Magnet or morass?

South Korea's prospects for foreign investment

A report prepared by the Economist Intelligence Unit

Magnet or morass? South Korea’s prospects for foreign investment was commissioned by the South Korean Ministry of Commerce, Industry and Energy and written by the Economist Intelligence Unit.

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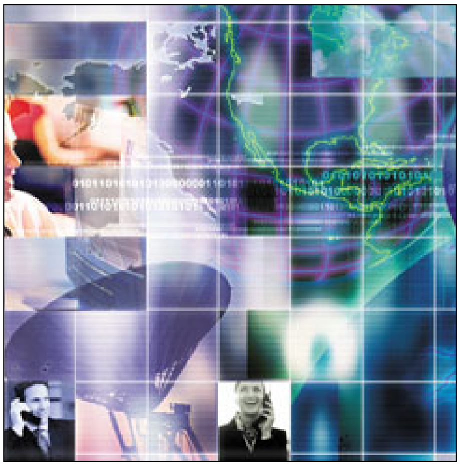
Our gratitude is due to the many executives and experts who shared their insights on South Korea’s foreign-investment environment during interviews conducted as part of the research for this report.



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Executive summary

Like every investment destination, South Korea has its strengths and weaknesses. Foreign direct investors must carefully weigh up the balance of advantages and disadvantages when making a decision to commit. But the country has never been worth a closer look.

- South Korea is a far bigger economy than many people realise. With a population of 48m and GDP at market exchange rates of $422bn, the country weighed in as the world's 13th-largest economy last year. The Economist Intelligence Unit expects the economy significantly to outpace the regional average over the next five years.

- Reforms undertaken since the 1997 financial crisis have profoundly altered the country's foreign-investment environment. The vast majority of South Korea's business sectors have been fully opened up to foreign investors; tax and other incentives have been put in place, and agencies such as the Korea Investment Service Centre and the Office of the Investment Ombudsman now exist to meet investors' needs.

- The results of this year's presidential election are unlikely to cause a deterioration in the foreign-investment environment. There is strong consensus among mainstream political parties about the need for—and value of—globalisation.

- Since 1997 South Korea has been one of the most successful countries in Asia in attracting foreign direct investment (FDI). Its 1997-2001 total of US$31.5bn rivalled Japan's US$32.1bn, ranking sixth in the Asia-Pacific region behind China, Hong Kong, Australia and Singapore. The Economist Intelligence Unit forecasts average annual inflows of US$6bn during 2002-06, though this remains well below the country's absorptive potential.

- According to the Economist Intelligence Unit's business environment rankings, South Korea will move from eighth in the Asian league between 1997 and 2001 to sixth in the 2002-06 period. Improvements in the country's macroeconomic environment, market opportunities, policy towards foreign investment and financing regime explain the upward movement.

This is not a counsel of complacency for the government in Seoul. Perceptions of Korea have been badly tarnished by a few long-drawn-out, high-profile asset sales, which either end in tears or never seem to end at all. How fast FDI actually grows will depend in large part on further progress in removing the obstacles that militate against South Korea realising its full potential: above all, red tape, union attitudes and intrusive bureaucrats. But the country has come a long way over the past five years and there are solid grounds for optimism that further progress will be made.

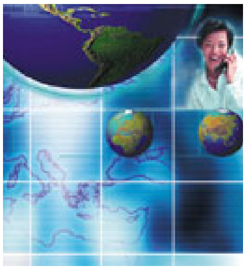
Introduction

Foreign investment in South Korea has been much in the news recently—not all of it good. Indeed, at one point earlier this year many regional and global media outlets seemed to be filing a single sad story. Stark questions such as "Why is it such a nightmare to do deals in South Korea?" gave a flavour of the prevailing tone.

The criticism was largely prompted by the failure of several high-profile asset sales to reach a swift conclusion, and the decision by American International Group (AIG) in January 2002 to end talks on a planned $840m investment in three Hyundai financial units.

But the fault-finding didn't tell the whole story. Overall FDI into South Korea has soared since 1998 and annual inflows now match those heading for Japan, a far larger market. AIG's partner in the proposed Hyundai investment, Wilbur Ross, has maintained that his own $420m stake in the deal is still "ready to go". And even as AIG pulled out, other investors were piling in.

So where does the truth lie? This report on South Korea's foreign-investment environment, commissioned by the South Korean Ministry of Commerce, Industry and Energy and written by the Economist Intelligence Unit, attempts to find out. It looks at the experience so far of South Korea's economic reforms and their impact on foreign investment. It assesses the likely future course of the economy. And it draws lessons—both positive and negative—from the experiences of foreign investors already operating in this market. All this enables an assessment of how South Korea rates



as an investment destination, and what its future may hold.

South Korea's emerging potential

A bigger tiger than you thought

The Economist Intelligence Unit's figures show this half-peninsula packed with 48m people weighs in as the world's 13th-largest economy. GDP at market exchange rates in 2001 of US$422bn was bigger than Russia's,

Gross domestic product
US$ m, market exchange rates, 2001

1	US	10,205,600
2	Japan	4,182,553
3	Germany	1,847,829
4	UK	1,429,776
5	France	1,307,397
6	China	1,179,710
7	Italy	1,089,390
8	Canada	705,189
9	Mexico	621,196
10	Spain	582,378
11	Brazil	491,015
12	India	487,246
13	**South Korea**	**421,694**
14	Netherlands	381,668
15	Australia	357,953
16	Russian Federation	309,951
17	Taiwan	284,519
18	Argentina	272,556
19	Switzerland	245,502
20	Belgium	227,206

Source: EIU CountryData.

and until recently India's; next year it is set to overtake that of Brazil.

South Korea has a similarly lofty rank as regards trade, with total two-way merchandise trade standing at US$292bn in 2001. A broad industrial base includes being the planet's number-one maker of both ships and computer screens, the number-five car producer (challenging France for fourth spot), and having the world's largest steelmaker, Posco.

Income per head, at under US$10,000, is by far the lowest of the original four Asian tigers—less than half that of Hong Kong or Singapore. But wealth levels are rising. Long notoriously high savers, South Koreans are getting used to spending—and taking to it with enthusiasm, ignoring moralistic strictures from another era

Korea's main trading partners, 2001

Main destinations of exports	*% of total*
US	20.7
China	12.1
Japan	11.0
Hong Kong	6.3
Taiwan	3.9

Main origins of imports	*% of total*
Japan	18.9
US	14.6
China	9.4
Saudi Arabia	5.7
Australia	3.9

Source: Economist Intelligence Unit.

Case study

Coca-Cola: Ice cool

South Korea looked a prime candidate for an anti-IMF backlash after the 1997 financial crisis. Here was a golden opportunity for a notoriously militant student movement to agitate. The mood that might have been was caught by a striking phrase in the *Hankyore Shinmun*, Seoul's only left-wing daily, on June 21st 1998:

"There have been many abuses in our economy, but government, corporations and finance have formed a Trinity to guide our economic development. Now, though, the government is leading the dismantling of this Korean system of development. In its place, it is pursuing ... the attraction of foreign capital [and] ... selling companies to foreigners at rock-bottom prices."

Strong stuff. And for Coca-Cola, the world's biggest beverage firm and a potent symbol of foreign capital, the threat of a backlash was especially real because of a restructuring that was then well under way.

Coca-Cola has had a presence in South Korea since 1951. Starting in 1969, the firm franchised four local bottlers, each part of a *chaebol*. Soon after, it made its own first direct investment, a plant manufacturing concentrate. By the mid-1990s it had well over half of the South Korean market in carbonated soft drinks.

Sales were flat, however, at a per-capita consumption level five times lower than in the US, and Coke increasingly believed that its four bottlers lacked focus. After five years of canvassing options, Coke decided to buy its bottlers out and in 1996 it set up Coca-Cola Korea Bottling Company, to run all production, distribution and sales directly. In 1997, one area at a time, CCKBC bought three of the four bottlers.

No non-Korean firm had ever taken full control like this before. And with the financial crisis having hit, a febrile nationalism was in the air. It was against this backdrop that Bumyang, the fourth bottler, held out for its independence by going to court and to the Fair Trade Commission, and by bringing 700 workers to demonstrate noisily at Coca-Cola's Seoul HQ.

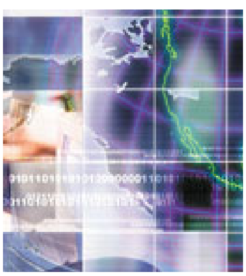
It looked like a nightmare scenario for a foreign investor—a South Korean David against a US Goliath. But Coke did not panic. It guaranteed all jobs, including those of the demonstrators if they joined CCKBC. It emphasised both a past and future long-term commitment to South Korea, as evidenced in a US$1bn investment programme over five years and orders worth US$60m already placed with local supplier firms—which in South Korea include not just glass or packaging but also equipment and trucks. Image-building promotions included taking South Korean soccer fans to France to cheer on their team in the 1998 World Cup.

Ice cool paid off. All Bumyang got from litigation was two extra months' supply of concentrate. It launched a rival "patriotic cola", named 8.15 after South Korea's liberation day, which made little impact and five years later has sunk without trace. Local media interest flared briefly and died as quickly.

Veterans of this episode are clear on its lessons. Despite a severe challenge, Coca-Cola overcame obstacles and was able to restructure its business the way it wanted. South Korea has its sensitivities, certainly, but if serious long-term investors factor these into their strategy and plan accordingly, they can be successfully accommodated.

on the evils of luxury. Attitudes towards foreign brands have changed as a result. If one thing symbolised fortress Korea, it was cars. In the old days, buying a foreign one meant a tax audit. Now, suddenly, it is okay to flaunt wealth. In March 2002, when this report was being researched, BMWs were being airlifted in to meet demand.

Few markets are saturated or tastes yet sated—especially for gadgets. In a country of 48m people, there are 30m mobile phones. South Korea was the first country to roll out third-generation (3G) services (before Japan), and boasts twice as high a broadband connection rate (12%) as any other nation. Already it is one of the world's top ten markets in fields as diverse as insurance and cosmetics; according to *Advertising Age*, it is the world's 12th-largest advertising market.



Add in the country's changing demographics—the population is ageing rapidly—and the result is excellent prospects for growth in sectors from high tech to healthcare. What's more, as workers, Koreans are educated and diligent—if costly and even fractious by Asian standards.

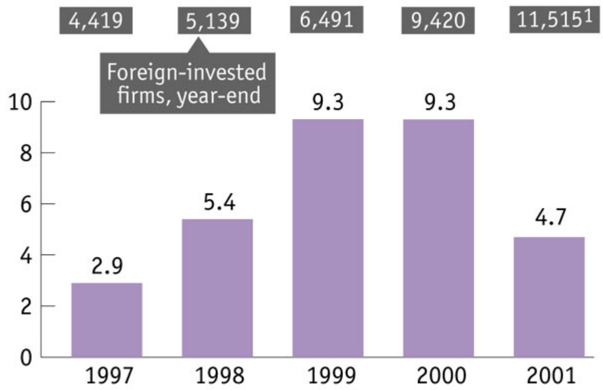
From crisis to reform

For some years now, therefore, there have been plenty of reasons why foreign investors might want to take a closer look at South Korea. But it is only in the past five years that the government in Seoul has become receptive to their scrutiny.

Park Chung-hee, South Korea's military president from 1961 to 1979, pursued a statist and nationalist development path. South Korea borrowed on global capital markets to build up its own firms, the *chaebol* (large conglomerates), with FDI playing only a minor role. Major change began only in the 1990s, when joining the World Trade Organisation (WTO) and the Organisation for Economic Co-operation and Development (OECD) entailed deregulation and market opening.

But the real turning point was the 1997 financial crisis, when South Korea was rescued from default by a $58bn IMF-led bail-out, its largest ever.

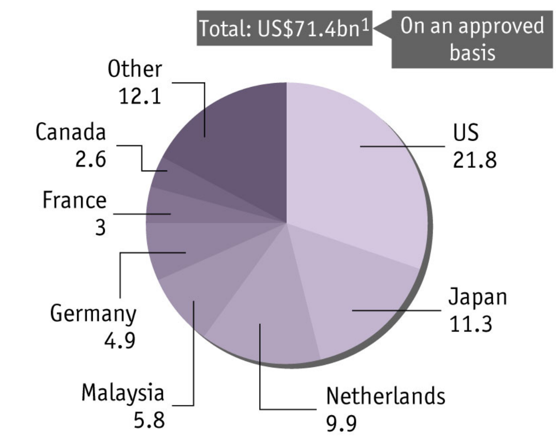
In actuality
Actual foreign direct investment in South Korea
US$ bn



[1] Trade was much the largest category (4,291), followed by services at 1,960, electrical-electronics 756, wholesale and retail 715, machinery 678, manufacturing 574, chemical 426, restaurants 287, finance 266 and foods 200.

Sources: Economist Intelligence Unit; MOCIE .

By origin
Cumulative FDI in South Korea
US$ bn



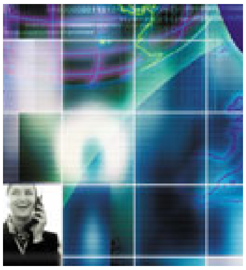
[1] The sectoral leaders are electrical-electronics (US$10.8bn), services (US$10.3bn), property (US$9.9bn) and finance (US$7.96bn).

Source: MOCIE.

This coincided with an election, when veteran democrat Kim Dae-jung won the presidency in his fourth try. Seen as a populist, he emerged instead as a free marketeer, swiftly calmed the markets and embraced reform. Four years on, the consensus is that South Korea has restructured more seriously than most in Asia, even if the process is not yet completed.

The government has had far greater success in financial-sector reform than seemed possible in the immediate aftermath of the crisis, closing down many loss-making banks and forcing weaker banks to merge with stronger ones. In part this reflects its tight control over the financial sector, even though most banks were privatised in the 1980s. Progress has also been made in dealing with the large stock of non-performing loans (NPLs) in the financial system, many of which have been transferred to an asset-management corporation. This process has gone faster than similar schemes in Thailand or Indonesia.

The government has, however, had less success with corporate-sector restructuring, particularly with regard to the largest *chaebol*. Although it has instituted important changes in encouraging greater corporate transparency and shareholder rights—for example, requiring *chaebol* to produce consolidated accounts from 1999—problems remain. A co-ordinated

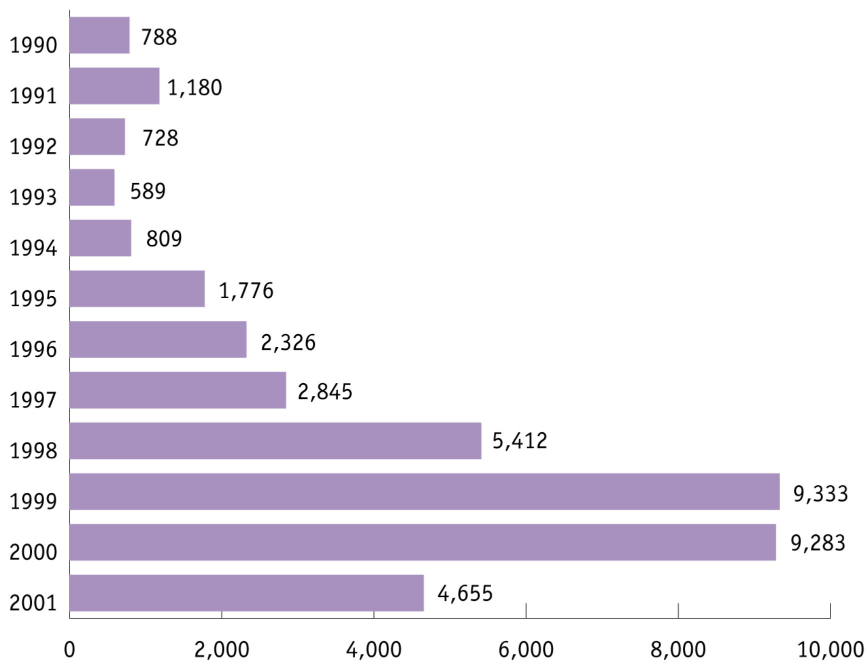


chaebol offensive has already won big concessions in postponing various deadlines for the unwinding of cross-holdings, for example.

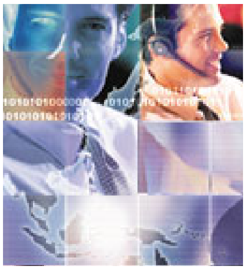
For foreign investors, a key moment was the November 1998 Foreign Investment Promotion Act. Offering tax and other incentives, this aimed to create a more transparent and open environment. By June 2000, the vast majority of the country's 1,121 business sectors, according to Korea's Standard Industrial Classification, had been fully opened up to foreign investors.

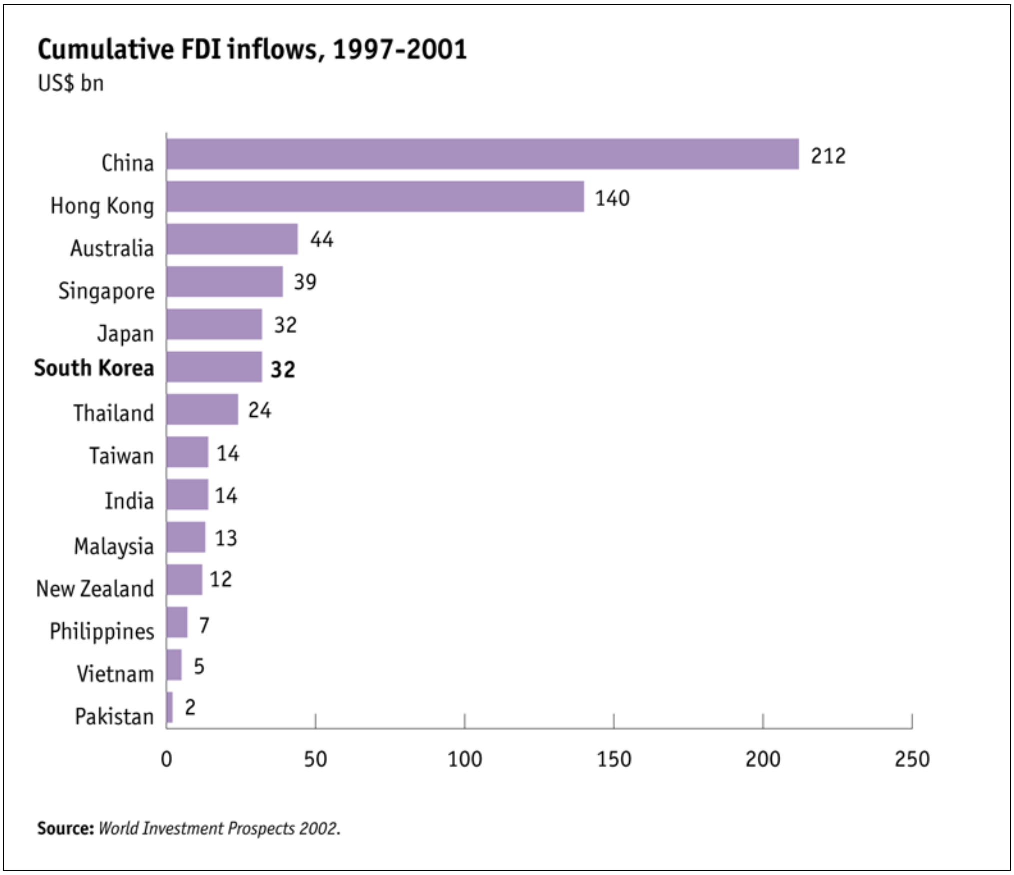
Hurdles remain. South Korea's inward FDI environment remains burdened by the continuing complexities of registration, notification, licensing and approval requirements.
Other problems include bureaucratic stonewalling, particularly at lower levels, inter-agency turf wars, which can delay approvals, and an often unrealistic understanding by South Korean firms of the fair value of their (often distressed) assets. But at its higher echelons, the government has shown a lively appreciation of the need to meet investors' concerns, not least through the Office of the Investment Ombudsman

South Korea: Inward FDI flows
US$ m



Source: *World Investment Prospects 2002.*





Source: *World Investment Prospects 2002.*

(OIO), a much-praised by-product of the 1998 act. And the country has clearly been doing something right—just look at the numbers.

Flow charts

Since 1997 South Korea has been one of the most successful countries in Asia in attracting FDI. From US$2.8bn in 1997, inflows almost doubled in 1998, and in both 1999 and 2000 topped US$9bn as the local investment environment improved and global FDI surged. In 2001 South Korea's inward FDI fell sharply, though against a backdrop of declining worldwide FDI.

The 1997-2001 total of US$31.5bn rivalled Japan's US$32.1bn, ranking sixth in Asia-Pacific behind China (way ahead with US$212bn), Hong Kong (US$140bn), Australia (US$44bn) and Singapore (US$39bn). Strikingly, that US$31.5bn also comprised three-quarters of South Korea's cumulative inbound FDI ever, totalling US$41.4bn. If this shows how far and fast South Korea has come, the fact that it still only equates to 9% of GDP, well below regional norms, indicates how much further it has to go. (President Kim Dae-jung's goal is 20%.)

On the figures, a clarification is in

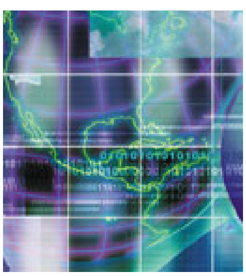
The neighbours

For almost half a century, business has gone on in Seoul as if the world's most heavily militarised border were not just 50 km up the road. Indeed, for theft and personal security, South Korea is about as safe as it gets. But the large and lowering question mark of North Korea cannot be ignored.

Besides the ups and downs of North-South relations, a new factor to emerge is growing US intolerance of rogue states since September 11th. President George W Bush's recent branding of North Korea as part of an "axis of evil" made South Koreans uneasy; they fear conflict over nuclear, missile and other issues. The next government in Seoul will be less kind to the North than Kim Dae-jung, but even Southern conservatives are uneasy at the US ratcheting up tension on the peninsula. That fact, plus Russian and Chinese pressure on both the North Korean and US governments to back off from brinkmanship and seek a diplomatic solution, will probably keep the peace. Best of all would be for Kim Jong-il, the North Korean leader, to finally wise up and embrace peace and reform, but he has disappointed too often to be sure. However, as of mid-April 2002 North-South dialogue is set to resume, and the North is reportedly ready at last to sit down with the US.

The hope must be that pragmatism will rein in the wilder types. But in South Korea the long-term investor must mull the cost of even a peaceful transition to unification. That would be a topic for another white paper; suffice it to say it will be just as much of a strain as in Germany, and proportionately a much heavier burden on South Korea. Clearly, unification will alter all Korean economic equations: for the worse in one sense, yet also offering opportunity in rebuilding the North, bringing 22m Northerners into the global economy as producers and consumers, and in the long run welding a 70m-strong new nation that really will be the hub of a new economic region.

order. The Economist Intelligence Unit reports FDI as investment actually made. By contrast, the Ministry of Commerce, Industry and Energy (MOCIE)'s data show notified investments, as in other countries, not arrivals. MOCIE's figures therefore tend to be higher.



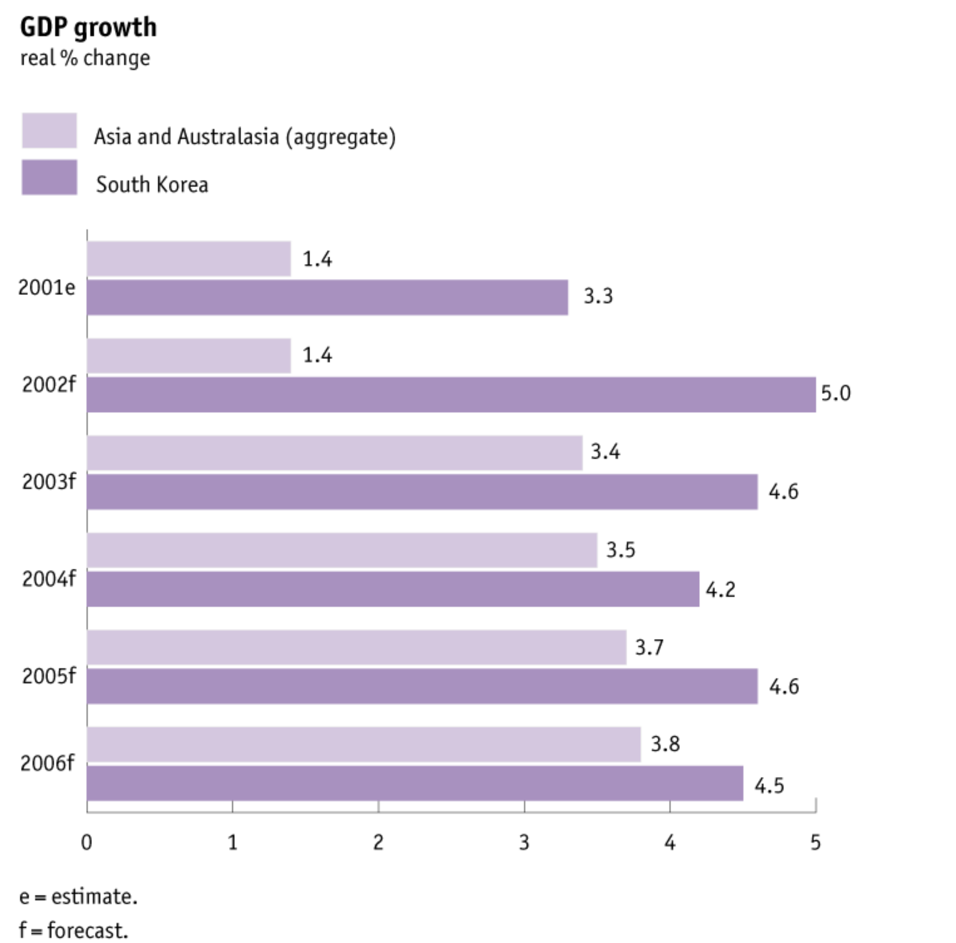
Rising FDI inflows are paralleled by growing portfolio inflows. South Korean equities and other financial instruments, formerly closed to foreigners, are now largely open. The results have been striking. As of end-2001, foreign investors owned 36.6% of equities listed on the main KSE—up from 30.1% at the start of the year—worth a total of W93.7trn (US$72bn); plus 10.4% of the over-the-counter Kosdaq market, up from 7%. Ten top blue-chip companies are now over 50% foreign-invested, including SK Telecom, Posco, LG Electronics and Kookmin Bank. Samsung Electronics (SEC), ever the favourite, is 60% foreign-owned.

Prospects and pitfalls

New government, old policies?

In less than five years South Korea's foreign-investment picture has changed dramatically for the better. What of the next five years? The question is timely, as 2002 is an election year in South Korea. Local polls in June will be a trial run for the big one: December's presidential election. Kim Dae-jung's successor—he cannot run again—will enter the Blue House in February 2003, and not leave until 2008.

For FDI, the obvious concern is that pro-business and foreign-friendly policies should continue and be enhanced. In principle they could be challenged from the right or the left. In fact there is little ground for concern from either quarter.



Source: EIU CountryData.

Asia: Forecast annual FDI inflows
US$ bn

	1999	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
China	38.8	38.4	46.8	50.0	55.0	60.0	65.0	72.0
Hong Kong	24.6	61.9	27.0	26.0	27.5	28.2	28.5	30.0
Australia	5.7	11.5	12.8	10.0	13.0	12.0	13.5	15.0
Japan	12.3	8.2	5.1	5.2	5.4	5.9	6.9	8.0
South Korea	9.3	9.3	4.7	5.6	5.6	6.0	6.8	7.7
Singapore	7.2	6.4	5.9	6.6	6.2	6.8	7.2	7.4
Taiwan	2.9	4.9	4.3	4.5	4.7	5.4	5.9	6.4
India	2.2	2.3	3.2	4.3	5.0	5.5	5.8	6.0
Thailand	6.2	3.4	3.0	3.5	4.0	4.4	4.8	5.0
Malaysia	1.6	3.4	2.4	3.2	4.5	4.6	4.7	4.8
New Zealand	1.4	3.2	3.1	3.0	3.2	3.5	3.9	4.3
Indonesia	–2.7	–4.6	–1.0	2.2	3.5	3.0	3.2	3.7
Philippines	0.6	2.0	1.1	1.3	1.6	2.2	2.5	2.7
Vietnam	1.4	1.3	1.1	1.3	1.7	2.2	2.3	2.3
Pakistan	0.5	0.3	0.3	0.4	0.5	0.5	0.5	0.6
Sri Lanka	0.2	0.2	0.2	0.2	0.3	0.3	0.4	0.4

Source: *World Investment Prospects 2002.*

South Korea's political centre has been shifted irrevocably by globalisation. *Segyehwa*, the Korean term for it, was a slogan of the last president, Kim Young-sam (1993-98), who led Korea into the WTO and the OECD. The aftermath of the financial crisis of 1997 might have led to a backlash against foreign capital—it did not. Few deny that culpability for the 1997 crisis lies within Korea, not outside: specifically, in reckless *chaebol* behaviour and bungled official policy.

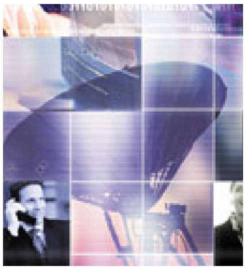
Moreover, the next government should inherit an economy in fine fettle. Dismay that 2001's growth of 3% was considerably lower than in the preceding two years has given way to recognition that, thanks to a diverse industrial base and prudent policy, South Korea weathered the year of recession and September 11th better than most in the region. Export growth is picking up again, and a vibrant consumer boom now leads some to fear overheating. Short-term interest rates, reduced several times last year, are expected to rise in May or June from 4%, historically very low for South Korea. Moody's Investors Service's upgrading in March 2002 of South Korea's sovereign rating, by two notches to A3, is a seal of approval that other agencies are expected to follow. That said, local and foreign firms alike

Asia: Forecast FDI inflows per head
US$

	1999	2000	2001	2002	2003	2004	2005	2006
Hong Kong	3,721	9,285	4,018	3,829	4,003	4,052	4,048	4,213
Singapore	1,860	1,592	1,437	1,557	1,423	1,511	1,553	1,561
New Zealand	371	838	797	785	815	882	967	1,058
Australia	300	602	663	511	658	602	671	738
Taiwan	132	221	192	198	206	233	252	266
Malaysia	68	144	99	131	181	181	180	180
South Korea	199	196	98	117	117	124	138	156
Thailand	101	54	48	54	63	68	74	77
Japan	97	65	40	41	42	46	54	63
China	31	30	37	39	43	46	50	54
Philippines	7	26	13	15	19	26	29	31
Vietnam	18	17	14	16	20	26	27	27
Sri Lanka	9	9	8	12	14	16	20	22
Indonesia	–13	–22	–5	10	16	14	15	17
India	2	2	3	4	5	5	5	5
Pakistan	4	2	2	3	3	3	3	4

Source: *World Investment Prospects 2002*.

need to adjust to the fact that sustained pre-crisis growth rates are a thing of the past.

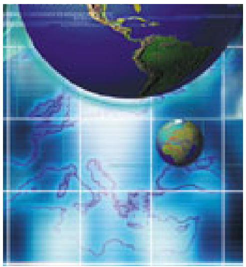


The FDI crystal ball

The likely upshot is that FDI inflows will continue at a very respectable pace, outdistancing pre-1997 levels, though not yet reaching the heights of which South Korea is capable. The 2002 edition of *World Investment Prospects*, a research report from the Economist Intelligence Unit, forecasts average annual inflows of US$6bn during 2002-06, though it adds that this “will remain well below the country’s absorptive potential”.

In each of the next five years, FDI will be well below its peak in 1999 and 2000. In absolute terms these forecast inflows are roughly similar to those expected in Japan, long South Korea’s reference point. As a proportion of both gross fixed investment and GDP, South Korea beats Japan hands down.

These inflows are likely to be directed at a wide variety of sectors, serving either South Korea’s increasingly affluent consumer market or its diversified manufacturing base. Retailing is a growth area, as discount formats and hypermarkets gain ground on market stalls and department stores. Tesco, a UK supermarket chain



that has a joint venture with Samsung, has ten of its top twenty stores by turnover in South Korea. Services in general are a good bet, as greater proportions of growing incomes are devoted to health, housing, education, insurance and pensions.

But three areas stand out as FDI opportunities:

Telecoms and technology. The economic slowdown has usefully tempered hype about information technology (IT) and the new economy, but the market remains appealing. The number of mobile-phone subscribers passed 30m in early April 2002, a 62.5% penetration rate in a country of 48m people. Only Singapore, Taiwan and Hong Kong score higher in the Asia-Pacific region. Growth will continue to be rapid over the next five years—by 2006, the penetration rate will be up to 85.7%, according to Pyramid Research, a telecoms consultancy.

The numbers of mobile-phone subscribers tell only half of the story, however. What catches people's eye about the South Korean mobile market is the popularity of the mobile Internet services that operators are pioneering. Currently, more than 50% of mobile phones in the South Korean market have data transmission capabilities, a number that helps explain why Internet usage in the country is so high. (South Korea also has the world's highest proportion of online stock traders.)

Age-related services. The OECD estimates that it will take only 22 years for the share of South Korea's population that is over 65 to double from 7% of the total currently to 14%, a level defined by the UN as an "aged society". Over the next 50 years or so, South Korea's dependency ratio, the ratio of those people older than 64 to those aged 15-64, will rise from being the third lowest in the OECD to the sixth highest. That means opportunities for the leisure industry and for healthcare and pharmaceuticals providers.

Financial services. An ageing population, which is driving rapid growth in private pension funds, is one of a number of factors encouraging foreign financial services institutions to deepen their presence in South Korea (see case study). Others include the

Speed of population ageing in selected countries

Country	*7%* [a]	*14%* [b]	*No. of years*
South Korea	**2000**	**2022**	**22**
Japan	1970	1994	24
Germany	1932	1972	40
UK	1929	1976	47
US	1942	2013	71
France	1864	1979	115

[a] Year when the number of people over 65 reached 7% of the total.
[b] Year when the number of people over 65 reached, or is forecast to reach, 14% of the total.

Source: OECD, Economic Surveys Korea, August 2001.

Case study

Allianz: banking on Koreans

As the world's sixth-largest life insurance market, South Korea has attracted FDI interest—and some disappointment. Yet while AIG and MetLife, both of the US, have walked away, Allianz, the world's leading insurer by gross written premiums (GWP), has invested more than US$1bn in the market so far, with the aim of becoming one of South Korea's major players, not just in insurance but a wide range of financial services.

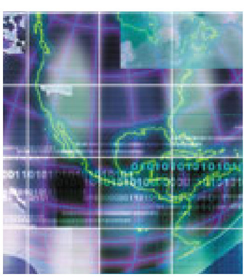
Munich-based Allianz today operates in 70 countries, has 181,000 employees and 60m customers, and conducts 70% of its business outside Germany. Its takeover of Dresdner Bank in 2001 signalled widening ambition: Allianz now has euro1.2trn assets under management. Both insurance and banking loom large in its Korean operations, by far its biggest in Asia and its fifth-largest subsidiary worldwide.

In 1998 Allianz acquired the South Korean subsidiary of French insurer Assurances Générales de France (AGF), France Life. A year later it bought First Life, South Korea's fourth-largest life insurer, from the cash-strapped Cho Yang group. The head of France Life, Michel Campeanu, became chief executive of Allianz First Life, which recently rebranded itself Allianz Life and moved into a new 23-floor head office.

Allianz's declared aim to become South Korea's preferred insurer is ambitious. Though GWP of US$1.5bn makes it the leading foreign player, with market share up from 3.5% to 4.6%, it is still far behind the South Korean Big Three: Samsung (29%), Korea Life (14.7%) and Kyobo (13%). But Allianz sees a market ripe for transformation. In South Korea life insurance is sold by mostly female agents, often to their friends; if they change jobs, policies are cashed in. Hence a key aim is to improve retention rates, both of staff and customers.

To this end Allianz is competing aggressively on quality. State-of-the-art information technology includes being the first in Asia to install SAP accounting software. Permanent staff was cut (voluntarily) by 11%, to 2,400; pay and promotion are becoming merit-based; training has risen fivefold, to 13 days each year. A streamlined salesforce of 15,000 is now complemented by multi-channel marketing, using an integrated call centre in the Seoul HQ.

But life insurance is only the half of it. Besides branching out into non-life, Allianz plans to be one of South Korea's five top asset managers in five years. To this end, in 2000 it paid US$157.4m for a 12.5% stake in Hana Bank, South Korea's fourth largest. In 2001 the two formed an asset management joint venture, HanaAllianz ITMC. In January 2002 they unveiled Allianz Hana Life Insurance, a 50:50 JV poised to launch full bancassurance operations once rules allow (expected in 2003). Here too Allianz sees not only a large and growing market, but one not yet well served. South Koreans want their assets managed professionally and reliably, yet the 1997 financial crisis dented confidence in most local institutions.



Looking ahead, changing demographics and culture offer Allianz and its competitors yet

more openings. South Koreans are growing richer and older, but busy professionals living in nuclear family-sized apartments no longer house elderly kin. The state pension is insufficient and inadequately funded. Health insurance is a mess after a botched reform. All this spells opportunity, as South Korea inexorably moves to more private provision in both pensions and healthcare.

new opportunities created in hitherto closed areas such as consumer credit by deregulation of the industry since the 1997 financial crisis.

Concerns about the sector remain, though. Foremost among these is the continued heavy presence of the government in the banking industry and its consequent ability to favour politically well-connected borrowers. But as the government retreats from the sector, a surge of merger-and-acquisition deals, with attendant opportunities for foreign investors, are expected.

One other point. Much is made of the threat posed by low-cost China to South Korea's economy. Will China do to South Korea what South Korea did to Japan, ask the worriers. The panic is overdone. China's growth and WTO accession spell opportunity as well as threat. China's economy needs inputs, which South Korea is well placed geographically and structurally to provide, from steel to telecoms infrastructure. And Chinese consumers buy Korean, be it Samsung's dinky hand phones or chirpy K-pop and weepy TV soaps. That trend should deepen—a 100%-plus jump in South Korean automotive exports to China in 2001 reinforces the potential that exists among the emerging Chinese middle classes.

The FDI environment assessed

Improving, but could do better

According to analysis by the Economist Intelligence Unit, FDI is closely related to the quality of a country's business environment. In its business environment rankings, the Economist Intelligence Unit measures the attractiveness of the business environment in 60 countries using a standard analytical framework comprising 70 qualitative and quantitative indicators. The overall quality of South Korea's business environment is expected to improve in the next five years—in Asia, South Korea is ranked ahead of Japan and Thailand, though behind Taiwan.

The strengths of South Korea's business environment relative to those of its competitors will be its economic stability and the market opportunities offered by its large, increasingly

South Korea: Business environment rankings

	Regional rank [a]	
	1997-2001	*2002-06*
Overall position	8	6
Political environment	8	8
Political stability	10	10
Political effectiveness	7	7
Macroeconomic environment	12	1
Market opportunities	4	3
Policy towards private enterprise & competition	7	7
Policy towards foreign investment	9	4
Foreign trade & exchange controls	8	8
Taxes	8	10
Financing	9	7
The labour market	12	12
Infrastructure	7	7

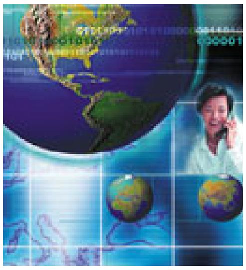
[a] Australia, China, Hong Kong, India, Indonesia, Japan, Malaysia, New Zealand, Pakistan, the Philippines, Singapore, South Korea, Sri Lanka, Taiwan, Thailand and Vietnam.

Source: EIU Country Forecast.

wealthy and well-educated population. But there are unattractive features too, among them the variable quality of the tax regime and continued rigidities in the labour market.

Key gripes among foreign investors include:

- Functional English, and a global mindset, are palpably both less in evidence than in Hong Kong and Singapore.
- Foreign-exchange controls make moving funds in and out a hassle: reporting and approval rules are burdensome; offsets are not allowed for intra-company transactions, and the won is not readily tradable.
- Although the labour market is now more flexible, downsizing remains difficult. Labour laws still discourage firms from dismissing staff by, for example, requiring companies recruiting new staff in the two years following dismissals to try to rehire laid-off workers and, in cases involving large numbers of workers, to notify the Ministry of Labour in advance, providing the reasons for the dismissal and proof that they have consulted sufficiently with staff.
- The power and recalcitrance of lower-level officials at the rock face, as opposed to the more internationally minded elites who in theory control them, is a long-standing complaint, as is opacity and variability in interpreting and applying regulations, which can themselves change bewilderingly.
- That only 12% of the workforce is unionised, and that strikes now are far fewer than a decade ago, cuts little ice compared with TV images of shaved heads, red headbands and clenched fists. While few foreign investors experience active labour problems—as opposed to strict rules on lay-offs, which affect everyone—and the weakening of the unions since the end-1997 crisis means that their disruptive power is much reduced, investors are not wrong to perceive a problem with union activity in certain important sectors.



Sullied sales

Perceptions of Korea have been badly damaged by a few long-drawn-out, contentious, high-profile sagas of asset sales, which either end in tears or never seem to end at all.

The sale of Daewoo Motor to General Motors and a tie-up between the ex-Hyundai chipmaker Hynix Semiconductor and Micron Technology of the US have been under negotiation for many months. Both deals have edged towards culmination only to falter—most recently, with the unexpected rejection in April 2002 by the Hynix board of Micron's $3.4bn bid. In January 2002 AIG withdrew from buying three Hyundai financial units after over a year of talks. In March another US insurer, MetLife, pulled out of the bidding for state-owned Korea Life. Two different deals to sell state-owned SeoulBank—to HSBC in 1999, and to Deutsche Bank Capital Partners last year—have also collapsed.

Harmful as they are to South Korea's reputation, such sagas are far from typical of FDI in South Korea. These cases involve disposing of the detritus of the old Korea Inc, with all the financial complexities and political sensitivities they entail. When Newbridge Capital, which bought Korea First Bank in 1999, was given indemnity against future emergence of hidden liabilities, there were howls from both competitors and the press. The government has not dared to repeat the promise (which is one reason why AIG walked away), so time-consuming due diligence is needed. Hidden liabilities at overseas subsidiaries are still an issue at Daewoo, so one reason for delay is the need to check each one out.

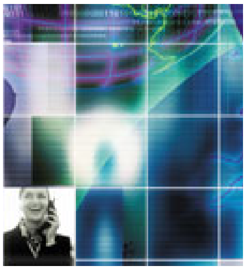
Throughout the negotiations, a vigilant and leaky press tracks the fate of these famous names and the public money they gobbled, crying foul if national assets are perceived as going for a song. Price is thus an abiding issue, from HSBC and SeoulBank in 1998 to MetLife and Korea Life recently. On the latter, it seems the gap was simply too wide between what MetLife deemed the business worth, and what the government believed the political marketplace would stomach in an election year.

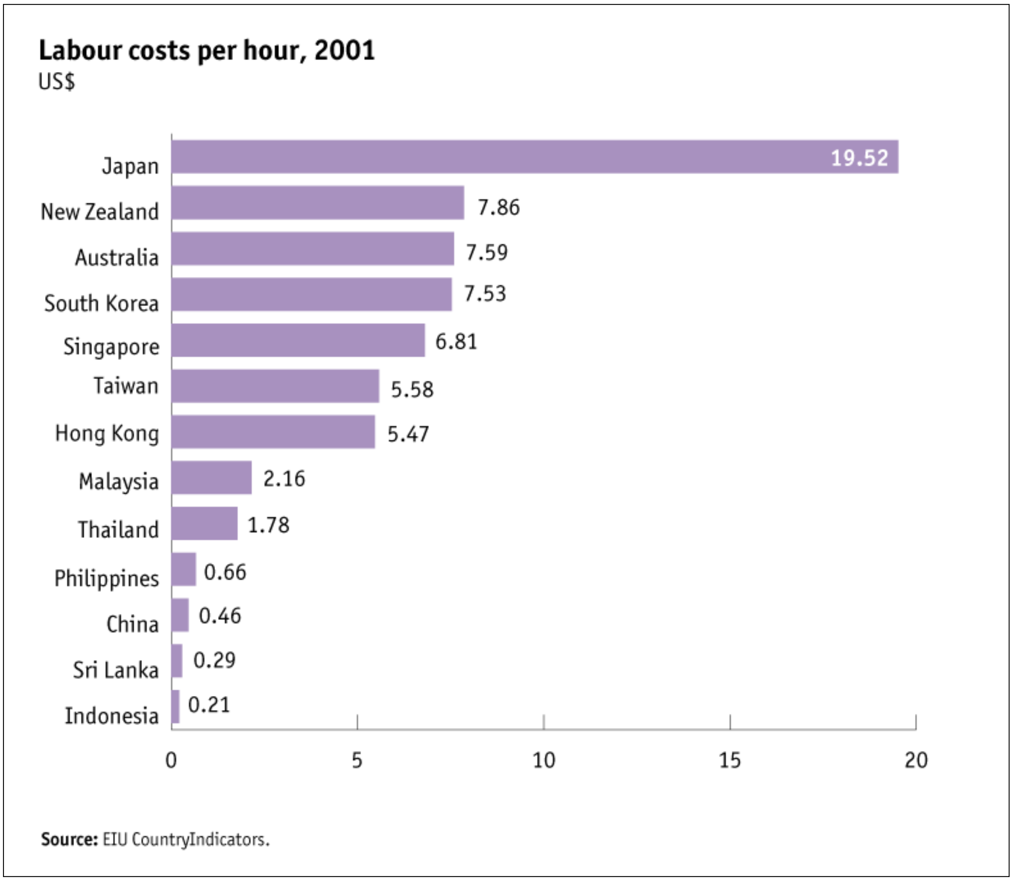
Yet another factor is a mass of stakeholders—shareholders, creditor banks, trade unions, various official agencies—all sticking their oars in. At Hynix creditors patched up divisions on whether to go with Micron only for the board to rebuff the US firm's offer. Unions had also threatened industrial action to prevent the deal from going ahead. At Daewoo, too, divided but partly militant unions are a problem.

Why Korea—and why not?

Given the country's strengths and weaknesses, what types of investor should choose South Korea?

As a nation that over the past decade has also generated considerable outbound FDI, South Koreans should be no strangers to the criteria governing investment decisions. While the *chaebol* now manufacture inside key export markets, partly to avoid tariffs and other barriers, a less noticed host of small Korean firms turn out cheap textiles and shoes in export zones





Labour costs per hour, 2001

Source: EIU CountryIndicators.

across the globe, from Guatemala to Bangladesh.

This exodus of small firms, pushed by rocketing wages at home over the past 15 years, explains why there is one kind of inward FDI South Korea has no hope of attracting. Where cheap and pliant labour is needed for low-cost manufacturing operations, South Korea is not in contention (its edge will be blunted further as its working-age population declines). Here it must cede in the region to the less-developed ASEAN states or, increasingly, to China.

Yet South Korean labour has virtues too, being highly educated and hard working. So where skill and diligence are at a premium, as in high tech, IT, telecoms and biotechnology—South Korea is one of only six countries to have cloned animals—the picture is much more positive (see case study on LG Philips).

The same applies to the automotive sector. GM's patience with Daewoo, Renault's purchase of Samsung Motor and DaimlerChrysler's 10% stake in Hyundai Motor all have a dual purpose: to act both as a back door into a large home market hitherto impenetrable by imports, and to use the world's fifth-biggest car producer as a platform to

Case study

LG Philips: equality on display

While Hynix and Micron have fought endlessly and loudly over prenuptials, many forget that another top global electronics firm and a leading *chaebol* quietly tied the knot in 1999—and got on so well, that the following year they did it again. This happy marriage has created global leaders in cathode ray tubes and LCD computer screens—proving that not all FDI into South Korea need rest content with the local market alone.

Philips Electronics NV is Europe's largest maker of consumer electronics, with group sales last year of US$28.3bn. LG (formerly Lucky-Goldstar) is now South Korea's number-two conglomerate, specialising in electronics, chemicals and telecoms. Always better run than the likes of Hyundai or Daewoo, LG moved swiftly after 1997 to restructure, attracting investment worth US$4bn. Of this, a healthy slice—still South Korea's single largest inward FDI to date—was Philips's US$1.6bn purchase in 1999 of 50% of LG LCD, the leading maker of active matrix liquid crystal display (AMLCD) screens at three sites in Kumi in the south-east. At a stroke Philips gained a major and immediately profitable stake in the fastest-growing sector of display technologies, one of its core fields.

A year later, in a related but more mature sector, Philips and LG merged their cathode ray tube (CRT) operations into a second joint venture, LG Philips Display, which is based in Hong Kong. LG received US$1.1bn. The two companies dovetailed neatly. Philips led in TV tubes, LG in computer ones. LG was big in Asia, Philips in Europe and the Americas. LG's manufacturing expertise complemented Philips' marketing and technical innovation. The new venture had 17 sites worldwide, 36,000 employees and sales of US$5.2bn.

Considering that control is often cited as an issue for FDI in South Korea, one remarkable feature of this pair of projects is equality. Both are split 50:50 in ownership and management alike. In LG Philips LCD, the chief executive and two vice-presidents are from LG, the chief finance officer and chief technology officer and one vice-president are from Philips, and the board of directors comprises three Philips people, two LG members and two auditors. LG Philips Display has a Philips CEO, chief sales and marketing officer, chief technology officer and two regional heads, while LG provides the chief operating officer, chief financial officer and one regional head.

sell on to the wider region. Similarly, in the unsexy but ever more globalised car-components sector, 199 or 18% of Korean firms in this field are now foreign-owned, with total FDI of a weighty W2.8trn (over US$2bn).

In general, however, South Korea's appeal for FDI aiming to sell to wider regional or global markets is limited to specific industries and companies. Certainly, in manufacturing, the Chinese juggernaut's mix of low wages, rising skills and emergent mass market is all but unbeatable.

Hence a new theme in South Korea's investment campaign—the touting of Seoul as a would-be regional headquarters (RHQ) for multinational

Trading complaints

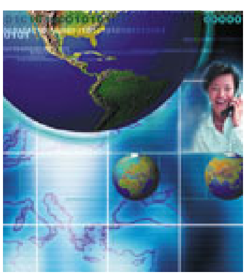
Trading into South Korea sits outside the remit of this report, which focuses on foreign direct investment. But it is worth noting that certain areas of trade remain difficult for foreigners to penetrate—notably agriculture, but also pharmaceuticals and automotive, where complex testing standards and certification regulations limit imports. Direct investment can therefore be the only way to reach the domestic market effectively.

For those seeking further information, the EU Chamber of Commerce in Korea (EUCCK) has for the past several years issued annual reports on trade issues. The latest report, *Trade Issues and Recommendations 2002,* published in March, consists of 320 pages (in English and Korean) from its 20 specialist committees. It is available online at http://eucck.org/trade2002. The American Chamber of Commerce (AmCham) also publishes an annual Issues report, available at http://www.amchamkorea.org/info/i-norm-issue.htm

enterprises, with China's proximity being a key part of the equation.

South Koreans were not always so fond of their geography. "Whales fight, shrimp crushed" is a local proverb that has a gloomier take on being squeezed between powers like China, Japan and Russia. Nor is this ancient history. The Japanese occupation ended only in 1945, and is neither forgotten nor forgiven. And the peninsula's division still persists. So does the RHQ pitch add up?

Logistically, as a post-cold war north-east Asian economic region starts belatedly to emerge, South Korea is certainly right in the middle. The fine new Incheon international airport is thus potentially well placed. Busan is now the world's third-largest container port, and a hub for trans-shipment to China. But wider hub hopes—like a much-touted "iron silk road" for rail freight between South Korea and Europe via Siberia—depend on North Korea opening up. After the optimism of 2000's North-South summit, a planned road-rail link across the Demilitarised Zone (DMZ) stalled, as did the entire peace process. In April North Korea agreed to resume this project and add a second cross-DMZ link. Let's hope this time they mean it.



Moreover, the competition from other would-be hubs is strong. In a March 2002 survey by the American Chamber of Commerce in Korea (AmCham) comparing Seoul with four other Asian cities—Hong Kong, Singapore, Tokyo and even Shanghai—the South Korean capital was rated bottom overall, and on five out of eight specific criteria: global business environment, foreign-exchange controls, labour flexibility, work permits/immigration and

country image. South Korea faces a formidable challenge to realise its RHQ ambitions.

Of course, if an investment in South Korea happens to facilitate exports elsewhere in the region, or evolves naturally into a regional headquarters, all well and good. But the primary attraction of South Korea for the majority of foreign investors lies in the size and strength of the domestic economy. As a burgeoning market of 48m avid consumers, fond of gadgets and brands yet also ageing and seeking better service in everything from pensions and personal finance to healthcare and insurance, there is no shortage of opportunity for foreign companies to invest and sell to South Koreans themselves.

Conclusion: inner strength

This report has argued that South Korea's foreign direct investment environment has improved substantially since the 1997 Asian financial crisis. Foreign companies have responded enthusiastically, committing unprecedented amounts of capital to the country over the past five years. The challenge facing South Korea now is to build upon this progress, and tackle the issues of red tape, union attitudes and bureaucracy that continue to preoccupy investors.

The task is a formidable one. But with much left to achieve, the country's sheer adaptiveness provides perhaps the best grounds for optimism. There are South Koreans alive today who were born under a feudal monarchy, soon to be conquered by a harsh colonial power. They and their children fought, willingly or no, for many armies: Japan's before 1945, North or South Korea during 1950-53. Out of carnage and destruction, and African levels of poverty, they educated themselves and built a growth machine *nonpareil*, thanks to which their great-grandchildren take mobile phones and the Internet for granted, barely able to imagine what life was like just yesterday. Along the way they ditched and jailed their dictators, and now enjoy a fractious democracy. Provided the pampered new generation has not lost its forebears' backbone and cunning, South Korea's progress—and that of the foreign investors committing to it—should continue apace.