U.S. Services Trade and Investment In South Korea Under The U.S.-ROK Alliance

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I. Introduction

The Republic of Korea (ROK), hereafter referred to as South Korea or simply Korea, was traumatically introduced to the modern, soon to be globalized, world as a result of the Korean War. One of the lasting effects of this forced modernization was a South Korean national imperative to develop economically as rapidly as possible. This was operationalized by the Park Chung Hee government which signed a peace treaty with Japan in 1965 after Park seized power.

Prior to 1965, the business legacy in South Korea was mixed at best. Korean business during Japanese colonial rule was one of small, local firms or economic organizations harnessed to Japanese wartime production. There did not exist the kind of international trade and business services which characterized the international/global trading system developed over several hundred years by the British and American venture capitalists. This international economic/business system was not equal, but it was global, and it rested on a series of business norms which became increasingly universal. World War II in Asia was fought in large part to insure the permanent establishment of these commercial/economic norms and prevent Japan from instituting an alternative form of modernization through an exclusive tribute system under the "co-prosperity sphere."

With the conclusion of a formal peace treaty between Japan and South Korea in 1965, the political economy of South Korea took on an increasingly "developmental state" form. Several elements often overlooked in this framework included a national security guarantee, in the case of South Korea (as in the case of Japan) provided by the U.S. military alliance. This allowed the South Korean government, by encouraging the development of *chaebols,* to undertake export-led growth. At the same time, Korean government policy maintained an orientation of nationalization or indigenousness with regard to advanced business services. Such a policy has been widely practiced by other Asia-Pacific Rim "capitalist development states" as part of an overall development strategy, in an effort to keep these key knowledge generating activities in local hands and avoid aggressive external competition.

As a result, it is difficult to causally prove that the U.S.-Korean alliance has in and of itself changed, liberalized or "globalized" the services industries and the trade in services dimensions of the South Korean economy. Rather, the alliance, by providing a security umbrella for South Korean economic growth, may have actually retarded liberalization of advanced international business services trade. Yet, without the military/political guarantees of the U.S.-ROK alliance, an industrial economy in South Korea could not have evolved as it did, and by so doing the South Korean economy created the need for advanced business services.

Recently the *Financial Times* reinforced this point. It quoted Deputy Finance Minister Kwon Tae-shin who referred to protected markets as "selfish." He went further to say "about 70-80 percent of government officials now know the importance of opening up the service market. But the final decision is made in the Blue House."[1]

Three interrelated contradictions are at work at the same time with regard to advanced business services in South Korea. First, and most important, information technology is changing the structure of the South Korean economy. By its very nature firms of all sizes in this sector are more flexible and therefore more "open" than mainline manufacturing firms which characterized the traditional Korean *chaebol* Yet it was the *chaebol* which were responsible for the "Korean miracle" in which high quality and modestly priced manufactured goods were exported to Korea's core overseas markets of the TRIAD; Japan, Europe and North America. Additionally, firms in this new sector experienced fewer barriers to entry, so a new generation of such firms was created as part of the recovery from the Asian Financial Crisis of 1997-1998.

Second, new flexible technology companies inherently seek out niche markets and as a result need managers who can work in a flexible, global context. Thus changes in the Korean society at large, which appear to create a more equal and "in tune" society, also represent the backbone of both corporate and society change in Korean society at large and its corporations.

Most importantly, LG Group, Korea's second largest *chaebol*, has dismantled its former complex web of cross-shareholdings and reorganized most of its affiliate companies under a holding company. Actually, this change, while hailed as a major organizational shift, simply puts the *chaebol* under an early 1900's U.S. trust framework. Nevertheless, key transparent elements emerge from this arrangement, including sources of income, degrees of management control, and resulting clarity of operations, all of which have attracted more foreign capital.[2]

Finally, changes in this Korean societal culture are represented in concurrent changes in Korean corporate culture, not only in new technology-driven niche player firms, but also within all South Korean firms as well. New and more progressive forms of business interaction generally are necessary, and require a more sophisticated managerial class. Yet while all these trends are evolving, strong resistance to societal and corporate change still exists. Increased nationalism and a desire not to be "dominated" by the U.S., as well as general generational confusion regarding lifestyles, attitudes and options for life on the part of Korean young adults all point toward a stormy transition as old values continue to exist along with new ones.

II. Accounting: Important Background Information

With the enforcement of the Sarbanes-Oxley law in the U.S., the Korean Financial Supervisory Service (FSS) is currently studying the potential impact of requiring a firm listed on the Korea Stock Exchange and the KOSDAQ market to rotate all accountants and accounting firms in charge of the firm's audit every five or six years.

According to data recently passed on to lawmakers by the (FSS), 53 accounting firms earned around 50 percent of total income from consulting work during fiscal year 2001, the last year data are available. If new regulations are adopted, regulators would be able to place restrictions easily on accounting firms that try to sell non-audit services such as consulting and tax-payment strategy. Five large accounting firms, including Youngwha, Samil and Ahn Kwon & Co., have increased their revenue significantly by offering such consulting services as well as tax strategies to clients. As financial scandals have demonstrated in the U.S., clear violations of conflict of interest norms exist when such practices exist. Yet, at the same time, such bundling of services would make sense in the Korean setting, where complex managerial challenges may establish requirements for consulting as well as normal accounting services.

Even though Korean accounting standards closely resemble U.S. standards "on paper" (i.e., from a formal and legalistic perspective), some experts in international accountancy have claimed that complex, personal and interlocking relationships between *chaebols* and accounting firms have distorted audits conducted in the past.

Example: Samjong KPMG

Based on FSS data, Samjong, Samil and Younghwa dominate the entire accounting market in South Korea with a combined market share of 70%. Samjong KPMG Inc. is a member firm of KPMG International, a Swiss non-operating association, which simply means that in compliance with Korean legal restrictions still in place concerning the activities of foreign accounting firms, the "association" can affiliate with a local firm, provide advice, but not complete openly for Korean business. The operating entities in Korea are KPMG Samjong Accounting Corp., KPMG Sehjung Tax Corp., and Samjong KPMG FAS Inc.

Samjong itself began in June 1991, with the establishment of Samjong Law Firm. In March, 1993, the Samjong Accounting Office was registered in Korea, and within the following year Samjong Accounting Corp was incorporated in Korea as well. Samjong Consulting was established in 1995, and Samjong Investment Bank was established in 1997. The year 2001 saw the establishment of Samjong KPMG, Samjong KPMG FAS (Financial Advisory Services), and KPMG Sehjung Tax Corp.

Samjong KPMG specializes in four lines of business:

- Financial Services—Banking & Finance, Insurance and Real Estate
- Consumer & Industrial Markets-Industrial & Automotive Products, Chemicals & Pharmaceuticals, Energy, Power and Natural Resources and Transportation, Consumer Products, Retail and Food & Beverage.
- Information, Communications & Entertainment-Software, Electronics, Communications and Media.

- International Trade Consulting~Anti-Dumping Lawsuit Defense and Countervailing Duties cases.

Samil Accounting Corporation (PricewaterhouseCoopers)

Since 1971, Samil has been the Korean affiliate of the global PricewaterhouseCoopers organization. SamiTs 83 partners and over 2,200 staff make it the largest professional services organization in Korea, more the double the size of the next largest accounting firm. For seven consecutive years, Samil has been ranked by the Financial Supervisory Service as the best accounting firm in Korea. Samil's local strength is demonstrated by the fact that it is the principal auditor of 6 of the top 10 *chaebol* conglomerates, 40 of the largest 100 Korean companies and 50% of the top-tier banks in Korea. Samil specializes in the following industries:

- Financial Services
- Technology, Information, Communications, and Entertainment
- Energy & Mining
- Service Industry
- REIT & Private Investment in Infrastructure
- Middle Market Services (essentially outsourcing service)

The People's Solidarity for Participatory Democracy (PSPD), South Korea's leading shareholder lobbying group, has recently alleged that Samil was lax in the auditing of Hyundai Engineering & Construction (HEC) from 1984-2000. PSPS claims that Samil inspected only "0.01 percent" of the construction firm's financial statements, including assets and liabilities, and then disclosed that HEC was in sound financial condition. Due to such compound lax accounting, HEC faced a financial crisis in 2000, posting 2.9 trillion won ($2.4 billion) in net losses at that time. PSPD further claimed that Samil destroyed of all of its audit records on HEC for the time period before 1998. Thus, investors and regulators could not figure out where the large amount of debt came when it suddenly/abruptly appeared in the year 2000. As a result of such multiple irregularities, in October, 2002, Samil was severely penalized by Korean securities regulators.

Ernst & Young (Youngwha)

South Korean accounting standards have come under further scrutiny this year (2003) following the discovery of a multi-billion dollar fraud at SK Global, part of the country's third-largest business group. The case was the latest in a series of accounting scandals involving Korean companies in recent years. Youngwha, the auditor for SK Global, is under investigation by regulators who are trying to find out why the firm failed to find a Won 4,380bn ($3.75bn) hole in the trading company's accounts. SK has been prominently featured in the news with the recent arrest of Chey Tae-won, the nephew of the founder of the *chaebol* and the son-in law of the former South Korean President.[3]

Deloitt & Touche

Deloitte & Touche LLC (Hana; the local name for Deloitte Touche Tohmatsu) announced in April 2002, that it has signed a Memorandum of Understanding to combine with Anjin & Co. (Andersen in Korea). The terms of the Memorandum of Understanding (MOU) provide for the transaction became final on July 1, 2002, with the final agreement subject to a due diligence review and partner approval from both organizations.

"The planned integration will support DTT's global strategies, and I hope the move will contribute to the development of the Korean financial services industry," said Robert A. Campbell, Managing Partner of DTT Asia Pacific.

"I am glad that Anjin & Co. joins the Deloitte family. I see our clients benefiting from our enhanced service capabilities particularly in the areas of audit, tax and corporate finance," said Jae Sool Lee, Managing Partner of Deloitte & Touche LLC. Lee, also added, "I expect that the integration of Anjin & Co.'s excellent client base and diversified service portfolio and the global network of DTT will generate a synergetic effect. We will combine our knowledge and experience to produce a professional service firm with creative vision and culture to cope with the rapidly developing accounting industry in Korea." Seung-Woo Yang, Country Managing Partner of Anjin & Co., said, "The synergies between the two firms should assist with a smooth transition and I expect the professionals of both groups will benefit from the opportunities the combined firm can provide."

Anjin & Co. currently has about 950 partners and employees, while Deloitte & Touche LLC has 250. The planned integration will make Deloitte & Touche LLC become the second largest professional services firm in Korea with over 1,200 partners and employees. Once the integration is complete, Deloitte & Touche LLC plans to continue its effort to recruit both domestic and foreign professionals and provide a new combined vision to its existing partners and staff.[4]

These firms point to an industry in need of rationalization, but such fundamental transformation is difficult as long as a "developmental state" mentality exists both within the companies and in some bureaucratic circles. Most important, while U.S. accounting firms wish to expand their presence and contribute their expertise to the accounting/auditing function in Korea, it is obviously difficult to accomplish as long as they are restricted in their operations and forced to partner with local firms that have their own "agendas."

III. Issues in Insurance

The South Korean insurance industry also struggles with traditional practices and foreign competition at the same time. This reflects the continued growth and transformation of the South Korean economy, yet the persistence of both traditional patterns of business and a mixture of cultural attitudes reflecting concurrent traditional values and global processes. By the end of 2001, 40 insurance companies operated in South Korea, 23 life insurers, and 17 non-life insurers, which included various types of business insurance, a guarantee insurance company and a reinsurance company. Within this mix a process of market concentration has taken place, particularly in the life insurance section, with the three leading companies accounting for over 80% of the market's total premiums. With the decline in South Korean interest rates, profitability for all companies has increasingly become difficult, as the insurance firms could not earn a safe rate of return sufficient to pay out the guarantees to the life insurance holders (i.e. a negative spread of interest rates).

Part of the problem is a result of the uniqueness of the Korean market. Many of the sales personnel are relatively untrained, (i.e., they are "order takers") who make their sales based upon personal relationships to the customer, more like Tupperware salespersons in the U.S., rather than on the financial needs of the customer and an evaluation of financial market conditions. Over time these sales personnel are at a disadvantage compared to college educated employees with some business background who have been recruited by the foreign insurance companies. Related to this point, better trained and educated sales personnel can use South Korea's extensive cyber-marketing and telemarketing capabilities and rely less on face to face personal selling. As a result they are more productive from a business/company perspective.

Also, most Korean insurance products are savings instruments of some type. This puts the insurance companies directly in competition with more obvious types of savings vehicles, including but not limited to banks and other types of investments. With various types of savings instruments accounting for about 85% of all insurance written, this competition put the insurance companies at a disadvantage, primarily because whole life insurance, with an accumulated cash value, is difficult to explain in the Korean context. Whole life looks like some type of "death" vehicle, rather than a savings instrument that can accumulate a cash value that can be used during one's lifetime.

Finally, Korean insurance companies have not developed the technical expertise on their own to estimate and forecast interest rate changes. This challenge is related to the point made above concerning the personal nature of selling in Korea. Without being able to forecast interest rates, it is difficult for sales people to project savings and financial returns to potential customers. At the firm level, the companies can not forecast their earnings, so their financial statements may fluctuate widely, appear unrealistic, or fail to meet investor expectations. In the area of corporate/business insurance, the major challenge to the industry is a pattern of kickbacks or an unofficial policy of setting a secret price which is lower than the published price for an insurance product. This practice is particularly common with smaller insurance companies, in their struggle to stay in competition with the larger, dominant firms. This pattern of kickbacks became more widespread after the 1997-98 financial crises and the subsequent liberalization of the Korean business climate. While deeply rooted in the Korean business culture, it offers a severe challenge to profitability and transparency in the industry as a whole. Yet by the late 1990s, foreign insurance firms showed more interest in the Korean market.

Allianz of Germany acquired First Life Insurance Co., Prudential of the United Kingdom acquired Youngpoong Life Insurance, and Met Life expressed an interest in acquiring Korea Life Insurance with its 20% Korean market share. Even though some non-Korean firms were small, their superior technical and managerial expertise made them profitable in Korea.

By mid-2003 Goldman Sachs had proposed to purchase 24% of Kyobo Life Insurance, the country's second largest life insurer. This initiative has forced the government to reexamine the ban on life insurance companies being listed on the Korean Stock Exchange. Anticipating that the purchase of Kyobo may simply be a short-term investment "play" by Goldman Sachs, which might well sell its shares in Kyobo if and when it is listed, government regulators must now decide if this example is the beginning of regulatory acceptance of international market forces. Because Kyobo is considered a well managed company, the Goldman Sachs interest indicates the profitability of well managed and relatively transparent firms in the emerging Korean economic context.[5]

IV. The Legal Profession

Exactly when Korea will fully open its legal sector to international firms remains impossible to say. While the country has committed to opening under an agreement concluded with the OECD, there appears to be little prospect of this occurring before 2004-2005, due to opposition and intransigence from certain quarters in the profession.

With regard to the opening of the legal profession in South Korea to outside (i.e., foreign) experts, there appears to be general agreement that when liberalization finally does occur, it will take the form of a Big Bang, rather than a gradual process. The government is believed to be keen not to repeat mistakes made in Japan, where a partial opening allowed foreign firms into the market but prohibited them from forming alliances with local firms or hiring Japanese lawyers, tying their hands to such an extent that they were unable to function. Big Bang or whimper, it is not yet clear whether international firms may be allowed to practice Korean law, or merely to advise their international clients from a Korean base.

In the meantime, international legal firms continue to lobby the Korean government for full access and participation in the Korean economy, with UK firms such as Clifford Chance taking the lead. UK firms are seen as well established in Asia and particularly strong in banking, finance and capital markets work - areas where the home-ground advantage enjoyed by established Korean firms may be comparatively small. U.S. firms appear more inclined to bide their time, professing contentment with existing arrangements, although suspicious observers suggest it is a case of once bitten, twice shy, with some U.S. firms burned by the unprofitable experience of rushing into Japan after liberalization. This notwithstanding, U.S. firms may enjoy an advantage over their UK rivals when the time comes, as the Korean-American community provides a ready pool of Korean-speaking, U.S.-qualified lawyers.

While foreigners are not permitted to practice as lawyers in Korea, many Korean firms employ Westerners and internationally qualified Korean returnees as "consultants." Of the "real" foreigners, Jeffrey Jones, current president of the American Chamber of Commerce Korea, is a permanent fixture of the Seoul business community and is judged to have been instrumental in the success of Kim & Chang. However, one American with several years' service to top firms describes the general position of foreigners in Korean firms as "deeply subordinated," irrespective of their fee-earning ability. He describes a vicious circle in which, kept as back-room English-language polishers, most junior foreign lawyers often feel unable to develop their careers, and change/jump firms relatively often. High turnover rates in turn discourage the firms from granting recognition or promoting career development.

The prospect of international competition on their home turf is only one of the things currently keeping Korea's lawyers engaged in the change process. There exists at present a chronic shortage of lawyers in Korea, so the Korean Bar Association has yielded to government pressure to increase the number of law students passing the Bar Examination each year from a mere handful to 1,000. With fewer than 4,000 lawyers currently in private practice in the entire country, this represents a significant change to a hitherto exclusive profession, which will be increasingly felt as the newly qualified gain in experience and seniority. The forthcoming increase in numbers is likely to dilute the profession's exclusivity. Fees and salaries may also come under upward pressure, if clients, the managing partners of some firms, and upstart competitors have their way. Many Korean clients have discovered the costly truth that some Korean firms tend to allocate large numbers of lawyers to a case where a handful would often be sufficient. Thus, while rates of US$200 to US$500 per hour may appear reasonable by international standards, the bill can come as a surprise to those not used to paying high legal fees for legal advice as a part of the Korean business context.

As Korea's Fair Trade Commission (FTC) becomes increasingly assertive, the volume of related legal work continues to rise. In a bid to distinguish itself as a leader in fair trade work, Shin & Kim established a Market Economy Research Institute (MERI) in April 2001. With a number of senior government officials among its ranks, including In-Ho Kim, a former director of the FTC, the MERI is seeking to influence the development of Korea's fair trade regime, deregulation and a free market economy. Of more immediate application, the MERI can also be utilized to support clients' legal positions in fair trade cases with economic arguments.

V. A Note on Korean Banking

A great deal has already been written on the relationship of Korean banks to the *chaebol*, how that relationship contributed to the 1997-98 Asian Financial Crisis, and how the restructuring of the banking sector has been an essential element in the recovery of the country. The case of Seoul First Bank has been particularly documented. More recently, the Korean government itself may be preparing to sell its 9.3 percent share of equity in Kookmin Bank, the country's largest lender. This bank is a particular model of successful banking, in that it avoided the extreme difficulties of the Asian Financial Crisis by primarily lending in the growing consumer credit market, instead of lending to overextended *chaebols.*[6]

The banking sector of the nation's overall financial services industries is the nation's most visible element, and also is the one which touches the majority of the citizens. As a result, by now most observers have come to accept the inevitability of the uncoupling of banks and their liberal loan policies to their affiliated *chaebol.* Therefore, this article has focused on other elements of financial and knowledge services which have maintained their development state and nationalistic postures during the growth and transformation of the South Korean economy, as well as its collapse in 1997-1998.

Kim Kihwan, writing in the Korean Economic Institute's *Korea's Economy 2003,* has identified numerous macro-challenges for the Korean economy going forward, including simmering anti-Americanism.[7] But he did not mention the formation of the Seoul Financial Forum which he will chair. The goal of this organization is nothing short of paving the way for Korea to be a (or the) financial center for Northeast Asia, i.e., the now-fashionable "hub" concept which is widely discussed in South Korean business and governmental circles. In order for that to happen, the banking sector, along with financial and knowledge services generally, must move forward by allowing foreign capital participation and investment, and operating with globally understandable, transparent rules.

VI. Conclusion

The developments outlined above, while not tied directly to the ROK- U.S. alliance, are an outgrowth of the fifty-year military/political relationship between the two countries. The alliance, by setting up a military security system behind which the South Korean economy could grow and mature, allowed for globally competitively *chaebol* conglomerates to mature. However, without the concurrent internationalization of Korean advanced financial services, the Korean economy was vulnerable to the contagion effect of the Asian Financial Crisis of 1997-98. Conditions for a globalized and transparent industrial business system evolved over the fifty years of the military alliance, including increasingly technological Korean products, in part from both a reverse brain drain of educated Koreans returning from the U.S. and the Korean diaspora to the U.S., all functions of the underlying alliance relationship.

Thus, while the alliance has contributed indirectly and directly to the transformation of South Korean society and economy on the Korean peninsula, the evolution and modernization of financial services in South Korea have been retarded until the present time, when other factors emanating from the world economy and new market forces arising within South Korea began the process of forced business services liberalization. That transformation has occurred because of the external pressures of economic globalization and the South Korean economy's increased participation in a globally interactive world. Similarly, the next step in the transformation of this economic and business sector will come from the South Korean business community itself, interacting with global counterparts from other countries and as well as non-Korean organizations and NGOs. That challenge has yet to be fully accepted and met, but the opportunities for real progress exist.

Notes

X.*Financial Times,* August 12, 2003, p.3.
2. *Wall Street Journal,* September 8, 2003, p. A-14.
3. *Financial Times,* July 9, 2003, p. 11.
4. http://www.deloittekorea.co.kr/pressroom/pressroom_board_sub.asp
5. *Financial Times,* September 4, 2003, p. 15.
6. *Financial Times,* September 6/7, 2003, p. 9.
7. For details, see Kim Kihwan, "A Preview of Korea's Economic Policy over the Next Five years," in *Korea's Economy 2003,* Korea Economic Institute, Vol. 19, pp. 13-20.