

**Bankers Trust
Company**  **Country
Assessment**

International Economics

280 Park Avenue, New York, N.Y. 10017 U.S.A.

SOUTH KOREA AT CHUN'S MID TERM

William H. Overholt

Vice President
Political Assessment Group
PAG 163/2-D 06 September 1983

DRAFT

This is a working document and is not in final form; the statements contained in it may need to be revised or corrected. It is reproduced for private circulation only, not for general distribution or publication, and it should not be cited or quoted without the permission of the author.

Drafts are reproduced at the discretion of the author, with no Bank review procedure, and thus no opinions, statements of fact, or conclusions contained in this document can be attributed to the Bank or its clients.

SOUTH KOREA AT CHUN'S MID TERM

South Korea possesses some of the third world's soundest government, military, and business institutions. The sound, efficient, and relatively non-political nature of the principal government ministries and the principal business institutions of South Korean society ensures a large measure of continuity even in the face of political successions and extraordinary adaptability in the face of economic and international crises.

The South Korean economy has performed spectacularly well during normal times during the last generation and has done remarkably well during such recent crises as the post-1973 oil price rise, the 1975 recession, and the recent recession and global financial crisis. At a time when most of the developed and developing countries alike were hardly growing at all, South Korea grew 6.4 percent in 1981, 5.4 percent in 1982, and is, according to Korea Development Institute (KDI) estimates, likely to grow 8 percent in real terms during 1983. For the first quarter of 1983, the GNP was 9.3 percent larger than in the first quarter of 1982. Wholesale price inflation for 1983 is running 1-2 percent and consumer price inflation is running 3-4 percent. KDI believes that a zero rate of inflation is possible for 1984. KDI estimates that, if the world economy were to resume growing at a rate of 3 percent and world trade at 4 percent, then South Korean growth could easily average 8 percent annually over the next five years with full price stability. These estimates seem reasonable, and KDI's track record in making such estimates is among the best in the third world.

The Korean government has undertaken a major reform of the economy, which began in 1981 and continues until today. It is instituting anti-monopoly laws patterned after U.S. anti-trust law. It has denationalized the major commercial banks and sold all government-held stock in the leading five commercial banks. The government is phasing out preferential tax and interest rate treatment for "strategic" industries and moving toward a situation in which all firms must compete on their own merits. It is liberalizing import restrictions, with 76 percent of imports now free of tariffs, more than 80 percent planned to be free of tariffs within a few months, and a standard of import liberalization similar to that of the OECD countries slated for the mid-1980s, despite a global trend toward protectionism. Such policies are 10 years ahead of Japan. It has liberalized direct foreign investment, allowing for 100 percent foreign ownership in some sectors and permitting foreign investments as small as \$100,000. The government has stated an intention to move from a "positive list" system (where investments are allowed only in designated sectors) to a "negative list" system (in which investments are allowed in all sectors except those specifically designated). It is gradually opening capital markets to foreign participation. These policies are impressive in the face of political and economic pressures which are propelling most of the world in an opposite direction. Because of such reforms, South Korea is making rapid progress in economic adjustment despite a period of slower growth and relative austerity. At the same time, actual practice lags far behind stated policy, for political reasons analyzed below.

Financial Position. In this context of institutional efficiency, institutional stability, economic growth, and economic adjustment, South Korea's combined short term and medium term debt amount to about half of Brazil's, while its exports are roughly the same size as Brazil's. In normal times therefore, South Korea would present very little financial risk. However, in extraordinarily nervous international financial markets, one must examine carefully whether South Korea might encounter domestic political or international political shocks might suddenly threaten its ability to maintain and service its short term debt, which amounts to about \$10 billion out of the total \$40 billion. There are four problems, two domestic and two international, which need to be considered.

Domestic Politics. President Chun is now roughly at mid term. His first bid for power emerged on December 12, 1979 and his term of office runs until 1987. Chun's emergence squelched a brief period of democratic euphoria and was punctuated by a major social uprising in the southern province of Kwangju which was thoroughly suppressed at a cost of several hundred lives. Chun incarcerated large numbers of people, deprived hundreds of figures of their political rights, and banished from politics the leading civilian candidates for the presidency: Kim Dae Jung, Kim Jong Pil, and Kim Young Sam. Chun emerged from 1980 as a political leader who was disliked, but was able to command obedience. His success in restoring growth from the minus five or six percent of 1980 to the positive six percent rate of 1981-82 and to the higher rate of 1983 has created grudging respect. Similarly, his ability to limit the most dangerous kinds of student activism by infiltrating up to six hundred agents within the student body of a single university campus, and his ability to monitor and control the activities of military and civilian organizations alike through wide-ranging use of the Defense Security Command have ensured acquiescence in his rule.

His leadership position was briefly threatened in the spring of 1982 by a billion dollar curb market financial scandal which destroyed the credibility of Chun's moral revitalization campaign. However, when Chun cracked down on his relatives, most notably an uncle-in-law, who were involved in the scandal and removed other relatives from high government offices, this problem was ameliorated.

Thus, Chun has been economically and politically effective. Moreover, as noted below, he has some extraordinary diplomatic accomplishments to his credit. However, his legitimacy -- that is, the popular sense that his rule is just and deserved -- rests exclusively on what is popularly perceived as relatively modest economic success and, most importantly, on his promise to be a one-term president. Koreans cannot remember any peaceful succession in their long national history and therefore regard Chun's promise to step down after 1987 as very important. In the absence of widespread elite and popular acceptance of his legitimacy, President Chun must rely on his highly efficient infiltration of the students, penetration of all military units by the Defense Security Command, enforced fragmentation of labor unions, and other organizational techniques to maintain stability, rather than being able to rely as a matter of course on willingness to comply with government policy.

In this context, Chun has extraordinary problems with his own governmental elite. His style is that of a commanding general who does not like take advice from his subordinates. Chun does not even make a diplomatic pretense of listening to advice. He responds to problems, such as the curb scandal, by shuffling the cabinet and replacing key Blue House advisors. A government minister typically lasts about one year. The key Blue House advisory positions have had three occupants in 2.5 years. Since the replacement of General Her Hwa Pyong and General Her Sam Su, following strong advice from them regarding policy toward his family members in the curb market scandal, Blue House has been run by yes men. Cabinet ministers, military people, and Blue House advisors alike are afraid to act or to suggest ideas. Many ministries actively oppose presidential policies, notably liberalization of the economy. Actual decisions no longer accurately reflect the economic reform policies outlined above. The degree of isolation is perhaps greater than that of Park Chung Hee as he approached the end of his career in 1979. The divergence of actual decisions from official policy is unparalleled in Korean policy of the 1960s and 1970s.

Complicating this problem is President Chun's lack of a long-term political strategy. He has promised the nation a peaceful succession after 1987 and an enhancement of democracy. However, his actual policies have evolved less in response to such a long range vision than in response to immediate problems. His heavy dependence on KCIA infiltration of the student body to limit student unrest, on the Defense Security Command to limit potential military dissidents, and on a Polish approach to workers which limits unions to single factories is in fact more repressive than the situation under Park Chung Hee. This repression ensures continued crises to which the government will respond with even more divide and rule tactics. In such a situation, it is very difficult to manage the movement toward a relatively democratic election which Chun foresees toward the end of his term. He has taken critical steps to "normalize" the political situation. For instance, he has restored political rights to several hundred banned political figures, released the majority of political prisoners, appointed a head of the governing party who comes from the dissident province of Kwang ju, and appointed some high officials from the old opposition groups. But none of this adds up to a long range political-economic strategy, and senior military as well as civilian officials are severely disconcerted by the prospect of moving into the coming tumultuous years without a long range strategy, particularly when the man at the top is believed to have a penchant for off-the-cuff decisions.

In this situation, President Chun's rule is stable as long as there are no shocks to the system. However, another major scandal like that of the curb market could lead military leaders to unseat him. Student demonstrations are now large and wide-spread, but of limited public concern so long as nobody gets killed; however, an incident in which an inexperienced police or military unit shot or otherwise killed one or more students could also create a wave of public revulsion which would lead to the unseating of the President. Such an unseating would not imply an extended period of instability, and it would not imply serious or long term damage to the economy. However, it could, in today's unstable financial market, lead to the withdrawal of groups of smaller banks, and of some European banks, from the Korean market and precipitate a

period of financial stringency. During any specific period of time, such an event is unlikely. Over a period of two or three years, the probability is significant. Even if such a financially unsettling event should occur, there should be an orderly transition back to financial normalcy. But the risk of a momentary problem could be kept in mind.

Domestic Economic Planning. The South Korean government has developed extremely ambitious economic plans for the 1980s. These plans, which are reminiscent of the great economic leaps forward of the Park regime during the 1960s and 1970s, reflect Chun's determination to go down in Korean history as having made the kind of contribution to the country's economic development that Park made earlier. The plans hinge heavily on two strategies: (1) moving heavily into high technology markets; and (2) opening the Japanese market for Korean products. The high tech strategy involves heavy expenditures by major Korean firms, including acquisitions of Silicon Valley manufacturers by those Korean firms. Both components of the plan involve substantial risk. Most analysts are extremely skeptical of Korean ability to open the Japanese market to the extent planned. The high tech strategy is audacious; South Korea has succeeded with such audacious strategies several times in the past, but it also overstepped itself severely in the late 1970s. The costs and prospects of the two-pronged strategy, and the potential irreversibility of key aspects of the strategy, should be monitored closely.

International: The KAL 007 Incident. The Soviet shooting down of a KAL 747 jet was a tragedy and is a major diplomatic incident. However, it was a one-time incident and does not represent a Soviet threat against South Korea. Moreover, the U.S.S.R. would oppose a North Korean thrust against South Korea. Therefore, the incident has no major implications for South Korean creditworthiness.

International: North Korea. The Chun regime has experienced an extraordinary string of diplomatic successes. Chun was the first foreign leader invited to visit President Reagan. Prime Minister Nakasone of Japan became the first Japanese Prime Minister to visit South Korea, and he has made a practice of regularly consulting with President Chun by telephone. Chun has had successful diplomatic trips to Southeast Asia and Africa. He has taken the initiative from North Korea on the issue of reunification of the two Koreas, an item of overwhelming significance in South Korean public opinion. He has successfully invited the International Parliamentary Union to hold its meeting in Seoul in September 1983, the Asian games to be held in Seoul during 1985, and the Olympics to be held in Seoul during 1987.

North Korea regards these diplomatic triumphs as a serious threat to its international position. It is extremely anxious to prevent the occurrence of the International Parliamentary Union (IPU) meeting, the Asian games, and the Olympics. It has sought to block the IPU meeting by bribing those who make the decisions on the location of the meeting. When the bribes were disclosed, it became impossible for anyone to vote against holding the meeting in Seoul. South Korean intelligence fears that North Korea will attempt some kind of military episode in order to disrupt such events.

It is difficult to assess the actual probability of such an episode. North Korea would be extremely unlikely to stage an incident sufficient to cause any real economic disruption. U.S. and Japanese ties to South Korea assure that South Korea would be well defended. North Korea cannot successfully attack South Korea. Both the Soviet Union and China would lean heavily on North Korea to prevent escalation of any incident. They have done so in the past, and would be even more likely to do so today than at most times in the past. Most important of all, any incident caused by North Korea would immediately unify South Korea, nullifying all the political problems within South Korea that have been analyzed above. Thus, the domestic political and economic situation of South Korea would become even more sound in the aftermath of a military incident.

However, many commercial banks might be frightened by an incident of a scale large enough to influence the decisions of the IPU. In this circumstance, if Bankers Trust were to understand the situation and limited numbers of other banks were to be frightened, Bankers Trust would immediately consolidate a much stronger position in South Korea by extending unusually large lines to the country for a short period of time at virtually no risk. On the other hand, if too many banks became frightened, Bankers Trust's lines would not necessarily succeed in fully averting a crisis, and the bank would then have to contend with the embarrassment of carrying another large third world credit which could not be immediately repaid. In all probability, this would be an extremely short-run problem, so the embarrassment would be both unlikely to occur and minimal if it did occur.

On balance, the South Korean situation remains among the soundest in the third world, and trends justify looking forward to an expanding Bankers Trust role in the market there. However, these short term vicissitudes require careful attention both to the possibly great opportunity presented by an unusual situation and to the associated risk.