidently with the advent of leftist administrations, investment has been in a prolonged slump. This may be a simple consequence of the exhaustion of investment opportunities and increased risk aversion on the part of both enterprise and financial investors.

The Korean government, like others, has encouraged investment but largely in vain. Very roughly, the addition of 300,000 jobs annually is necessary for the Korean economy to continue a virtuous circle—on average, about five percent annual growth. During the ten years after the Asian financial crisis, Korea was unable to achieve that.

Even though more than 300,000 jobs were annually added during the

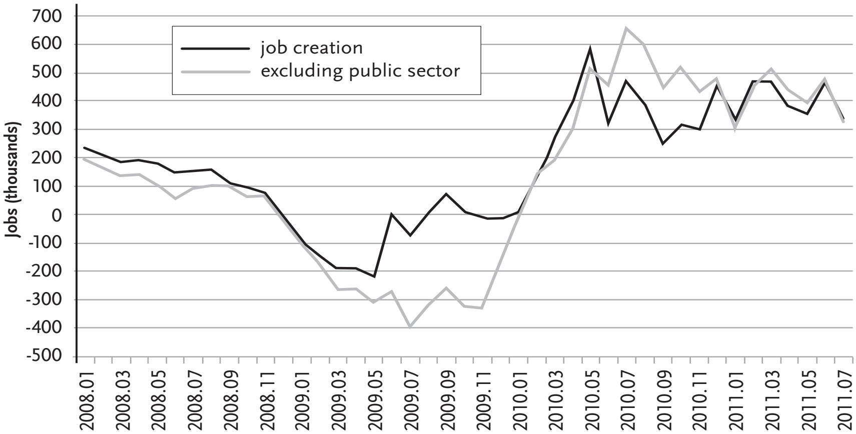

FIGURE 4.1 Monthly Job Creation over Previous Year (2008–2011)
Source: Korean Statistical Information Service (KOSIS).

latter four years of the Kim Dae-jung administration (1998–2003), it was largely nothing more than a rebound from the loss of 1,276,000 jobs in 1998; and taking into account the needed annual growth, it left a deficit of 545,000 jobs. There was no additional job recovery under the Roh Moo-hyun administration (2003–2008) and 236,000 jobs were added to the deficit.

Some attributed stagnation in investment and job creation to the psychological uneasiness in business circles about the leftist government. This is only partly true. The current Lee Myung-bak administration came into power (2008) with a campaign pledge to achieve seven percent growth and 600,000 jobs a year on average—not regarded feasible by most economists. As shown in Figure 4.1, the actual jobs added over a three-year period were 145,000 (2008), -72,000 (2009), and 323,000 (2010), and in mid-2011 the record shows an increase of 400,000 over the previous year. Even we assume the final result of 2011 will be 400,000, the first four years of the Lee Myung-bak administration created 800,000 jobs, falling far short (400,000) of the necessary level of growth. In sum, 1.2 million more jobs should have been created in Korea over the past 14 years.

Now that a neoliberal government has been in charge for more than four years, it is no longer possible to lay the blame on past administrations. The failure to create necessary jobs in three consecutive administrations only proves that an economic development strategy based on the manufacturing sector and exports, one extremely successful in the past, no longer works; nor will this dated strategy create necessary jobs.

If significant progress is to be made in the remaining years of the cur-

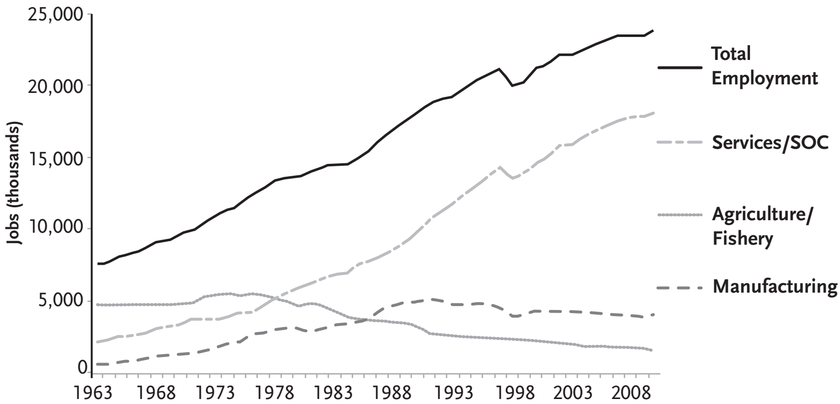

FIGURE 4.2 Change in Korea's Employment Structure (1963–2009)
Source: Korean Statistical Information Service (KOSIS).

rent administration, precise diagnosis and deliberate prescriptions are required. Diagnosis begins with acknowledging a harsh reality: additional job creation can only be expected in an extremely limited range of businesses within the services industry.

Agriculture began to lose jobs as early as 1976, when it recorded its peak employment of 5,514,000. For 15 years thereafter, agriculture experienced a sharp employment decline, losing 186,000 jobs every year between 1976 and 1991. The rate of decrease has recently been decelerating; the average yearly loss of jobs in the sector is 60,000 since 1991 (as shown in Figure 4.2).

The manufacturing sector, which led the development of the Korean economy and whose exports continued to shore up the whole economy in the midst of the worldwide economic crisis, has been losing jobs for a long time. After recording its peak of 5.22 million jobs in 1991, until which time it had seen an average annual increase of 163,000 jobs, it began to lose jobs at a rate of 65,800 jobs a year until 2008. (Note, however, that this average was skewed by the loss of 627,000 jobs just in the year 1998. And note also that in 2010 and 2011, jobs in the manufacturing sector suddenly significantly increased due to an increase of exports depending upon depreciation of the local currency, the won. No one is sure how long it will be before the manufacturing sector can again contribute to job creation. Most economists, including those in the government, are very skeptical.)

Even though the services and social overhead capital (SOC) sectors continue to produce jobs, their yearly contribution has fallen from 514,700 jobs for the period 1989–2002 to only 308,100 since then—a drop of almost half. Given the loss of jobs expected in the agriculture and manufacturing sectors

TABLE 4.1
Recent Changes in Services Sector Employment (thousands, %)

	2000	2008	Average increase (%)	2009	2010	2010 increase
Wholesale/Retail	3,833	3,635	-0.66	3,600	3,580	-20
Restaurant/Hotel	1,919	2,042	0.78	1,936	1,889	-47
Transportation	1,068	1,203	1.50	1,247	1,280	33
Communication	192	269	4.31	652	668	16
Finance/Insurance	752	827	1.20	652	808	42
Real Estate/Lease	351	488	4.21	500	517	17
Business Services	**1,010**	**1,920**	**8.36**	**1,788**	**1,906**	**118**
Public Services	758	840	1.29	1,032	960	-72
Education	1,191	1,747	4.91	1,831	1,799	-33
Health/Soc. Welf.	**428**	**852**	**8.99**	**998**	**1,153**	**155**
Recreation/Sports	365	532	4.82	390	380	-11
Personal Services	886	1,356	5.46	1,211	1,216	5
Household Serv.	186	150	-2.65	147	150	3
Int'l Institutions	19	16	-2.13	13	13	1

Source: Korean Statistical Information Service (KOSIS).

(roughly 120,000 per year), the services sector, which is the only sector that produces new jobs, must create over 420,000 jobs a year to prevent increased unemployment and to maintain the virtuous circle of the economy. In recent years, the actual increase in services sector jobs recorded more disappointing numbers: 260,000 (2008), 179,000 (2009) and 200,000 (2010).

This must be due to the fact that some sub-sectors of the services industry have also begun to lose jobs, as Table 4.1 illustrates. Compared to 2000, 253,000 jobs have been lost in the wholesale and retail trades until 2010; in just two years from 2008 to 2009 alone, 153,000 jobs were lost in the restaurant and hotel businesses. The sum of these two sub-sectors in 2009 accounted for 30.8 percent of services employment and 23.6 percent of the total employment of 23.5 million. If these two sub-sectors are added to the declining groups of agriculture and manufacturing, it amounts to 47 percent of total employment. Thus the remaining half of the economy must bear the entire burden of job creation—an extremely difficult task.

Recalling that an 300,000 additional jobs a year are required to absorb the still-increasing population of the economically active and avoid a rise in the unemployment ratio, the performance in 2008 (gained 145,000) and

2009 (lost 72,000) is very disappointing. Even though the number recovered to 323,000 in 2010 and about 400,000 in the first half of 2011, these numbers are too heavily dependent upon manufacturing, health and social welfare services, and business services. Many believe that the sustainability of job creation in manufacturing is questionable and jobs creation in social services is too much dependent upon government expenditures that cannot be increased indefinitely.

For example, a large number of the new temporary jobs were artificially created in the public services sector by government expenditure in 2009 (refer back to Figure 4.1). Without 192,000 jobs created by the public sector, the number of jobs lost in 2009 was actually 264,000. The disappearance of the "additional" contribution by the public sector in 2010 shows that job creation by the public sector has limited meaning, and that we cannot depend upon it for creation of sustainable jobs. The recent increase in health and public welfare services sector jobs is partly due to genuine need, but might be at least partly, I have to say, "artificial."

Recent job statistics are rather confusing, primarily due to temporary jobs artificially created by government expenditure. In the year ending July 2010, the major contributors to job creation turned out to be manufacturing, construction, and business services, while the public sector lost 182,000 jobs. But this data noise does not change the reality that we cannot expect a lot of new jobs in manufacturing, nor that the additional jobs gained by the construction sector are partly attributable to the Four Rivers Project. Such efforts by the public sector to provide temporary jobs are necessary, but we cannot allow ourselves to be misled by non-sustainable job creation tied to temporary government expenditure: Korea needs to catch up and gain 1.2 million jobs.

Balance of Payments Deficit and Outflow of Job Opportunities in the Services Sector

After the Asian financial crisis, except for 1998 itself, the deficit in the services balance of payments (BOP) rapidly increased, reaching \$13.3 and \$12.0 billion in 2006 and 2007, respectively (see Figure 4.3). The services deficit increase ended in 2008 due to the soaring exchange rate, one which initially was the consequence of the worldwide economic crisis, and later was intentionally left unattended. The BOP dropped to \$5.7 billion (2008) and \$6.6 billion (2009), but very soon began to increase again, reaching \$11.2 billion in 2010. But since the manufacturing sector has been producing a surplus in the trade in goods large enough to cover the deficit in the services trade, it is

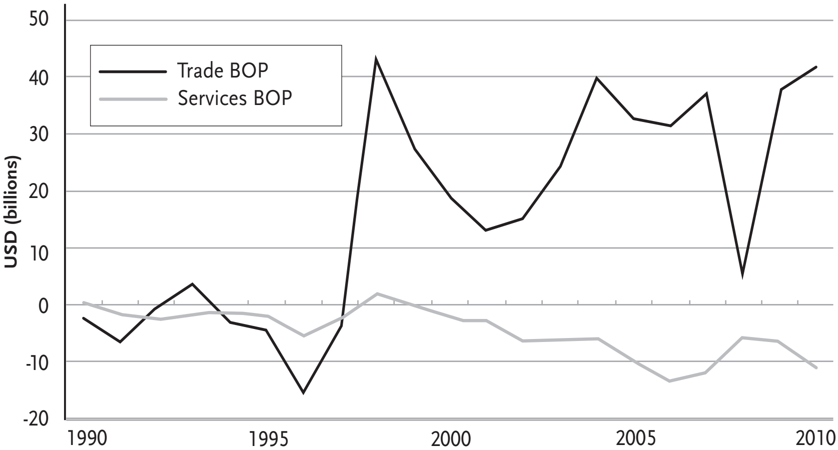

FIGURE 4.3 Korea's Chronic Deficit in Services Balance of Payments (1990–2009)

Source: Bank of Korea, Economic Statistics System (ECOS).

TABLE 4.2

Balance of Payments of Major Sub-sectors in the Services Industry (USD millions)

	2007	2008	2009	2010
Total	-11,967.3	-5,734.1	-6,640.5	-11,229.4
Patent Loyalties	-3,398.7	-3,274.1	-3,988.5	-5,818.8
Business Services	-7,408.5	-14,279.4	-15,005.2	-16,836.4
Cultural/Entertainment	-481.6	-363.9	-323.1	-381.1
Government Services	611.5	270.2	419.0	178.6
Communication	-365.9	-425.0	-502.2	-575.0
Construction Services	7,869.4	11,078.6	11,746.8	9,607.7
Insurance	-585.4	-277.4	-394.7	-468.6
Financial Services	3,304.4	3,094.7	1,572.5	1,986.6
Computer/ICT Services	-203.7	-267.8	-182.8	-242.3
Transportation	4,480.5	7,998.0	5,242.3	9,252.4
Travel	-15,836.9	-9,291.7	-5,220.9	-7,904.3

Source: Bank of Korea, Economic Statistics System (ECOS).

not easy to persuade the public that government reform of the services sector is necessary to make it competitive.

Looking into the details of the services trade deficit during the period from 2006 to 2010 (shown in Table 4.2—we began to make detailed statistics of services BOP only in 2006), the deficit in business services trade grew from $7.2 to $16.8 billion, and the deficit in royalties for patents, etc. from $2.6 to $5.8 billion. These deficits are already built in and are unaffected even by the depreciation of the Korean won over the course of the worldwide economic crisis.

The travel deficit has also been rising very rapidly, from virtually zero in 2000 to $15.8 billion in 2007, but it then decreased to $5.2 billion in 2009, as it turned out to be quite sensitive to the exchange rate. But attention must be paid to the fact that inbound travel didn't increase noticeably. Outbound travel responded to the exchange rate much more sensitively, but recovered very rapidly, recording a $7.9 billion deficit already in 2010 and $4.5 just in the first half of 2011, as we experienced after the Asian financial crisis.

In the services sector, only transportation, where both shipping and air transportation have been from their births exposed to international competition, has been recording increasing surpluses, including an $8 billion surplus in 2008. The number dropped to $5.2 billion in 2009 due to the worldwide recession but promptly recovered to a $9.3 billion surplus in 2010. Financial services have also exhibited a similar pattern.

I highlight the chronic deficit in the services BOP not because the BOP deficit itself is a cause for concern, but because it is clear evidence that services in Korea are for the most part not competitive. Desperately needed demand and job opportunities are being lost there—and this is why making the services industry competitive is the most important, efficient, and effective way for Korea to overcome the present crisis and continue sustained growth.

Other means of creating jobs and improving the BOP are less effective and efficient. For example, job creation by the public sector cannot last long, and younger job seekers do not regard such temporary jobs desirable. Fostering high-tech industries such as the so-called greenomics industries—trendy recently and certainly desirable in the longer term—takes too much time to bear fruit, and can create only a limited number of jobs for a highly educated and trained minority.

For the improvement of BOP, an increase of exports or a decrease of imports is not a very desirable or feasible alternative because it would aggravate trade frictions with other countries. Moreover, the traditional importer countries, such as the United States and the EU, can no longer afford continuing increases in imports. They now expect that Korea, China, and other successfully developing countries will share the burden of being locomotives to pull along the world economy by creating more domestic demand and increasing imports from other countries. It is time for Korea and China to try to find sources of growth and job creation in their own domestic markets, thereby also contributing more to the recovery of the world economy.

Korea's Current Services Industry: Ample Room for Development

Below I further elaborate why we should pay more attention to the services industry and enable it to stand on its own.

Korea's share of services in GDP and total employment, compared to those of advanced countries, is shown in Table 4.3. The comparison vividly shows us that there is ample room for services to grow, while the share of manufacturing is naturally dwindling (see Table 4.4).

That there is room for further growth for services can also be ascertained by the changes in consumption. In the ten years following 2000, consumption for services grew by 2.0 times, raising its share in total household consumption from 54.3 percent in 2000 to 57.3 percent in 2010 (Table 4.5). Durable goods consumption showed the lowest growth, confirming its saturation. Look at overseas consumption! It increased by 3.2 times over the ten-year period up to 2010, and pushed up its share in total household consumption from 2.0 to 3.4 percent in that year. In 2008, it sharply dropped to the 2005 level, but recovered promptly and will continue to increase if we cannot create competent domestic suppliers who can replace foreign competitors.

Consumption changes within the services sector also are significant in identifying the most prospective business lines for growth and job creation. As detailed in Table 4.6, consumption in medical and health care services grew fastest, while that for transportation stayed almost at the same level, with its share contracting from 12.8 to 11.3 percent in 2000 and 2010, respectively. Communication and entertainment are the next most promising. The slightly disappointing figures for education, dining out and travel are certainly due to the leakage of demand abroad.

The competitiveness of services is pivotal not only for job creation and BOP improvement—by keeping more demand in the domestic market—but also for maintaining, as long as possible, the competitiveness of manufacturing.

The productivity of the services industry of Korea is just 58 percent of the manufacturing sector. Compared to the productivity of services in OECD countries, it is again about half, 44 percent of the United States and 55 percent of Japan. This productivity disparity may be partly because shares of

TABLE 4.3
Shares of Services in GDP and in Employment (2009, %)

	Korea	US ('08)	Japan ('08)	UK	France	Germany	OECD ('06)
GDP	60.7	77.5	71.3	78.2	79.4	72.7	71.8
Employment	68.5	80.9	69.9	78.6	73.0	69.6	66.9

Source: OECD Statistics (OECD StatExtracts).

TABLE 4.4
Changes in GDP and Employment Structure (1970–2010, %)

		1970	1980	1990	2000	2010
Share in GDP	Manufacturing	16.9	21.9	24.0	25.2	27.5
	Services	40.4	42.8	46.4	51.2	52.4
Share in Employment	Manufacturing	13.2	21.6	27.2	20.3	16.9
	Services	32.4	37.0	46.7	61.2	68.8

Source: Korean Statistical Information Service (KOSIS).

TABLE 4.5
Changes in Consumption Structure (2000 vs. 2010)

	Shares in Household Consumption (%)		Increase (2010/2000)
	2000	2010	(times)
Domestic Consumption	99.9	98.4	1.823
Durable Goods	18.0	15.0	1.544
Non-Durables	27.7	26.1	1.743
Services	54.3	57.3	1.955
Overseas Consumption	2.0	3.4	3.189
Household Consumption	100.0	100.0	1.851

Source: Korean Statistical Information Service (KOSIS).

TABLE 4.6
Changes in Services Consumption (2000 vs. 2010)

	Shares in Household Consumption (%)		**Increase in Household Consumption** (**real terms**, %)	
	2000	2010	2010/2000	**Av. Inc. Rate**
Medical/Health	4.22	6.53	2.15	7.96
Transportation	12.83	11.34	1.21	2.08
Communication	4.05	5.20	1.78	5.95
Entertainment	6.67	8.65	1.80	6.05
Education	6.13	6.58	1.49	4.07
Eat Out/Travel	8.33	7.96	1.33	2.87
Others	12.31	12.27	1.50	4.13
Services Subtotal	46.51	66.69	1.99	7.14
HH Consumption	100.0	100.0	1.39	3.35

Source: Bank of Korea, Economic Statistics System (ECOS).

the less-productive business lines (e.g., wholesale and retail trades, restaurants and hotels) are too high compared to those of other OECD countries, and shares of high value-added, knowledge-based services (such as finance, and business services) are too low.

Whatever the cause, this low productivity affects other sectors. We already saw that business services produce the largest BOP deficit, one that did not decrease even in this round of economic recession. This means business services are the least competitive part of the Korean economy, and the weakness of this sector can negatively affect the competitiveness of all the other industries that have to outsource business services from them.

For example, inefficient logistics services can incur more costs to exporting manufacturing companies and undermine the competitiveness of the whole economy. If Korea's fashion design services were as strong as in France or Italy, the fates of the country's textile, garments, and shoe industries would have been much different. A more serious problem is in education services. Education that neither satisfies the needs of students nor of the companies hiring them causes a vast amount of additional costs to the economy and, moreover, pushes many students abroad.

The Korean services industry's lack of competitiveness is essentially a result of its relatively low exposure to international competition. In the past, services were regarded as non-tradables, and many thought that important ones—such as finance, transportation, telecommunication, and broadcasting—should not be entrusted to foreigners. And through the period of ex-

TABLE 4.7
Changes of Shares in the World Services Export Market (1998–2008, %)

	1998	2000	2002	2004	2006	2008
United States	17.8	18.8	17.1	14.9	14.5	13.8
France	6.3	5.4	5.3	5.1	4.5	4.2
UK	8.3	8.0	8.3	8.7	8.3	7.5
Korea	1.9	2.0	1.7	1.8	1.7	2.0

Source: World Trade Organization, Statistics Database.

port-led development, most of them were regarded as merely a means to support export and manufacturing. Even when Korea began import liberalization in the late 1970s for the sake of price stabilization and enhancement of competitiveness, opening of the services market to foreign direct investment (FDI) was belated—even today FDI in services is not very welcomed.

Protection, natural or artificial, and a lack of competition are the best excuses for governments to intervene with regulations, and regulations usually lead to further protection and subsidies. And after that, a vicious circle of regulation, protection, and subsidy continues. There are still numerous legal and virtual barriers to FDI in services. Perhaps it is a lack of will or intention to induce FDI in services, or, more fundamentally, ignorance about the benefits of FDI is the reason. Korea's share of services in FDI is only 49 percent, the third lowest among OECD countries. The consequence: shares of foreign companies in total sales and employment in the services sector are both less than half of the OECD average.

What is more astonishing and ill-boding is the great leap forward by China and India in the world services export market. Their shares in the ten-year period 1998-2008 have doubled and tripled, while Korea's is stagnant. Shares of most advanced countries are declining (Table 4.7). Why was Korea able to achieve astounding performance in the export of goods, yet make no advancement in the export of services?

One reason is that in some parts of the services industry we have other structural problems hindering innovation and growth. Korea has a peculiar system of business conglomerates, the so-called *chaebŏl*. In many cases, each *chaebŏl* group has its own subsidiaries for services like sales outlets, logistics, design, advertisement, system integration, insurance, and securities and asset management. These captive relationships do not leave much incentive to the subsidiaries to innovate and compete. Smaller, independent companies in these service areas lack access to large and meaningful projects that would be vital for them to accumulate successful track records.

On the other hand, in many other parts of the services industry, sub-sectors are composed of too many tiny self-employed and quasi-self-employed business entities that do not have any margin to invest and to innovate. The negligible share of R&D investment for services is the natural consequence of this lack of competition and competence to innovate.

Above I have explained that making services competitive is the way to create jobs and improve BOP while at the same time preventing an unproductive services sector from undermining the competitiveness of the whole economy. It turns out that there is another area of the Korean economy that shares similar problems with services: agriculture.

Agriculture Has the Same Problem on a Smaller Scale

Nowadays, agriculture seems to be an almost forgotten sector of the economy. It now accounts for only 7 percent of employment and 2.5 percent of GDP. Agriculture—because it has the same problems as the services sector, albeit on a smaller scale, placing a heavy and ever-growing burden on the economy as a whole—is worthy of a brief discussion.

Korea is constantly losing jobs in agriculture, although most of them are the consequence of belated retirement and hence do not cause serious social issues. The increasing current account deficit due to the import of agricultural products is also widening infinitely. The difference is that this deficit is regarded as inevitable, thus attracting no efforts to improve it. As with services, agriculture has a similar structural problem—it is composed of numerous petty farmers who lack the capacity to innovate or invest to realize innovation.

The producer support estimate (PSE) increased from 8.3 trillion won in 1986 to 24.2 trillion won in 2007. It accounts for 60 percent of total agricultural production, and as Table 4.8 reveals, is much higher than the United States (10 percent) and the EU (26 percent), and even higher than Japan (45 percent), a country notorious for protection of its agricultural market. Another feature of support for agriculture both in Korea and Japan is that it mostly consists of price support instead of fiscal expenditure. The result is high food prices and then high wages, directly undermining the competitiveness of restaurants and tourism, and indirectly the competitiveness of the whole economy. Protection of agriculture decreases the supply of land for non-agricultural purposes and results in the notoriously high prices of Korean and Japanese real estate.

We need to pay at least a proportional amount of attention to agriculture, not only because any amount of deceleration in job losses and reduc-

TABLE 4.8
International Comparison of Korean PSE (2007; USD millions, %)

	Korea	Japan	EU	US	Canada
PSE	25,461	35,230	134,317	32,663	7,001
Price Support	23,144	29,546	32,546	9,227	2,295
Fiscal Expenditure	2,317	5,636	101,772	23,436	4,706
PSE/Production (%)	60	45	26	10	18

Source: OECD, Agricultural Policies in OECD Countries 2008: At a Glance.
Note: Korean PSE in won billions: 1986, 8,290; 1990, 13,569; 2000, 21,726; 2007, 24,154.

tion in the BOP deficit in agriculture can be helpful, but to relieve the burden on the manufacturing sector and the economy as a whole. Since the diagnosis is similar to that of the services sector, the prescription is naturally also quite similar. Before we can understand the right prescription for services and agriculture, however, we need to understand how Korea succeeded in manufacturing and export of manufactured goods.

How Korea Succeeded in Manufacturing and Export of Goods

It is well known that Korea in the early 1960s differentiated itself from other developing countries by an *export-oriented development strategy dependent upon production factors borrowed from advanced countries*. It borrowed not only factors such as capital, machinery, raw materials and parts, and technology, but also marketing and managerial skills. Korea even borrowed the brands of companies of advanced countries, especially at the beginning stage of exports, paying royalties for that privilege. There may have been times when an excessive price was paid for such dependence, but the nation did not hesitate to rely upon others, whenever necessary, to catch up. This borrowing or dependence strategy goes hand in hand with the export-oriented strategy. To make quality products marketable in the world market, it is necessary to employ the highest level technologies, facilities, and brands, all of which might not be necessary to make products simply to meet domestic needs.

This export-oriented borrowing strategy was not only applied to light industries in the 1960s, but also to heavy and chemical industries during the 1970s. The cases of Hyundai Heavy Industry, which successfully obtained twelve very-large crude carrier (VLCC) orders even before it had constructed its first shipyard, and Hyundai Motors, which in 1975 began to export its first model, the Pony, are vivid examples. Countries much larger than Korea were generally less successful in pursuing the development of heavy and chemical industries because they were reluctant to depend upon other countries and were more focused on import substitution. Korea, on the other hand, had to depend upon foreign facilities and technologies from the beginning because it held no production factors, and it aimed to export from the start.

At the time, Korea had only land and labor to offer, and it received meager compensation for the production factors it provided. Korea's only source of comparative advantage was a well-educated and disciplined workforce. From the 1960s through the 1980s, the majority of the smartest youth attending university chose to study engineering—whether chemical, electrical and electronic, mechanical, shipbuilding, or metallurgical engineering—just as the government encouraged them to do. The students' choices turned out to be a surprisingly exact match with the mainstay industries of Korea since the 1990s—a prime example of human resources development deciding the future economic structure of a country.

The government provided support to the manufacturing sector in the form of financial and tax incentives until the mid-1980s, and thereafter in the form of human resources development and technology R&D. Government leadership in R&D activities played an increasingly important role as the industrial structure became technology-intensive. Public investments in human resources and technology development remained largely in the realm of manufacturing. In the area of intangible services, they were not very substantial until recently. The role of the government was also extremely important for SOCs; on this front, the Korean government has performed its role relatively well.

Another factor in Korea's economic success was, ironically, its early import liberalization; from the late 1970s, government economists began to emphasize the necessity of import liberalization as a measure necessary for price stabilization. To overcome strong objections from business circles, it is necessary to mobilize support from the general public and political circles, and price stabilization was the perfect justification. The Comprehensive Economic Stabilization Measures (April 1979) were the turning point away from a government-led, export-oriented development strategy to a market-led, open-door competition-encouraging strategy. The measures laid down the basic guidelines for the Korean economy to this day. In the late 1980s, import liberalization was almost complete for manufactured goods, while most agricultural products remained protected.

Even in the process of building its heavy and chemical industries (HCIs) in the early 1970s, Korea pursued exports from the outset. Korea's HCIs were not for import substitution as in many other countries. The existence of the Economic Planning Board (EPB), which consistently opposed protection and supported liberalization and price stabilization, was one important difference. The government urged companies to be prepared to export from the very beginning, and made it clear that protection, a synonym for import substitution, would not be available for a long time. Recall that Korea began HCI projects in the early 1970s and import liberalization in the late 1970s.

Even though Korea has succeeded by depending upon foreign production factors and by pursuing timely import liberalization, Korean businesses have predominantly preferred loans over direct investments in order to maintain control over themselves, and politicians, the public, and some government officials supported this approach. Even domestically, Korean businesses are very reluctant to induce investment. This resulting over-dependence on debt (domestic and foreign) was definitely the most important reason the Korean economy was so vulnerable to international financial turmoil as witnessed during the Asian financial crisis.

Finally, in my view, rivalry and competition among the *chaebŏl*, Korea's version of business conglomerates, proved useful as it in turn made the *chaebŏl* more competitive in the world market. In practice, this oligopolistic competition model seems more effective than the theoretically perfect competition among numerous small competitors. Theoreticians may object, but in reality we all know that size does matter, at least in most cases.

The Problem with Korea's Services and Agriculture

What, then, is wrong with the agriculture and services sectors? First, the players in these sectors are still very reluctant to rely upon others by inducing FDI to compensate for inadequate production factors. In principle, FDI is now "allowed" in all sectors in Korea. In reality, however, there are numerous regulations and obstacles to investment in services or agriculture in Korea. (In most other countries, FDI is something to be welcomed and induced, not just reluctantly allowed.) For example, investment in broadcasting and telecommunications is strictly limited, even for domestic investors. Hospitals and schools can be built and run only through donations, and, under strict regulations, loans—investment is simply not allowed. Most of these regulations are not especially intended to block FDI, since they are applied equally to domestic investors. But the end result is low performance in the inducement of FDI in the services sector.

Statistics show it is becoming increasingly difficult to induce FDI into Korea, not only in manufacturing but also in services. China has an indiscriminate appetite to induce FDIs, offers much better conditions for them, and shows a much more flexible approach to FDIs in services. Geographic proximity and a similarity in development strategy has placed Korea in direct competition with China in inducing FDIs. But many Koreans still worry about the possible loss of the domestic services market to foreign competitors.

Korean leaders must educate the people about a harsh reality: there is no need to worry that, by simply *allowing* them to invest in the country, foreign competitors will enter Korea's domestic market. To the contrary, we will have foreign competitors if and only if the nation does its best to succeed in inducing them.

In the case of agriculture, even investment or management by domestic capital and companies is still strictly regulated, a legacy from years past when agriculture was virtually the only source of wealth. The constitution of Korea still stipulates that only farmers can own agricultural land, suggesting that agriculture is strictly the domain of farmers. If Korea had, beginning in the early 1960s, attracted FDI, capital, technology, and managerial skills from advanced countries such as the Netherlands, Denmark, and France, Korean agriculture and its food processing industry would look very different—and much more successful—today.

To put it bluntly: the Korean agriculture and services sectors today are managed in the same way as China, India, and many other socialist countries managed their economies in the 1950s and 1960s.

Second, the players in these sectors still refuse to open their markets. They offer endless excuses: protection of infant industries, national security, food security, the public interest, cultural identity, social welfare, and so on. But does anyone really believe they are more concerned about these "patriotic" causes than merely making profit? These are simply excuses to avoid competition. Thus, among Korean services industries, only shippers and airlines, which, from the outset, had no choice but to compete with foreign companies, and hence to depend upon foreign equipment and technology, are competitive and efficient. But there are some other more recent examples: in July 1991 giant global retail distributors were allowed to enter the Korean market, a step that only made their Korean competitors stronger and eventually confident enough to attempt to move abroad themselves.

Third, the Korean market will never itself be large enough for world-class players. In other words, Korean companies can never become global players if they remain complacently active only in the domestic market. But services companies have not been eager to attempt to export their services or move abroad. Korea has quite a few manufacturing companies that successfully established themselves in the world market; in the services sector, however, there are none. In agriculture also, if Korea focused on capital- and technology-intensive products and injected appropriate production factors, instead of clinging to land- and labor-intensive items such as grain, Korea could have already become competitive in agriculture, in a much shorter period of time than was needed to build a globally competitive manufacturing industry.

Finally, in the good old days, services were regarded as non-tradables and, quite naturally, not exposed to competition from abroad. This is no longer true. As the cost of travel and communication gets lower—even negligible in case of the latter—many kinds of service businesses are increasingly exposed to foreign competition in the form of consumers' movements or services through information and communication technologies (ICT). On the domestic scene as well, the barriers which traditionally separated broadcasting from telecommunications are rapidly disappearing as ICT technology develops, and the established media's market predominance is evaporating.

Here we see the fastest and least costly path to additional economic growth and job creation in the services industry and agriculture. All we need to do is to be loyal to economic principles and benchmark what we have already done to nurture the manufacturing sector: deregulate and open markets to expose them to domestic and foreign competition; induce FDI to make up for missing production factors; encourage moves abroad; and remove discriminations unintentionally favoring the manufacturing sector against the services sector.

Changes Urgently Needed in Important Specific Sub-sectors

The first thing Korea needs to do is to completely end a number of built-in discriminations against the services industry. For example, most government support, such as tax exemptions and reductions, R&D subsidies, and preferential financing, are given only to small and medium enterprises (SMEs). Thus, being classified as an SME is the first step toward eligibility for government support. In this regard, services businesses were discriminated against because the criteria for their classification as SMEs were much tighter than those for manufacturers. The situation is now much improved, but until 2001 a company in some lines of service businesses with thirty or more permanent employees was regarded as a large company and thus denied benefits for SMEs, while all manufacturing companies with fewer than 300 employees were classified as SMEs.

Even today, services companies have to purchase electricity at a price 26.9 percent higher than the cost of its production, while manufacturers pay only the production cost; until 2001, the situation was even worse: manufacturers actually paid 10 percent less than the cost. This partial leveling of the playing field in 2001 was achieved after long effort. When I first raised this issue, the ministry in charge promised to end the remaining absurd disparity within three years, but the reform has been repeatedly postponed.

Offering real estate for factory construction is regarded as the strongest inducement the central and regional governments can extend to attract manufacturing investment, and accordingly Korea has numerous industrial estates. But I am unaware of a single local government that has ever offered business space in an effort to attract service businesses.

There are numerous other laws and practices that discriminate against the services sector, whether by design or by negligence. At the current pace, removing them will take far too many years. Since space does not permit a detailed sector-by-sector examination, I will below focus on the critical issues that urgently need to be addressed in key sectors.

Tourism, Recreation and Sports

Tourism and sports are fundamentally labor- and land-intensive businesses. Land in Korea is extremely scarce and expensive, indeed, sometimes not available at all, because almost no land there remains developable. Almost every hectare of land in the country is regulated to preserve and protect various public goods, including military facilities, agriculture, fisheries, forestry, cultural assets, and nature. In earlier days, rice paddies were sacrosanct, and thus the protection of agriculture offered the strongest justification against land development. Now, as the nation suffers from an oversupply of rice, the most vocal opposition to development comes from environmentalists. There are many other means to protect the public goods mentioned above, but in Korea there is an inexplicable, almost single-minded focus on land-use restrictions.

Governments, both central and local, have long sought to provide ready-made industrial sites to manufacturers at the cheapest possible prices, equipped with electricity, water, and sewage treatment facilities, and access to roads—even going to such lengths as constructing worker lodging for small factories. Although recently the government has repeatedly emphasized the priority of promoting services industries as a way to boost domestic demand, apparently no local government has ever offered land at low rent for use by entertainment and sports companies.

Korea is perhaps the only country where government is not seriously interested in helping investors secure the necessary land and business space for services businesses. Governments there have been concerned about the long-term, rapid rise in the price of real estate and, understandably, they have tried to keep land ownership by companies for business limited to a necessity level. But now sluggish investments have reduced or eliminated this worry, and even if land speculation remains a concern, governments can and should try to provide land or office space by lease instead of sales—providing real estate by lease is a good strategy to exclude speculators. The time has come for local governments to offer land and office space at negligible rent to attract recreation and knowledge-based services businesses.

Medical Care and Education

Medical care may be Korea's most promising services business. With a rapidly aging population and increasing personal income, Korea itself will likely see a very rapid growth in domestic demand for medical services. Moreover, within only a couple of hours by air, a vast demand exists in Japan and China for better medical services. (Like Korea, Japan and China have service sectors that are weak compared to their manufacturing sectors.) A lopsided flow of the best human resources into medical services since the 1980s and competition among hospitals for the newest and best medical facilities and equipment have made Korean hospitals extremely competitive.

The main obstacle to the growth of the Korean medical services sector is the popular attitude that medicine is a calling too noble to be governed and sullied by economic principles and the pursuit of profit. Thus, medical services in Korea are uniformly regulated by a single National Health Insurance System (NHIS).

The popular ideal in Korea is a perfect national health insurance system with equal coverage for all. Unfortunately, the pursuit of this ideal has stifled competition among hospitals to provide new and improved services. With all hospitals providing the same services, defined and priced by the NHIS, patients are left with only narrow choices. It is difficult for globally competitive hospitals to emerge and for advanced medical technologies to be developed. Wealthier Korean patients themselves travel to the United States for the finest care, and the idea of attracting large numbers of foreign patients to Korea remains a distant dream.

Korea's barring investments in hospitals and schools and universities is another problem. Capital for these may be raised only from donations and borrowing, because only non-profit corporations are allowed to run hospitals and schools. Investment in Korea is, by definition, for-profit. The issue, however, is not in fact about whether to allow profit-seeking by running hospitals and schools. Individuals with medical licenses can and do own and operate hospitals to earn money; and entrepreneurs are free to run private tutoring institutions for profit, as long as they do not hang out a signboard containing the word "school" in it. (In Korea, the term "school" may be used only by educational institutions under the strict control of the Ministry of Education. They have a legal monopoly on issuing "diplomas"—their only comparative advantage over private tutoring institutions.)

Indeed, tutoring companies are prospering in Korea in a competitive market, and students and parents rely on them more than schools. Meanwhile, public and private schools are stagnant under the pretense and self-deception that they guarantee equality of education. They have closed their eyes to the fact that, in 2007, they lost at least $50 billion to foreign competitors who attracted Korean students.

The non-profit corporation regulation is purely technical: it focuses on the means of raising capital and is not actually intended to prohibit profit-making by medical and educational institutions. However, internationally competitive hospitals and schools cannot be built with only simple supplies like stethoscopes and syringes, and chalk and blackboards. Millions of dollars are required to establish and operate world-class hospitals and universities. Unless the government deregulates and diversifies ways of capital funding for schools and hospitals, patients and students will continue seeking advanced care and education abroad, and Korea will lose substantial opportunities for economic growth and job creation.

Education must solve another problem if it is to convince well-to-do young people to remain in Korea instead of going abroad to study. The ideology of "equal education" has long stifled competition and choice in elementary and secondary education in Korea. The country's most vocal and influential teachers union has adamantly rejected proposals to evaluate students, because evaluations would naturally reveal the differences in performance among schools and teachers. The union firmly believes that evaluation and competition are not part of the educational system.

There have been numerous attempts to allow competition in at least a handful of schools, such as when the Ministry of Finance and the Economy (MOFE) provided the Ministry of Education (MOE) with 1.6 trillion won in the 2002 supplementary budget, in exchange for an agreement by the MOE to allow thirty independent private high schools—ones with greatly increased autonomy in the selection of their students and in decisions about their tuition and fees. The deal resulted with only six such schools.

Since that time further attempts have been repeatedly made, but the scope of these "reforms" has been so limited that they have not yet had any significant effect on competition with private tutoring institutions or on the number of students going abroad. Worse yet, some recently-elected superintendents of education in provincial elections, including those elected in Seoul and Gyeonggi (Kyŏnggi) provinces, are affiliated with the abovementioned union. Making domestic secondary education more attractive than foreign education and introducing competition and autonomy is sure to become even more difficult.

The last and desperate attempt by economic ministries to make a breakthrough on this front was a compromise: allowing foreign hospitals and schools to operate in limited areas in Korea, such as the Free Economic Zones (FEZs) and Jeju International Free City. Although enacted at the end of 2002, no significant success has been achieved. (I myself established the FEZs, and have to confess that I could not make them free enough to attract foreign investment in high-end services. I thought FEZs themselves, once established, and with regional governments hosting them, would fight for more freedom. But they did not.) In contrast, since the early 2000s, Singapore has been attracting foreign universities and schools not only for Singapore students but for all students in neighboring countries. Singapore now hosts INSEAD, Duke, MIT, and so on. This success neatly shows the difference of approach and way of thinking between the two countries.

Child Care and Social Services

Among the numerous needed institutional reforms in the services sector, especially in the realm of so-called social services, the most important are in the child care and broadcasting industries. Unfortunately, in the Korean government, oversight of these industries does not fall under economic ministries. Thus, economic factors are very often overwhelmed by social, and sometimes ideological, considerations. For example, fees for child care centers are still regulated and suppressed, limiting the development of child care services at a level far beneath the potential.

Telecommunications and Broadcasting

FDIs in the telecommunications and broadcasting industries are not very welcomed and are limited up to certain levels; this is because most consider the telecommunication industry to be important for national security and feel that the broadcasting industry should not be allowed to be run by foreign capitalists in order to protect the nation's cultural identity. This way of thinking might have made some sense when the wired telecommunication network was a natural monopoly and when there were only a few broadcasting stations because of technical reasons of electromagnetic wave availability. In this new world of smart communications and satellite and internet broadcasting, such arguments are meaningless. We need more deregulation with these industries.

Entertainment and Cultural Industries

Korean television dramas are now very popular in most Asian countries and Korean singers are well received, not only in Asia but also even in Western countries, signs that show it may be possible for Korea to develop various facets of its entertainment industry.

Many kinds of culturally-related businesses—including entertainment, design, and advertising—are based upon and derived from more pure forms of arts and culture. Government should nurture the arts not only for their own sake but also to enrich and strengthen the foundation of businesses that draw upon the arts.

The Korean government, like others around the world, is trying to do so, but mostly by supporting the suppliers of the arts. But nurturing the arts and cultural activities does not seem very effective in the face of low interest for them. Boosting demand for them would be far more efficient. For example, we need to encourage consumers to spend more on cultural products and performances and encourage schools to allocate more time to turn out more future music and art lovers, instead of giving subsidies and tax favors to suppliers of the arts. Support for suppliers usually spoils them, while nurturing demand can better help them.

High-tech and Greentech

There is little need to be concerned about Korea's high-tech and cleantech industries, because both the government and private sector are knowledgeable and quite capable in these areas. The great weakness of the Korean economy lies in its services and agriculture industries. People engaged in those sectors do not even understand the problems they face, much less know how to solve those problems. Policy efforts for those doing well tend to be redundant, and instead should be focused on those who are not able to solve their own problems. Korea is doing well on all other fronts, but if the nation cannot advance along these fronts as well, its economy will remain fettered.

Concluding Remarks and the Korea-US FTA Agreement

I have argued above that Korea needs development of its services industry to sustain necessary job creation and BOP management; that the success strategy of the manufacturing industry should be benchmarked by the agriculture and the services industries because of their dependence upon foreign advanced countries and enterprises to make up for a lack of production factors such as capital, technology, management skills, and brands; and that the Korean domestic market must be opened to enhance competition.

TABLE 4.9
Accumulated FDIs into and ODIs by Korea until 2010 (USD millions, %)

FDIs into Korea			ODIs by Korea		
Country	Amount	Share	Country	Amount	Share
United States	43,783	25.2	United States	32,760	20.1
Japan	25,975	15.0	China	31,861	19.5
Netherlands	20,034	11.5	Hong Kong	11,967	7.3
UK	10,699	6.2	Vietnam	6,772	4.1
Germany	9,242	5.3	Netherlands	6,109	3.7
Malaysia	7,152	4.1	Indonesia	4,871	2.9
Singapore	6,689	3.9	Bermuda	2,585	1.6
Total	173,584	100.0	Total	163,329	100.0

Source: KEXIM Overseas Economic Research Institute, Overseas Investment Statistics; Ministry of Knowledge Economy, Foreign Direct Investment Statistics.

In this context, I believe the best economic policy decision Korea has made since 2000 is its current pursuit of omnidirectional FTAs. When FTAs were first made with Chile, the EFTA (European Free Trade Association), and Singapore, Korea also underlined the possibility of increasing exports with its FTA partners. Since then, we have come to recognize that increasing exports is no longer the most important policy goal for Korea's economic well-being, but that opening markets and inducing FDIs for the development of high-end service businesses should instead be the priority.

Since then, Korea has begun to pursue FTAs with countries bigger, stronger, and more advanced than itself, and successfully concluded negotiations with very significant economic partners such as the United States, the European Union, India, and ASEAN. Negotiations with Japan have been halted and delayed, but we expect to begin formal negotiations with China quite soon.

We chose the United States and the EU as the first counterparts for meaningful FTAs because we thought they are the most advanced in services businesses. Even though the Japanese and Chinese markets can be more important for Korea, neither has an advanced services industry and hence we cannot expect very much to learn from them. The irony is that the United States, the champion of free trade and still the strongest in service businesses, has been hesitant in ratifying an FTA with Korea and, after four wasted years, has been overtaken by the EU.

Table 4.9 shows FDI into Korea as well as Korea's outward direct investment (ODI). The United States remains the number one investor in Korea and at the same time the number one destination for Korean investment abroad, even though both shares are on secular decline. This strong relationship in mutual investments is no less important than the trade relationship, and should be maintained as long as possible. The point of FTAs these days is not just to mutually increase exports, but to strengthen cross-investment.

Considering that China is now by far the Korea's largest economic partner, and has recently made an FTA with Taiwan, a strong Korean competitor, Korea will inevitably hasten to conclude an FTA with China. Will the United States and Japan be even further left behind on the FTA front?

Economic Globalization and Expatriate Labor in Korea[1]

Gi-Wook Shin and Joon Nak Choi

In recent years, South Korean policymakers and business leaders have been searching for new engines of economic growth in the services sector while at the same time trying to preserve South Korea's (hereafter simply Korea) engineering prowess. *Expatriate labor*, or "global talent" working in Korea, can be a solution for both problems. Academic research has long viewed expatriate labor as a key instrument for enhancing a country's economic competitiveness. As countries have followed this strategy, competition to recruit global talent has intensified (Kirkegaard 2007; McHale 2003).

Although Koreans are often seen as nationalistic and inward-looking, they view economic globalization as an instrument to be used to compete against other nation-states. Thus, despite their deep-rooted sense of ethnic homogeneity, Koreans have been surprisingly positive toward various globalization-driven policies intended to improve Korean competitiveness (Shin and Choi 2008). If expatriate labor is presented as such an instrument, Koreans are likely to embrace it.

This paper investigates two potential sources of skilled expatriate labor for the Korean domestic market: (1) foreigners studying at Korean universities for PhD degrees, as a source of global talent in engineering; and (2) second- and third-generation ethnic Koreans living overseas, as a source of top global talent in finance and general business.

We will first examine these groups' current situation in Korea, comparing and contrasting the Korean government's policies versus those adopted by four comparison cases. This comparison highlights potential ways to improve Korean policies. We conclude by summarizing these policy recommendations.

1 An extended version of this paper, entitled "Expatriate Labor in the Korean Market," was published by the Korea Research Institute for Vocational Education & Training (KRIVET) in 2010. A grant from KRIVET has aided this research and we are grateful to its president, Dr. Daebong Kwon, for his generous support.

Expatriate Labor Market

"Expatriate labor" includes a wide range of foreigners working in Korea, as categorized in Figure 5.1. Skills, national origin, experience and education create distinctions in this typology between the two main divisions of skilled labor, including service professionals and engineers, and unskilled labor, those who perform tasks commonly labelled as "3D"—dirty, dangerous and difficult.

The two population segments selected for this study—ethnic Koreans overseas, and foreign students studying in Korea—may potentially be tapped as sources of global talent. Unlike some other segments, these groups have yet to attract much research attention. Second- and third-generation Koreans living in advanced industrial societies face strong pressures to become skilled professionals. Although ethnic Korean parents once pushed their children to become engineers, they have recently started encouraging their children into the higher-prestige professions of law, medicine and business, with the result that many overseas Koreans have become top professionals in these fields. In contrast, the best foreign students in Korea are studying to become engineers. Policies consistent with these preferences will be more likely to be successful. For each group, we examine the status quo in Korea, in terms of the underlying situation and extant policies, and then compare it to four cases overseas to formulate policy recommendations for the Korean government.

Four countries that employ expatriate labor in different ways are examined in this study as comparison cases: Canada, the United States, Germany and Japan. Some (Canada and the United States) are multicultural "settler states" while others (Germany and Japan) are monocultural nations having a *jus sanguinis* basis for citizenship. In addition, some (Canada and Germany) are more aggressive than others (the United States and Japan) in recruiting skilled labor. The 2x2 typology in Figure 5.2 explains how these countries are similar to and/or different from Korea. While Japan is nearly identical to Korea on both dimensions, Canada is very different.

Foreign Science and Engineering Students in Korea

In recent years, manufacturing firms in Korea have had much difficulty recruiting research and development engineers. Table 5.1 shows that as of 2006 the manufacturing sector suffered a shortage of 2,545 MA and PhD holders, and 23,653 junior-college or college graduates.

Korea may attract foreign students to fill this gap like the United States, which has been fantastically successful in recruiting the most talented sci-

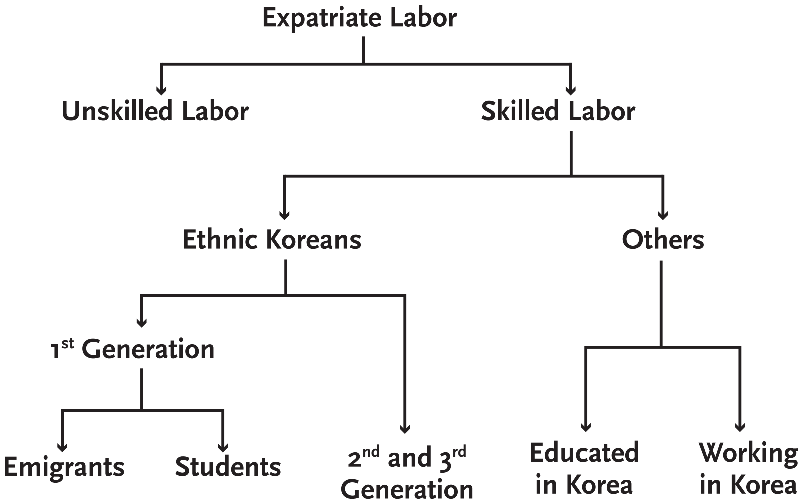

FIGURE 5.1 Typology of Expatriate Labor
Source: Authors.

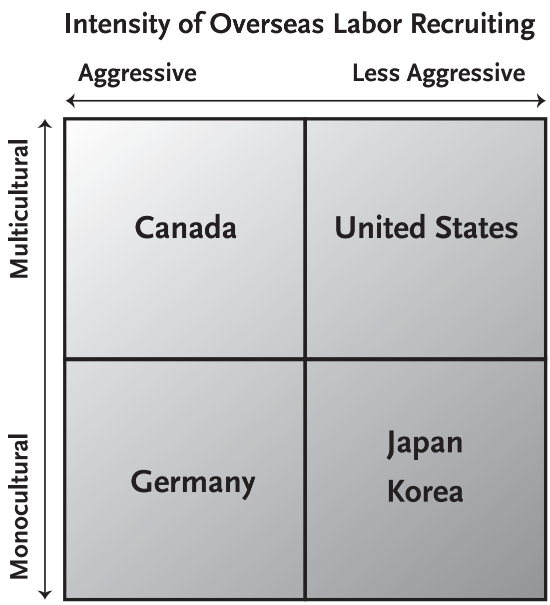

FIGURE 5.2 Comparable Cases
Source: Authors

TABLE 5.1

State of Industrial Technical Labor Market by Employee Educational Attainment

	2004		2005		2006	
	Currently employed	Labor shortage	Currently employed	Labor shortage	Currently employed	Labor shortage
MA & PhD holders	62,094	2,772	82,905	4,294	89,127	2,545
Associates Degree & BA holders	337,968	26,276	468,401	30,767	478,454	23,653

Source: Ministry of Knowledge Economy, "Report of Survey on the Demand and Supply of Industrial Technical Labor by Sector," 2008.

TABLE 5.2

Foreign Students Studying in Korea by Region of Origin and Field of Study

	Language Study	Humanities and Social Sciences	Science and Engineering	Natural Sciences	Physical Sciences	Subtotal	Others	Total
Asia	13,188	17,640	8,341	2,503	1,756	30,240	2,194	45,622
Africa	42	83	141	16	1	241	8	291
Oceania	26	29	36	7	10	82	34	142
N. America	472	291	383	78	66	818	402	1,692
S. America	56	87	70	8	7	172	12	240
Europe	400	192	254	30	27	503	380	1,283
Total	14,184	18,322	9,225	2,642	1,867	32,056	3,030	49,270

Source: Korean Educational Development Institute (KEDI) "Foreign Students Statistics in 2007," 2008.

TABLE 5.3
Foreign Students Studying in Korea by Country of Origin

	China	Japan	Vietnam	United States	Mongolia	Taiwan	Others	Total
Number of Students	33,650	3,854	2,242	1,388	1,309	1,047	5,780	49,270
Proportion of Total (%)	68.3	7.8	4.6	2.8	2.7	2.1	11.7	100

Source: Korean Educational Development Institute (KEDI), "Foreign Students Statistics in 2007," 2008.

ence and engineering students and keeping them as members of its labor force.

Current Situation in Korea

Korean universities attract many foreign students. The best Korean universities may rank below the most prestigious U.S. universities, but are competitive within Asia. As of 2007, there were a total of 49,270 foreign students studying in Korea, as indicated by the number of student visas issued by the Korean government (KEDI 2008). The vast majority (92.6 percent) have come from within Asia, as shown in Table 5.2. Table 5.3 reveals that Chinese students are the largest group, amounting to 68 percent of the Asian total. Although the humanities and social science disciplines attract the majority of Asian students, about 1 in 5 students seek degrees in science and engineering. The next largest group of students comes from North America, amongst whom only 383 students sought degrees in engineering and science fields.

For students from Asian countries pursuing postgraduate education, top engineering universities in Korea are said to provide a better research environment than their homelands. Korea has a highly organized system of scientific research, experiment-based training, and an established research network. Asian graduate students and researchers are now bringing along their families to enjoy the better life chances available in Korea. Yet, many return to their home countries—particularly to work for Korean multinational firms.

Current Policies in Korea

Improving the Quality of the Study Abroad Experience in Korea

Some institutions and government agencies have specific arrangements for attracting foreign students into Korea. For example, the Korea Institute of Science and Technology (KIST) established the International Research and Development Academy, which recruits highly-qualified foreign students and helps them pursue academic degrees while they conduct field-based research. The academy also provides students with tuition and fee waivers and living expenses, including lodging and food. As of July 2009, 98 students have joined the academy. This approach both trains foreign scientists and engineers and promotes collaboration for international scientific technology transfer.

The Ministry of Education has made arrangements for supporting foreign students studying engineering in Korea. Of special interest is the issuance of the "Science Card," a support system for foreign scientists that facilitates the immigration process into Korea. Since April 2002, 1,061 cards have been issued.

Although these measures help relieve the material or psychological costs of studying abroad, there needs to be a more comprehensive support framework for foreign students. Many are funded by their academic advisors or the managers of research projects they participate in. However, the administrative and legal procedures for sharing research outputs are not well established, causing conflicts between Korean researchers and their foreign students over publication authorship, other forms of credit, and the distribution of funds. Set procedures would help alleviate this problem. Also, qualified foreign researchers should be given opportunities for obtaining large-scale research projects on their own.

Attracting more foreign students

The Korean government has instituted the "Study in Korea Program," aimed at attracting foreign students to study engineering and the sciences in Korea. The program seems to be successful in increasing the number of foreign students, but the quality of these students has yet to come under close scrutiny. For instance, interviews with local experts suggest that many "students" in two-year programs (perhaps as high as 60 percent) are actually *working* in Korea in 3D-type jobs, using a student visa mainly for entry into Korea. Also, there appears to be a difference in the quality of foreign humanities and social science students in Korea (low) versus engineering and technical students (high) (Choi et al. 2008; Kim H. J. 2008).

Since around the turn of this century, the Korean government has put forward plans to recruit foreign students into engineering majors, out of concern that Korean students are reluctant to enter those fields and that the resulting shortage would decrease Korea's competitive edge in high-tech industries. According to the Ministry of Education, foreign graduates who have majored in engineering and sciences seek a seamless transition between their studies and employment in related jobs, without having to worry about visa problems. Recently, the Korean government proposed new plans allowing foreign students who achieved their degrees in humanities and social sciences to extend their stay in Korea for an additional two years after graduation. The government expects that this policy will recruit most talented foreign students into the business and producer services sectors, areas in which labor demand is expected to grow owing to the transition of the Korean economy into a service-based and knowledge-driven one (Korea's Delegate to OECD 2007).

Immigration policy

Immigration policies have been modified to ease the immigration process and aid foreigners in seeking employment opportunities. For instance, the Ministry of Justice has started to issue "Gold Cards" for technology professionals and "IT Cards" for information technology professionals (in addition to the Science Cards mentioned above) to recruit a highly skilled foreign workforce. Holders of these cards are guaranteed three years of unlimited entry and departure, as well as permission to hire household assistants. Foreign students in science majors have been added to this program, ensuring that there are enough specialized workers in Korea.

Many researchers emphasize that Korea's foreign labor policy, at its core, resembles that of Japan: it aims to recruit a high quality workforce, but to restrict the influx of low-skilled labor so that the latter does not impact the employment of domestic workers (Lee and Park 2005; Park 2008). These policies, however, are sometimes considered to be discriminatory against low-skilled foreign workers. This issue needs further consideration and debate. Table 5.4 shows the progress of Korean policies regarding foreign labor.

Best Practices in Other Countries

In recent years, many countries have emulated the U.S. Optional Practical Training (OPT) program, which allows foreign students a one-year work permit after graduation. Australia has made it easier for foreigners with local degrees to obtain permanent residency. Canada has made it easier for graduate students to work off campus, and has allowed them to stay after graduation. The United Kingdom expanded its one-year visa for graduates of science and engineering fields to cover all BA and MA recipients. France introduced a six-month renewable visa for current students to allow them to search for employment. The German government has provided one-year work permits for foreign students who receive a job offer (Kirkegaard 2007).

TABLE 5.4
Adoption of Foreign Labor and Related Institutional Changes

Year	Institutions	Details
1991	Adoption of the "Industrial and Technical Training Program" (ITTP)	Firms that made foreign direct investment were allowed to bring their local trainees into Korea.
1994	Adoption of the association-recommended ITTP	Small sized firms that made no FDI were allowed to accept foreign trainees as well.
1995	Regulation on the Protection and Management of Foreign Industrial and Technical Trainees	Trainees were covered under industrial accident remuneration insurance and health care insurance and protected partially by the Basic Standard of Labor Act.
2000	Adoption of the Industrial Training system	To mitigate problems with the ITTP, three-year training period was modified into two-year training and one-year employment.
2004	Adoption of the Work Permit system	The system adopted foreign laborers as workers, not trainees. Became effective with ITTP remaining valid .
2007	Abolition of the ITTP	Adoption of foreign labor was made possible only through the Work Permit system.

Source: Park 2008, 74.

United States

The United States has historically retained a large proportion of the science and engineering students it educates. Data from the National Science Foundation reveal that from 1988 to 1996 roughly two-thirds of foreign science and engineering PhD recipients planned to stay in the United States after graduation. While Chinese (86 percent) and Indian (79 percent) students were likely to stay in the United States, Korean (36 percent) and Taiwanese (48 percent) students were much more likely to leave. Students from these four Asian countries accounted for nearly 80 percent of all foreign recipients of science and engineering PhDs awarded in the United States. Kirkegaard (2007) expresses concern that as China and India increase their income levels, their students would increasingly resemble Korean and Taiwanese students, becoming more likely to return home.

The OPT program is the primary vehicle for retaining foreign graduates of U.S. universities. Foreign students enter the United States under the F-1 student visa, and all F-1 students graduating from U.S. universities have the option of taking a one-year OPT period of legal employment in the United States. Considering that the OPT is available for a minimal fee, while the main employer-sponsored work visa (H-1B) involves a petition process, most F-1 students remaining in the United States use the OPT for employment before transitioning to the H-1B. As of fiscal year 2008, approximately 70,000 individuals were undergoing OPT. These individuals are split between pre-completion OPT, which allows student employment in a field directly related to their program of study prior to graduation, and post-completion OPT (U.S. Citizenship and Immigration Services 2008). Historically, OPT duration has been limited to a total of 12 months, which could be split between pre- and post-completion OPT. However, the U.S. Department of Homeland Security (2008) recently implemented two changes designed to make it easier for employers to hire F-1 students. First, it extended OPT from 12 to 29 months for F-1 students with a degree in science, technology, engineering, or mathematics. Second, it automatically extended OPT for all F-1 students with pending H-1B (long-term working visa) petitions, eliminating the possibility that an F-1 student would have to return home despite having an employer-sponsored H-1B application currently in process.

Canada

More than 130,000 foreign students study in Canada every year, and like the United States, Canada has instituted a program designed to retain these students after graduation. This program offers work permits for students at certified four-year institutions. For students who study less than eight months in Canada, no permits are offered. Students who study eight months to two years are offered a work permit for a period no longer than the length of time of study. Students who study longer than two years are offered a three-year work permit (Citizenship and Immigration Canada 2009).

Germany

Germany is now allowing foreign graduates of its universities a one-year period to seek employment there. Citizens of long-standing EU states are automatically given an EC Long Term Residence Permit; citizens of new EU states, as well as non-EU countries, are granted one year after obtaining a university degree to find a job matching their qualifications. Students who obtain a job offer are then given residency permits (German Federal Ministry of Labour and Social Affairs 2009).

Japan

Unlike the other cases examined here, Japan does not appear to provide any special dispensation to foreign graduates of its universities. Students are simply urged to secure employment while still attending school, and file for a change-in-status from a student visa to a working visa before the expiration of the student visa (Ministry of Foreign Affairs of Japan 2009).

Summary

Many advanced industrialized countries have recently entered an “arms race” to retain foreign graduates of their universities. Most of these programs have been modeled on the U.S. OPT program, allowing students a limited amount of time to secure employment. The one exception is Japan, which appears to provide no such dispensation.

Policy Recommendations

Korea has followed the United States, Canada, Germany, the United Kingdom, and other advanced countries in streamlining the retention of foreign graduates of local universities by implementing an OPT-like program. However, the large perceived gap in quality between foreign science/technology and social science/humanities students may necessitate a re-evaluation of this policy.

A Restricted OPT-Like Program

Korea is now extending an OPT-like program towards all graduates of its universities and colleges. Immigration policies have been modified for the purpose of easing the immigration process (e.g., the IT and Gold Cards) and helping foreigners better seek employment opportunities. However, a universal OPT-like program may not be entirely applicable to Korea for two reasons.

First, there is a widespread perception that many foreign students at junior colleges are abusing their student visa statuses by working in 3D jobs. This perception cannot be checked against factual data, however, because this subject has not been researched in sufficient depth. If true, this phenomenon would necessitate a re-evaluation of the student visa program and would preclude an extension of an OPT-like program to junior college graduates.

Second, there is a widespread perception that foreign students at four-year universities majoring in the humanities and social sciences are inferior to those in engineering and the sciences. Again, this perception cannot be checked against factual evidence because of the lack of data. Regardless of the quality of these graduates, the fact remains that Korea is facing no shortages in humanities and social science professions—so this group would simply be competing with Korean university graduates.

Considering these two points, we recommend that an equivalent to the U.S. OPT be provided *primarily* for graduates of four-year educational institutions majoring in science- and engineering-related fields. Although the allegations made against junior college and humanities/social science majors cannot be verified against actual data, extending an OPT-like program to these individuals would create competition for Korean college graduates regardless of the foreigners' actual merit. In contrast, the documented shortages in top science and engineering labor make the retention of locally-educated "global talent" a viable task. Furthermore, there is a precedent for the differential treatment of science and engineering graduates; for instance, the United States grants technical graduates a much longer OPT program.

An Expanded Science Card

We also recommend that policymakers closely monitor the Science Card program. As of today, this program only has approximately 1,000 enrolled persons, so it cannot be properly evaluated. However, if it proves successful, it may be expanded to all individuals who qualify for OPT-like programs.

Expanded Support for Foreign Postdoctorates

We also recommend that the Ministry of Education collaborate with leading research universities to design and implement a postdoctoral fellow program aimed at retaining top PhDs in engineering and the sciences. Our research shows that Korea has an unambiguous need for engineering PhDs, and one of the best ways to retain foreign students with Korean PhDs would be to provide postdoctoral fellowships.

An ideal program would be funded and administered by the Ministry of Education, but awarded to top researchers at individual universities. Researchers who need research support would write competitive grants to the ministry, and the winning grants would receive the services of a qualified foreigner with a PhD from a Korean university.

A National Database on Foreign Students in Korea

Our most pressing policy recommendation is the creation of a comprehensive national database on foreign students in Korea. Such a database is critical because we cannot investigate key questions with existing data.

Existing databases, shown in Table 5.5, capture basic statistics on foreign students. However, they do not offer the data needed to ascertain how many former students are currently working in Korea, and what their career trajectories look like. As far as current data are concerned, the Korean Education Development Institute and the Ministry of Education provide statistics on foreign students by three major fields of study: humanities and social sciences; science and engineering; and arts and physical sciences. However, to be able to predict labor market supply and demand, very detailed statistics by specific fields of study are needed. The government must collaborate with academic institutions to conduct such research.

Ethnic Koreans in the Services Sector

Ethnic Koreans overseas, particularly the top global talent that has been nurtured and educated in host societies, could help enhance Korea's competitiveness in the service industries. Were these talented professionals to be recruited to Korea, they could help expand the service sector in Korea, creating entry-level professional services positions to be filled by Koreans graduating with university degrees.

Recruiting ethnic Koreans back to their ancestral homeland is based on the concept of *diasporic return*. As Cohen (1997) suggests, diasporas are drawn to their homelands in search of social identity and belonging, despite ties to adoptive homes. Such tendencies manifest themselves as "return migration." Sassen (1999) finds that there is considerable return migration; for instance, 60 percent of all Italians who left for the United States around 1900 eventually returned home.

Current Situation in Korea

As Table 5.6 shows, there are about seven million ethnic Koreans living around the globe. Over half of them reside in Asia, with China having 2.76 million and Japan 893,000. Outside Asia, North America hosts 2.34 million ethnic Koreans; most reside in the United States, with 825,000 having U.S. citizenship, 732,000 having permanent residency, and 459,000 holding educational visas and other short-term visas. Europe hosts the next largest number, with 645,000 ethnic Koreans. Of this number, 86 percent reside in the former Soviet Union, which created this diaspora through forced migration.[2]

As the children and grandchildren of Korean emigrants, second- and third-generation ethnic Koreans have become integrated into their host societies. In the United States, for instance, Asian-Americans are disproportionately over-represented among the wealthiest quintile of U.S. households (U.S. Census Bureau 2005). Korean-Americans have also achieved social integration, as evidenced by high intermarriage rates. Although ethnic Koreans in Japan have faced legal and social barriers to full integration, they have also achieved some degree of integration (Ryang 2000).

2 Large numbers of Koreans had fled the Japanese occupation to the Soviet Far East. During the 1930s, most of these individuals were relocated to Central Asia for political reasons.

TABLE 5.5

List of Databases Available for Expatriate Labor Policy

Data Set	Description	Government Agency and Available Data
Korean Statistical Information System	Collects nationally conducted surveys from various government agencies and provides detailed information statistics on population, immigration, labor, and education. Also available are the number of foreigners staying in Korea with various visas.	Ministry of Justice, Korean Immigration Service: "Statistics on Foreigners by Status of Sojourn (1992–2008)." Ministry of Public Administration and Security: "Foreign Residents by Provinces and Local Governments (2006–2008)"; "Basic Survey of Nationwide Foreign Residents (2006–2008)."
National Science and Technological Information System (NTIS)	Provides information on highly educated personnel who studied in Korean universities and those who are pursuing their academic or professional careers in research institutes or educational institutions. Also available are the size of entering college cohorts by field of major, and forecast of labor demand and supply in engineering and science fields.	Ministry of Education, Science, and Technology: "Survey of Current Situation of Science & Engineering Labor. (2008)" Ministry of Education, Science, and Technology and Korean Institute of Science and Technology Evaluation: "White Paper of Science and Technological Statistics. (2009)"
Employment Permit System	Provides general introduction of employment permit system and also statistical resources for policy and educational services. Number of foreign workers residing in Korea with various status are available. However, no detailed information is given about foreign workers in terms of their job-seeking behavior or careers.	
E-nara Index	Provides current situations of South Korea in social, economic, political, and cultural aspects using high quality data collected by government agencies. Provides not only government-acknowledged data but secondary data of administrative resources or predictions. Allows changes due to government policy using time-series data, and provides easy tools for graphically presenting outputs.	Ministry of Labor. "Currents of Foreign Laborer Employment-General and Ethnic Koreans) Ministry of Justice, "Annual Statistics of Immigration Service." Ministry of Foreign Affairs and Trade, "Report of Foreign Residency."
Foreign Students Statistics	Data collected by Korea Educational Development Institute March–August 2008 and released November 2008. Data subjects: foreign students enrolled or registered as of survey period.	Ministry of Education, Science, and Technology: Number of Foreign Students Residing in Korea by Institution, Country of Origin, Type of Education, Year
Overseas Koreans	Data surveyed and released July 2009; collected by overseas diplomatic offices (embassies, consulates, branch offices) by examining residency reports of overseas Koreans, issuance of passports, reports of local associations of overseas Koreans	Ministry of Foreign Affairs and Trade: Statistics of Overseas Ethnic Koreans (by Size and Purpose of Residence; Annual Change in Number)

Source: Authors.

TABLE 5.6

Overseas Korean Populations by Status of Sojourn, 2007

Region	Country	Citizens	Residents	Sojourners		Total
				General	Students	
Total		4,047,934	1,451,346	1,211,148	334,288	7,044,716
Asia	Total	2,577,953	546,919	751,288	164,216	4,040,376
	Japan	*296,168	499,553	80,530	17,489	893,740
	China	**2,244,398	3,112	438,238	76,412	2,762,160
	Others	37,387	44,254	232,520	70,315	384,476
The Americas	Total	938,650	878,696	396,439	127,378	2,341,163
	United States	825,420	732,329	354,031	105,131	2,016,911
	Canada	95,062	78,497	21,536	21,533	216,628
	Central and South America	18,168	67,870	20,872	714	107,624
Europe	Total	531,062	24,456	47,981	41,753	645,252
	Confederation of Independent States (CIS)	518,437	3,342	9,052	3,145	553,976
	Continental Europe	12,625	21,114	38,929	38,608	111,276
Mideast	Total	82	15	9,139	204	9,440
Africa	Total	187	1,260	6,301	737	8,485

Source: Ministry of Foreign Affairs and Trade, "Overseas Koreans," available at Korean.net. Downloaded on August 5, 2009.

Notes: * Figure represents total of Korean-Japanese who naturalized into Japan during 1952–2005 including those with North Korean nationality. Statistics are drawn from the Ministry of Justice.
** A total of 1,923,800 Korean Chinese with Chinese nationality were reported to be living in China by Chinese Census 2000.

Despite such integration, many ethnic Koreans are attracted to their ancestral homeland. This attraction has been encouraged by government policies like the F-4 visa, a permanent residency visa giving former Korean citizens and their children unrestricted access to Korean jobs and services (Ministry of Justice 2008). As of 2008, 37,740 overseas Koreans lived in Seoul under the F-4 visa program.

Many young Korean-Americans work in Korea for substantial periods of time. For instance, many Korean-American graduates of top educational institutions spend some time working in Korea, especially in English language education and related activities. Anecdotal evidence suggests that these individuals go to Korea partly in search of their ethnic identities and partly to enjoy the vibrant lifestyle. After a few years in Korea, however, these individuals typically return to their adopted homelands to pursue professional careers.

Second- and third-generation ethnic Koreans, particularly from the United States and Japan, are one of the two focal points of this chapter.

Current policies recognize that many young Korean-Americans and other ethnic Koreans return to Korea for short periods of time. However, little research has been done to assess this group's potential as a source of skilled labor. Korean-Americans living in Korea often have degrees from some of the best universities in the world, giving them the chance to become highly-skilled professionals. Indeed, many of them return "home" to the United States to become doctors, lawyers, scientists, businessmen, and financiers. Yet, few choose to settle permanently in Korea. The challenge is to create an environment that encourages second- and third-generation ethnic Koreans to become professionals in Korea, instead of heading back "home."

Current Policies in Korea

In light of globalization and transnational migration, the concept of citizenship or "nationality" has come under scrutiny in many countries (Sassen 1999).

Korea has been no exception; in recent years, Korean policymakers have debated extending dual citizenship to overseas Koreans. The debate has been spurred more by Korean domestic politics than the actual needs of overseas Koreans beyond the first generation—presumably the ones who would be served by the new policies. As some experts argue, dual citizenship is peripheral to expatriate labor policy: because Korean immigration policy is *already* hospitable to second- and third-generation ethnic Koreans, few care if they can actually obtain Korean citizenship. The existing F-4 "permanent resident" visa provides its holders nearly all of the benefits of citizenship, without mandatory military service. If any immigration policy refinements are needed, it might be to change the duration of the F-4 from the current two-year period to five or ten years, to encourage more ethnic Koreans overseas to obtain and maintain the F-4 status.

The debate has intensified since the Lee Myung-Bak administration proposed the new First Basic Plan for Immigration Policy, to be put into effect from 2008 to 2012. The plan calls for: (1) the recruitment of high-quality personnel to advance technological innovation and high value-added tasks; (2) the granting of permanent residency to technicians whose skills fill specific labor shortages; (3) the provision of consumer-centered support services (e.g., schools, local cultural centers, social welfare facilities, and civic organizations) by local governments; (4) the allowance of dual citizenship for Korean citizens eligible for foreign citizenship because they were born overseas, as well as for specific types of global talent; and (5) the provision of social integration programs for marriage migrant women (Kim E. M. 2009).

Global competitiveness also figures into expatriate labor policy. Many

Korean politicians and scholars emphasize the need to invest in a globally-competitive labor force to continue Korea's economic growth. This argument resonates with the need to import high-skilled expatriate labor. So far, a consensus exists that Korea should "follow up" on these ideas, but nothing stronger has been proposed. In line with this argument, overseas ethnic Koreans can potentially serve as global talent in major segments of the economy, mainly in business and customer services. Medicine, law, finance, business, and engineering appear to be particularly conducive to global talent.

Best Practices in Other Countries

Germany and Japan are the most relevant comparative cases here. Like Korea, both have had *jus sanguinis* views on nationality. In contrast, Canada and the United States are both multi-ethnic settler societies that cannot have "returnees" based on *jus sanguinis*.

Germany

Germany has experienced two waves of returnee migration: the first wave of returnees has been very successfully reintegrated into German society; however, a second wave, in the years following the fall of the Berlin Wall, has not integrated as well.

The social integration of ethnic Germans into West Germany was initially extremely successful. West Germany's Basic Law, in Article 116 (1), included refugees or expellees of German origin amongst the definition of a "German." "Expellees" only had to originate from a communist country to be labeled a "resettler" meriting residency, and eventually citizenship, in Germany. Many of these individuals had ancestors who had left "Germany" as long as eight centuries ago (Joppke 2005). From 1945 to 1987, 1.6 million "ethnic Germans" entered West Germany. They quickly blended into the native population and ethnic German returnees from that era became socially indistinguishable (Bommes 2006).

An additional 1.6 million returnees, arriving after the fall of the Berlin Wall, have had a different experience. Initially treated no differently from earlier returnees, the new wave was gradually stripped of its special status. Although the German government had originally allowed ethnic Germans to enter without restrictions, it responded to the increasing volume of immigration by restricting annual inflows to 220,000 per year. Furthermore, it amended citizenship laws in 1990, 1993 and 1999 to allow non-German migrants and their children access to German citizenship, weakening the *jus sanguinis* basis for citizenship. The new wave returnees have a much higher unemployment rate than natives, even if it is lower compared to most non-EU immigrant populations in Germany. Overall, ethnic Germans immigrants have been transformed into "normal" immigrants (Bommes 2006).

Opposing "liberal" and "restrictive" forces have both contributed to this change. Liberal politicians decried the hypocrisy of Germany's refusal to assimilate its Turkish population while providing special privileges to individuals of dubious ethnic German background. Meanwhile, conservative politicians took advantage of a worsening economy, with mass unemployment and decreasing welfare benefits, to attack generous resettler benefits. These conflicting forces resulted in regulations that reduced ethnic German immigration (Joppke 2005). Following the 2005 reforms, Germany ceased making special provisions for ethnic Germans.

The German experience represents a cautionary tale for Korea. On one hand, the first wave of return migration was highly successful, buoyed by a cultural environment welcoming even those "returnees" who had little in common with their ancestral "homeland," and by West Germany's postwar re-industrialization. On the other hand, the second wave was less successful, perhaps because of the weakened *jus sanguinis* basis for citizenship, or because West Germany's reunification with East Germany had created a large pool of surplus labor. Either way, the German experience shows that diasporic return is most successful when it meets a demand for labor and is supported by appropriate institutional frameworks for second and third-generation returnees.

Japan

Japan is perhaps the closest analogue to Korea, not only as an East Asian society that shares many cultural elements, but also as a monocultural society that has typically not recruited foreign labor. The recruitment of overseas ethnic Japanese, however, represents one key exception.

Much like Korea, Japan has a large diaspora created through outbound emigration. From 1885 to 1923, half a million Japanese left for reasons that included poverty, unemployment, over-population, and heavy taxes. Although emigration had been prohibited during the Tokugawa period, emigration companies received official sanction in 1890. However, Japanese immigrants soon became unwelcome in most host countries. An exception was Brazil. Facing a shortage of labor after the curtailment of the Atlantic slave trade in 1850, large coffee planters, later joined by the São Paulo state government, encouraged European immigration. They instituted a contract labor system where they paid for partial passage to Brazil, transportation to São Paulo, lodging and food while a job was arranged, and transportation to the place of employment. These measures created intense immigration, with 1.6 million Europeans arriving in Brazil from 1880 through 1900. Brazilian employers, however, soon obtained a reputation for mistreating their workers, resulting in the Italian, French and Spanish governments forbidding emigration there. While Chinese immigration was considered unacceptable on racist grounds, Japan had gained prestige after its victory in the Russo-Japanese War, so Brazil turned to importing Japanese. By 1940, there were 205,000 Japanese and Japanese descendants in Brazil, constituting 0.5 percent of the Brazilian population (de Carvalho 2003). In 2000, the Brazilian Institute of Geography and Statistics estimated that there were 1.4 million ethnic Japanese in the nation, with 28 percent having some mixed, non-Japanese ancestry.

In the 1970s, Japan began recruiting Japanese-Brazilian labor in large numbers. The economic expansion of the era created shortages in unskilled labor and despite being prohibited by law, foreign workers, particularly from Asia, were used to alleviate labor shortages. Recognizing this situation, the Japanese government amended the Immigration Control and Refugee Recognition Law in 1989, with four major provisions: (1) the number of foreign professionals and skilled workers allowed to work in Japan increased from 18 to 28 categories; (2) Japanese descendants up to the third generation, along with their spouses, were permitted entry for an indefinite period; (3) sanctions on illegal workers were intensified; and (4) an on-the-job training program was recognized under certain conditions. Because these amendments favored returnees of Japanese descent (the *dekasegi*), the number of South Americans coming to Japan skyrocketed from 88,201 in 1991 to 274,442 in 1998. 81 percent of these individuals were Brazilian. *Dekasegi* are recruited through several channels: Japanese and Brazilian job-brokering agencies (the most popular option), directly by companies (about 35 percent of the whole), or by networks of friends and relatives working in Japan (de Carvalho 2003).

The *dekasegi* migrate to Japan for economic and identity-related reasons. The most common aspiration is to buy a house and start a business. Other motivations include experiencing life in a developed country, acquainting themselves with the land of their ancestors, meeting relatives, and learning about Japanese culture. The *dekasegi* emphasize the positives of their experience, encouraging others to follow in their footsteps. Although most intend to return to Brazil after a few years, some experts believe it inevitable that many *dekasegi* will bring their families to join them in Japan and settle there (see de Carvalho 2003).

The overwhelming majority of *dekasegi* are in their twenties and thirties, and are from the second or third generations; half of them have attended secondary school, and 25 percent have university degrees. While many previously worked in white-collar jobs, the majority in 1993 (51 percent) worked in manufacturing, with 25 percent in construction and 13 percent in service industries. Available data indicates that *dekasegi* income and working conditions are similar to that of their Japanese peers (de Carvalho 2003).

Available evidence and academic research suggest that the *dekasegi*, contrary to accounts in the popular media, experience little discrimination in Japan. For instance, very few *dekasegi* interviewed by de Carvalho (2003) had actually experienced discrimination in Japan; on the contrary, they tended to think that the Japanese had a good opinion of them. De Carvalho suggests that discrimination, if any, comes from the *dekasegi*'s concentration in low-prestige jobs, not their origin: the Japanese concept of national identity is tied to Japanese "blood." Yet, research suggests that mutual contact between the Japanese and the *dekasegi* has led to an assertion of mutual differences (de Carvalho 2003). The *dekasegi* are dissatisfied about being called "Japanese" in Brazil and "Brazilian" in Japan. They have been organizing discussions to change this status, despite the Japanese government officially recognizing as "Japanese" only those who emigrated in the past three generations (Stanlaw 2004).

The *dekasegi* enter Japan through a variety of visas, including the working visa category. They also have a special claim on two visa categories: the Long-Term Resident category within Specified Visas, and being the child of a Japanese citizen.

Policy Recommendations

The current regulations governing the return of second- and third-generation ethnic Koreans appear an excellent foundation for recruiting the top global talent in the service sector. These regulations are comparable to the Japanese treatment of the *dekasegi* and are superior to current German regulations. However, some issues remain to be resolved: (1) the small proportion of eligible overseas Koreans who have obtained the F-4 visa; and (2) the lack of institutional mechanisms that match the needs of the Korean economy with the appropriate overseas Koreans.

Increase the Duration of the F-4 Visa

The current F-4 visa fits the needs of ethnic Koreans in the United States, Japan, and other advanced countries. Allowing return migrants unfettered access to employment and residency, this visa serves as an excellent foundation for policies designed to recruit the top global talent amongst overseas ethnic Koreans.

Yet only a miniscule proportion of eligible overseas ethnic Koreans actually hold the F-4 visa—just 45,384 amongst the nearly three million ethnic Koreans in Japan and the United States, according to the Korea Immigration Service as of June 2009. This is largely because the F-4 is designed for ethnic Koreans *actually residing in Korea*, instead of those *potentially returning* to Korea. For the F-4 to be used for the recruitment of elite professionals instead of as a convenience tool for individuals already coming to Korea, we recommend that the F-4 be reconceptualized as a visa for any ethnic Korean residing overseas in an advanced country.

Although this reconceptualization would occur in several steps, a first step would be to increase the duration of the F-4 from the current two-year period to five or ten years. Currently, ethnic Koreans who obtain the F-4 visa but end up leaving the country cannot renew the visa—even though it is easily renewed in a domestic immigration office.[3] If the duration of the visa were increased, ethnic Koreans who end up leaving Korea can more easily return. As individuals who have already spent time in Korea are the ones most likely to return, this policy would have maximum impact without disrupting the current policy framework.

The extension of the F-4 is consistent with the recommendations in *Vision for Society 2030* (Presidential Commission on Policy Planning 2006) which suggest that Korea simplify visa application and immigration policies for non-ethnic Korean global talent.[4] The Commission's recommendations focus on the permanent residency and Special Occupations (E-7) visas. For ethnic Koreans, however, the F-4 would be a more efficient vehicle, as applicants would simply need to prove their Korean ethnicity, rather than having to establish permanent residency via long-term sojourns, or provide evidence of their "special talents."

Construct a Systematic Recruiting Framework

We also recommend that the government partner with quasi-governmental organizations, such as the Korea Trade-Investment Promotion Agency

3 The renewal process has become increasingly streamlined. As recently as 2007, F-4 renewal required two separate trips to an immigration office, separated by a week's worth of processing time. F-4 renewal now requires a single trip and only 15 minutes of processing time.

4 Note that the Presidential Commission on National Competitiveness (PCNC) confines the categories of "global talent" to those with visa status of E1 (Professorship)–E7 (Special Occupation) with the exception of E6 (Arts & Performance) and D8 (Corporate Investment), according to the Immigration Enforcement Ordinance. This contrasts with our categorization of global talent and skilled labor, according to which the latter corresponds closely to the PCNC's global talent category.

(KOTRA), as well as industry organizations like the Federation of Korean Industries, to construct a cohesive system designed to match overseas Koreans with specific needs.

The Korean government already runs "Contact Korea," a special-purpose agency under KOTRA, providing job placement consultation for foreign workers and assisting foreigners with immigration procedures in collaboration with the Ministries of Justice and Labor. In addition, *Vision for Society 2030* proposes to introduce a "visa nominator" system whereby the overseas offices of Korean public agencies, trade agencies, and large Korean corporations are allowed to nominate specific foreigners for visas via HuNet Korea, an online visa nomination and review system. We strongly support these policy propositions, not only for non-ethnic Koreans, but also for the purposes of return migration.

We note that such policies are most likely to be most effective in the financial services and general business fields. Overseas ethnic Koreans can potentially serve as global talent in five occupations: engineering, medicine, law, finance and general management/business. Of these professions, engineering, medicine and law do not represent promising opportunities for recruiting overseas Koreans. Increasingly few Korean-Americans and Korean-Japanese consider engineering a desirable occupation; rather, they are drawn to medicine and law. However, Korean professional associations in medicine and law have strongly opposed the domestic recognition of professional credentials awarded overseas. No such barriers are present in financial services and general business fields—especially since top overseas Koreans can help domestic industries become more competitive and create new jobs for Korean university graduates.

Enhance Data Collection

Our final policy recommendation is to create two national databases: one of overseas ethnic Koreans, and another of global talent positions that need to be filled amongst Korean businesses. The task is not only to facilitate the matching of skilled ethnic Koreans with suitable and open positions in Korea—but also to generate data that will suggest future policy improvements.

Extant databases relating to this issue have major limitations, summarized earlier in Table 5.5.

The Korean Statistical Information System and the Employment Permit System provide basic immigration statistics, but give few details on the life histories of overseas Koreans. Specifically, they provide no details on the reasons why ethnic Koreans return to Korea—beyond the general type of visa issued—and no data at all on the reasons why they leave. More generally, the "Overseas Koreans" report provides basic statistics for all overseas Koreans, without examining their current conditions, specific expertise, and level of education. Additionally, these databases have yet to compile a list of jobs that are suitable for overseas Koreans, like the Japanese have done with the *dekasegi*.

Given the current state of these databases, we recommend data collection efforts. First, gaps in demand of and supply for professionals and skilled labor should be forecast, especially in producer and customer service sectors like finance, accounting, corporate law, consulting, and engineering and the sciences. Second, this system should be integrated with HuNet Korea, matching specific candidates with specific job needs.

Beyond these suggestions, valid for *all* expatriate labor, a more specific database should focus on the needs of Koreans living abroad—why they would (or would not) return to Korea, what their skills are, and what their needs might be. Specifically, government agencies should collect data on the number of second- and third- generation ethnic Koreans who reside overseas, and the skills they possess. Another urgent task is to identify ethnic Koreans with highly valuable skills who already have jobs in Korea and to assist them in building up their careers. A nationwide survey may be conducted for this purpose. Finally, additional research should focus on current F-4 holders, especially on the reasons why they would leave Korea. Beyond this, we recommend research on the life histories of overseas Koreans in general, and the ones currently residing in Korea in specific. Overseas Koreans entering Korea, as identified by specific visa categories, could be asked to fill out a short description (one or two lines) why they are entering Korea. On their departure, they could be asked the same.

Conclusion

Our investigations reveal that the Korean economy would benefit by utilizing global talent in two distinct fields. Korea would benefit from an enlarged talent pool within the service sector, especially in finance and general business management, to fulfill its ambitions of becoming a financial and business hub. Korea would also benefit from renewing its engineering talent so it can maintain its traditional strengths in manufacturing and design.

Our investigations have also uncovered potential sources for each type of labor. On one hand, the top global talent in business and finance could be recruited from the millions of second- and third-generation ethnic Koreans living primarily in the United States and Japan. Korea already has a substantial institutional infrastructure for such recruitment, and compares favorably to two roughly comparable cases, Japan and Germany. On the other hand, global talent in engineering could be recruited from the foreign students who are studying at top universities in Korea. Although Korea should institute something like the U.S. Optional Training Program, care should be taken to distinguish truly qualified foreign students from others.

Our most pressing recommendation is to collect data more systematically, especially on the life-courses of ethnic Koreans overseas as well as foreign students in Korea. Both groups have some attachment to Korea, and could potentially fit into Korean society. However, there is much we have yet to learn about these potential future Koreans.

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