Some Policy Lessons from the Opening of the Korean Insurance Market

Yoon Je Cho

This article examines the recent dispute between the United States and the Republic of Korea over the opening of Korea's insurance market to U.S. companies. The article assesses the interests and motivations of both countries that lay behind the formal arguments presented during the negotiation process. It also analyzes whether the long-run interests of both developing and industrial countries would be well served by the approach to the opening of the market adopted in this case—sharing the rent while continuing to regulate the insurance market. The analysis suggests that the opening of a developing country's insurance market (or the wider financial services market) would serve the long-run interests of both developing and industrial countries only if it were accomplished in the context of overall domestic liberalization of the finance industry. "Opening" of the market, if this means only the sharing of the rents that were generated by regulation of the market, is unlikely to be beneficial to developing countries.

This examination of the recent United States–Korea trade dispute over the limitations placed on the access of U.S. firms to the Korean insurance market provides an opportunity to investigate the interests and motivations of industrial and developing countries with respect to international transactions in financial services. The article also derives some policy lessons for other developing countries that may face a similar trade negotiation environment.

Section I of the article briefly discusses the policies of the government of the Republic of Korea with respect to the insurance market, describes the structure and size of the market, and suggests some reasons for the strong interest of U.S. firms in entering the market. Section II introduces the trade dispute, and describes the issues between the two countries and their respective positions on these issues during the negotiations pursued under Section 301 of the U.S. Trade Act (see appendix). It also investigates the motivations underlying the formal arguments during negotiations and describes the bargaining counters

The author is an economist in the Technical Department of the Asia Region of the World Bank. This article was prepared for the World Bank Conference on Developing Countries' Interests and International Transactions in Services, Washington, D.C., July 15–16, 1987. The author is grateful to J. Michael Finger and Brian Hindley for their valuable suggestions, to Jagdish Bhagwati and Andrej Olechowski for helpful comments, and to Peter Bocock for editorial assistance.

used by each party. Section III draws some conclusions from the case and identifies their implications for future negotiations between developing and developed countries on transactions in financial services. Section IV examines the national welfare implications of the relationship between the opening of financial services markets and the regulation of these markets and elaborates on the policy lessons that can be derived for other developing countries facing similar trade negotiations.

I. The Korean Insurance Market

The Korean insurance industry is young (most insurers in the market date back only to the 1950s), but its growth has been rapid, owing to rapid economic growth and to strong government encouragement of the industry. The government has created various types of compulsory insurance and has authorized life insurance companies to receive a quasi-pension type of savings and to claim tax deductions on premiums.

Although government policy has fostered rapid expansion of the insurance industry, it has also imposed various restrictions on the industry that have inhibited its efficient development in terms of quality of service and international competitiveness. The government regulates asset management, with the objective of channeling funds into the finance of strategic industrial sectors designated by the government. The government also exercises detailed control over the business activities of insurance firms, through formal regulations, administrative guidance, or both. Premium rates are strictly controlled. The government has severely restricted entry into the industry and has tried to limit competition, both domestic and foreign.[1]

More recently, however, in conjunction with the overall economic liberalization policy pursued since 1980, the government has allowed more autonomous management and freer competition among insurance firms. But the pace of liberalization in insurance has been slow.

Life Insurance

At the end of 1986, the life insurance industry was dominated by six companies, all of them Korean.[2] No firm, either domestic or foreign, had been allowed entry to the life insurance market for three decades (except to sell insurance to resident aliens).

Life insurance firms in Korea are primarily savings institutions. About 95 percent of premium income comes from savings, which are in a form similar to time deposits at banks. Only 5 percent of premiums are paid directly for

1. Koreans often describe this protective policy as a "fleet policy," which means that the government wants every insurance company to achieve a similar market share and profit. It does not want any company to fail.

2. The insurance industry in Korea is divided strictly into life and nonlife insurance. No company may handle both types of business.

insurance. Thus the rapid growth of life insurance companies has been due largely to their role as savings institutions rather than to demand for insurance.

To a great extent, this feature of Korea's life insurance business is due to government policy. In the 1960s, in order to mobilize domestic resources to finance its ambitious economic growth plans, the Korean government designated life insurance companies as savings institutions, eligible to receive a quasi-pension type of savings from groups of employees of companies and associations. The government has also used other measures to encourage the role of life insurance companies as depositories of savings.

The growth of the life insurance industry, and of other nonbank financial institutions such as investment and finance companies, has been particularly rapid in recent years (see table 1). This growth received its impetus from two main factors: (1) a reduction in inflation, which attracted financial savings to nonbank financial institutions, especially long-term savings institutions such as life insurance companies (which also offered higher interest rates than did the banking sector) and (2) the Korean government's domestic financial liberalization policy, which enhanced the attractiveness of financial savings.

The ratio of life insurance premium income to gross national product (GNP) provides an indication of the speed and extent of the growth of the life insurance industry. In 1980 this ratio was 1.6 percent, but by 1983 it had reached 4.0 percent, a higher value than in the United States or the United Kingdom (see table 2). By 1984 it had reached 4.7 percent.

Despite this rapid growth, however, available evidence suggests that Korean life insurance firms have not reached the levels of efficiency and competitiveness achieved in most industrial countries. Government regulation of premium rates and asset management of Korean life insurance firms has led to inefficiency and

Table 1. *Growth of the Korean Insurance Industry, 1976–84*
(in billions of won)

Item	*1976*	*1978*	*1980*	*1982*	*1984*
Premium income					
Life insurance	85	243	603	1,685	3,084
		(73.6)	(25.9)	(82.8)	(33.0)
Nonlife insurance	99	202	387	633	874
		(56.6)	(30.3)	(27.9)	(14.2)
Total assets					
Life insurance	145	355	998	2,488	5,314
		(67.5)	(48.1)	(69.5)	(44.2)
Nonlife insurance	141	326	607	918	1,111
		(48.2)	(36.1)	(18.9)	(6.5)
GNP	13,381	24,225	37,205	51,787	65,380
	(37.5)	(33.7)	(17.4)	(12.4)	(12.6)
GNP deflator	46.6	65.7	100.0	124.1	137.5
	(15.7)	(21.2)	(15.9)	(3.0)	(3.5)

Note: Figures in parentheses are annual growth rates in nominal terms.
Sources: Korea Insurance Corporation (1986); Republic of Korea (1986).

Table 2. *Comparison of the Life Insurance Industry in Selected Economies, 1983*

Item	*Korea*	*United States*	*Japan*	*United Kingdom*	*Taiwan*	*Malaysia*
Per capita GNP (U.S. dollars)	1,884	14,093	9,696	8,144	2,744	1,849
Life insurance premium paid (millions of U.S. dollars)	2,915	80,809	49,106	16,280	684	—
Per capita premium paid (U.S. dollars)	72.9	344.7	411.8	289.0	36.8	—
Premium per GNP (percent)	4.0	2.44	4.15	3.71	1.48	0.85

Sources: Republic of Korea (1986); Swiss Reinsurance (1985).

a sort of cartelized market. One recent study shows that the Korean life insurance companies' management expenses (or their intermediation costs as financial institutions) are much higher than those of commercial banks for the same amount of savings mobilization (Lee, Kim, and Park 1986). The study suggests that if commercial banks were to add an insurance feature to their time deposits, they could fulfill the same function as life insurance companies but at a much lower cost. Another indication that Korean insurance firms have not been wholly efficient in serving buyers of insurance is the prosperity of insurance providers organized outside the mainline insurance industry, such as the Marine Association Mutual Insurance Fund and the Teachers Association Mutual Insurance Fund.

Nonlife Insurance

Total premium income of nonlife insurance companies is currently about 28 percent of that of the life insurance industry, and the share has been shrinking since 1980 because of the rapid growth of the life insurance industry. Thirteen companies are licensed to sell nonlife insurance, including two U.S. firms and three joint ventures between Korean and non-Korean companies.

Until recently, nonlife insurance in Korea has been dominated by the pool system, in which member firms share total premium income according to a preestablished formula. Mortgage insurance, marine insurance, and compulsory fire insurance companies operated as pools from their beginnings, whereas automobile insurance was monopolized by a government-sponsored insurance company. Although the pool system and the monopolies have been gradually phased out during the 1980s, some categories of insurance, such as compulsory fire insurance, still operate under the pool system.[3]

The nonlife insurance industry has few incentives for innovation or improvement of the quality of service or marketing skills. This situation may account for the industry's failure to penetrate the household sector: as of 1985, only 13 percent of nonlife insurance business came from household customers, whereas

3. In seven major cities of Korea, buildings of more than four stories are required by law to have fire insurance, which is operated in the pool system and is referred to as the compulsory fire pool.

Table 3. *Selected Indicators of the Size of the Korean Insurance Industry and Its International Standing, 1980–84*

Indicator	*1980*	*1981*	*1982*	*1983*	*1984*
Premium paid (millions of U.S. dollars)					
Total	1,502	2,024	3,096	3,877	4,785
	(23)	(19)	(14)	(12)	(11)
Life	915	1,317	2,250	2,915	3,728
	(17)	(13)	(11)	(10)	(7)
Nonlife	587	707	846	962	1,056
	(24)	(23)	(20)	(19)	(17)
Per capita premium paid (U.S. dollars)					
Total	39.4	52.3	78.7	97.5	117.9
	(31)	(31)	(25)	(24)	(23)
Life	24.0	34.0	57.2	72.9	91.9
Nonlife	15.4	18.3	21.5	24.1	26.0
Premium paid per GNP (percent)	2.89	3.34	4.82	5.28	6.05
	(20)	(20)	(12)	(10)	(7)

Note: Figures in parentheses are Korea's rank in the world insurance business.
Sources: Korea Insurance Corporation (1986); Swiss Reinsurance (1985).

corporate customers accounted for 87 percent (Korea Insurance Corporation 1986).

Interest of U.S. Firms in the Korean Insurance Market

The Korean insurance market is quite large by international standards. In terms of total premiums paid, as of 1984 only ten national markets were larger than that of Korea, which ranked seventh in life insurance and seventeenth in nonlife insurance. In terms of the ratio of premiums paid to GNP, Korea ranked seventh in the world (see table 3).

Because of the large size of the market, its high growth potential in a rapidly growing econony, and the relative inefficiency of the local insurance industry, the market is very attractive to foreign firms. Some U.S. insurers have already obtained limited entry to the market because of the special relationship between the United States and Korea. These firms have recently become more actively interested in expanding their business and therefore in removing the restrictions under which they must operate. In addition, U.S. firms that have not yet entered the market are also more interested in Korea as a potential source of business.

II. The United States–Korea Dispute on the Opening of the Korean Insurance Market

Since 1968, several foreign insurers have been licensed to underwrite certain kinds of life and health insurance policies for resident aliens, including U.S. Armed Forces personnel and their families.[4] At present, seven U.S. companies provide such insurance in Korea.

4. This section draws heavily on Cho (1987b).

In 1968, two U.S. insurers, American Home Assurance Company (AHA) and American Foreign Insurance Association (AFIA), received licenses to underwrite other kinds of insurance for resident aliens. Later, in 1977 and 1978, these companies were also licensed to write fire and other casualty policies for Korean nationals.[5]

In September 1985, the U.S. Trade Representative (USTR) initiated an investigation under Section 301 of the U.S. Trade Act into Korea's policy of prohibiting or restricting U.S. firms from providing insurance services.[6] The opening of the life insurance market and the compulsory fire pool was a central issue.

The U.S. government demanded that the compulsory fire pool be dismantled or that the two U.S. firms operating in Korea be given access to the pool, with shares of premium income equal to those of the Korean firms. Because the Korean government had specific reasons for opposing abolition of the pool, including an unwillingness to immediately close down the company that organized and managed the pool, the ensuing negotiations focused on the participation of the U.S. firms and their shares in the fire pool. In addition, the United States demanded that several U.S. firms be licensed to sell life insurance by June 1986 and that three additional nonlife insurance firms be licensed by the end of 1987.

U.S. Position and Motivation

The United States approached the case on legal grounds, based mainly on "national treatment" arguments. The U.S. firms argued in their petition that the Korean government's restrictions on their access to the life insurance and compulsory fire insurance markets denied them the benefits to which they were entitled under the 1956 Treaty of Friendship, Commerce, and Navigation between the United States and Korea.[7] They alleged that the policies of the Korean government violated its treaty obligations and the international legal norms incorporated in Section 301(e). The USTR transmitted these arguments to the Korean government without alteration.

Why did the U.S. firms chose this moment to make their complaints? One

5. In October 1984, AFIA transferred its license to CIGNA, another U.S. insurer.

6. This was not the first U.S. case brought under Section 301. In 1979, AHA filed a petition on the grounds that it was not being treated equally to other firms in the Korean nonlife insurance market. Its complaint was based upon its exclusion from the pools for noncompulsory and compulsory fire insurance. AHA also alleged that it was excluded from the marine insurance market. In 1981, the Korean government responded by licensing AHA and AFIA to write marine insurance. By 1984, the noncompulsory fire pool had been abolished, and the U.S. insurers were given unrestricted licenses to underwrite noncompulsory fire insurance, pursuant to an agreement in connection with the Section 301 petition filed in 1979. Life insurance was not an issue in this petition.

7. The treaty specifies: "Neither party shall take unreasonable nor discriminatory measures that could impair the legally acquired rights or interests within its territories of nationals and companies of the other party in the enterprises which they have established . . . [and that] nationals and companies of either party shall be accorded national treatment with respect to engaging in all types of commercial, industrial, financial and other activities for gain (business activities) within the territories of the other party, whether directly or by agent or through the medium of any form of lawful juridical entity."

plausible explanation lies in the recent explosive expansion of the Korean life insurance industry and projections of strong future growth. These characteristics, combined with the relatively inefficient management of Korean insurance firms and the oligopolistic structure of the market, made entry potentially very profitable. In particular, the fire pool, although accounting for only 3 percent of the fire insurance market, was the most lucrative part of the nonlife insurance market, so U.S. firms had a strong interest in sharing in its profits.

Entry would also enable U.S. firms to invest in the Korean capital market, in which investment by foreign nationals was restricted. Investments in the Korean capital market by foreign bank branches and special funds managed by foreign finance companies (such as the Korea Fund) have been very profitable.

Korea's Position and Motivations

Korea argued that limiting foreign entry did not violate "national treatment" because the policy of protecting the industry from overcompetition and securing its stability also involved restrictions on the entry of domestic firms. For example, the government had limited the number of domestic life insurance firms to six during the last thirty years. Therefore, it argued, U.S. firms were treated no differently than domestic firms that did not succeed in gaining access to the life insurance market.

Behind the formal arguments, however, Korea's restrictions seemed to be motivated largely by three concerns. First, the Korean government believed that the inefficiency of domestic firms relative to U.S. firms would lead to a significant reduction in the market share of domestic firms, resulting in bankruptcies among inefficient firms and serious instability in the financial market. That the increased competition resulting from the entry of U.S. firms would probably improve the quality of service and the efficiency of domestic firms was admitted by the government. It believed, however, that improvements in efficiency and welfare could be obtained through deregulation and by enhancing competition among domestic firms, and that foreign entry was not essential to achieve that goal. Second, the government did not want foreign firms to share in the rent generated by the oligopolistic structure of the insurance industry, which had developed as a result of extensive government regulation and protection. A third concern, given the government's intention to continue to regulate and control the insurance industry,[8] was its belief that foreign firms are harder to control than domestic firms, a belief that was based on its experience in dealing with foreign bank branches in Korea.

The Negotiation and Its Results

Negotiations between the U.S. and Korean governments took place in November 1985 (Washington, D.C.), December 1985 (Seoul), and June 1986 (Seoul). The United States demanded that Korea (1) permit full participation

8. A discussion of whether regulation should be relaxed on efficiency grounds is beyond the scope of this article.

of the two U.S. firms in the compulsory fire pool; (2) allocate shares of fire pool premium income equally among the U.S. and Korean firms; (3) allow other U.S. insurers (the number of companies was unspecified) to enter the life insurance market by the end of June 1986; and (4) allow three additional nonlife insurance firms and four life insurance firms to enter the market by the end of 1987.

The initial Korean response was to propose that the issues be discussed in a multilateral forum, through the dispute-settlement procedures of the General Agreement on Tariffs and Trade. The Koreans felt that their trade surplus with the United States and their weak political position vis-à-vis the United States undermined their bargaining position in bilateral negotiations under Section 301. Korea also wanted a multilateral forum because it believed that multilateral negotiations would take more time than bilateral negotiations, thus permitting it to maintain the status quo in the insurance market for a longer period.

The Korean suggestion was not accepted by the United States. The USTR threatened to recommend that the president take action against Korea's exports to the United States if the issues were not resolved by September 1986.

The threat was effective. The United States is a major Korean export market, accounting in 1985 for 35 percent ($10.7 billion; billion is 1,000 million) of total exports and a trade surplus of about $4 billion (Republic of Korea 1987). Moreover, the increasingly protectionist stance of the U.S. Congress put the U.S. negotiators in a strong position. The threat of possible cuts in the Generalized System of Preferences (GSP) and of increased protection against Korea's major exports (such as electronics, textiles, footwear, and steel) provided the United States with effective leverage for obtaining concessions in the insurance market.

Korea, meanwhile, had little leverage. Under these circumstances, the Korean government believed that the best that it could achieve would be to postpone a massive influx of U.S. firms.

On July 21, 1986, the two governments simultaneously announced the results of the negotiations. Most of the U.S. demands were accepted. Specifically, the government of Korea agreed (1) that the two U.S. firms would participate in the fire pool by July 1986; (2) that the member companies would determine the method of sharing pool premium income, with the Korean government ensuring that the distribution would be equitable (in a supplementary announcement immediately following this one, the Korean government agreed that U.S. firms would get the same share as Korean firms);[9] (3) that one U.S.

9. The United States had proposed that equal shares of premium income be distributed among companies, whereas Korea had proposed that the income be shared on the basis of company size. The two U.S. firms (which are branches) are much smaller than the Korean firms; their total share in the nonlife insurance market is less than 2 percent.

firm would be licensed to enter the life insurance market by the end of 1986; and (4) that qualified U.S. firms would be permitted to enter both the life and nonlife insurance markets.

III. Conclusions from the Trade Dispute Case

Four conclusions can be drawn from this dispute and its outcome. First, it is probably more realistic to approach insurance transactions (or more broadly, transactions in financial services) between developed and developing countries in the context of international investment rather than international trade. The United States presented its arguments in the dispute strictly in those terms. The U.S. government suggested that multilateral negotiations on trade in services should be restricted to nonfactor services, that is, services that can be traded between countries in the conventional sense, without requiring the relocation of either buyer or seller. Such trade in financial services, however, can be realistically considered only among countries without foreign exchange controls and restrictions on capital account transactions. In other words, a person or firm wishing to buy an insurance policy or to undertake financial transactions with firms (or banks) in a developed country must first be able to convert domestic currency freely into the foreign currency. In most developing countries, however, foreign exchange and capital accounts are strictly controlled.[10] Thus it is necessary to establish a local entity in order to sell financial services in these countries.

A second conclusion is that both governments basically represented the interests of their insurance firms. They entered the negotiations with the perception that the main issue was the sharing of profits (or rents) in Korea's insurance market. Broader considerations—for example, the effect of the outcome of the negotiations on economic efficiency or consumer welfare—seem not to have arisen.

The issues from the beginning were those of "national treatment" and U.S. entry to the market through "establishment." The U.S. government concentrated its efforts specifically on improving access for U.S. firms to Korea's relatively inefficient, highly regulated (and oligopolistic) insurance market. Alternatively, it could have pressed for relaxation of the strong domestic regulation of the Korean insurance industry and for freer general conditions of entry.

Issues such as deregulation of cartelized premium rates did not assume any importance in the negotiations. This fact partly reflects the sensitivity and

10. The advisability of liberalizing the capital market in developing countries in which there are still many distortions in the commodity market is a matter of controversy. The experience with liberalization in the Southern Cone countries suggests the importance of the order in which liberalization takes place; premature opening of the capital market in the presence of domestic market distortions can cause serious macroeconomic disruptions and massive capital flight.

difficulty of the issue of domestic policy reform in financial markets and the strong objections of developing country governments to such discussions. However, it also reflected a U.S. interest in obtaining for U.S. firms a share of the profit and rent of Korea's highly protected and oligopolistic market. Whether the repeated application of such an approach in other developing countries would improve welfare in the world economy is highly questionable.

The third conclusion is that, given the strong U.S. pressure for opening up the market and the threat of retaliation against Korea's exports to the United States, the Korean government's decision to open the insurance services market to U.S. firms made economic sense. By accommodating the U.S. demand, Korea chose more trade rather than less. The potential loss in exports as a result of U.S. retaliation would lead to a far greater reduction in GNP than would opening the insurance market to U.S. firms.[11] If, in addition, the cost of protection and the benefits of increased competition (improvements in efficiency and consumer welfare) are included in the calculation, the net cost of refusing U.S. entry would be even greater.[12]

A fourth conclusion relates to the issue of deregulation versus the sharing of rents in a protected, cartelized market. The principal concern of the Korean government during the negotiations was not to lose the domestic firms' market and profit shares to U.S. firms and to protect domestic firms from the shock of foreign competition. Despite the Korean recognition of the positive effects that could result from increased competition, the government gave little consideration to liberalizing the domestic market as an element of its response to U.S. demands. In a sense, the government entered negotiations with the assumption that it would maintain the current level of regulation of insurance firms. From this position stemmed its decision to allow U.S. firms to enter and share equally in the premium income of the compulsory fire pool—rather than to disband the pool and deregulate the market so that rents from the protected and cartelized market would disappear.

Given the current trade negotiation environment, developing countries like Korea may need to consider which approach would better serve their national

11. For example, the United States apparently suggested at one point in the negotiations that if Korea refused to open its insurance market, the United States would cut its GSP grant to Korean exports and increase protection, thus reducing the volume of Korea's major exports. Had there been a 50 percent cut in the GSP grant and a 5 percent reduction in the export volume of Korea's major exports, Korea would have experienced a 1.5 percent reduction in total exports, or roughly a 0.4 percent reduction in annual GNP. The cost to Korea of allowing entry to the U.S. insurers, however, would be less than 0.01 percent of GNP (assuming they received 2/13 of the compulsory fire pool business and a 5 percent share in the rest of the insurance market and had a net profit rate of 2 percent of total premium revenue). A variety of other scenarios under different assumptions are explored in Cho (1987a), all with essentially similar results.

12. There may also be direct and indirect benefits in terms of technological, pecuniary, marketing, or entrepreneurial stimuli that result from the entry of foreign firms. See Lall (1978) and Caves (1974) for a discussion of the effect of foreign investment in host country markets.

interest: to maintain protected and cartelized market structures and share the resulting rents with foreign firms or to deregulate these markets and allow the rents to be redistributed to buyers through competition.

IV. Deregulation of Domestic Markets: An Alternative Strategy for Developing Countries in the Current Trade Negotiation Environment

What is the best strategy for developing countries in the current international trade environment? The effects of different policy options on national welfare can be illustrated with a diagram such as figure 1, which is a simple supply and demand curve for insurance services.[13]

Suppose that in a protected insurance market, the government-regulated premium rate is P_c. Then I_c is the amount of insurance services sold, the combined area of W and X is the rent to insurance companies, and the triangular area Y is the welfare loss. If the country continues its market protection with regulated premium rates while allowing foreign companies to enter and share the market (I_iI_c being their market share), then the total welfare loss to the national economy would be $Y + X$, where X is the rent going to foreign firms, which they may repatriate to their home country.[14] Thus a country's welfare may worsen after allowing foreign firms to enter a domestic market in which prices are regulated.

If, instead, the country deregulates the domestic market and allows more competition, then the rent that insurers received under regulation will go to the buyers, and the increased competition will achieve the further welfare gain Y. In addition, in the competitive market, domestic insurance firms will have a strong incentive to learn from foreign firms, which will in turn lead to advances in technology, innovation, improvement of management skills, and so on. This effect may shift the overall domestic supply curve S (including both domestic and foreign firms) down to S'. If this happens, the welfare gain ($Y + Z +$ part of Z')[15] will be greater than under domestic deregulation without entry of foreign firms (Y).[16]

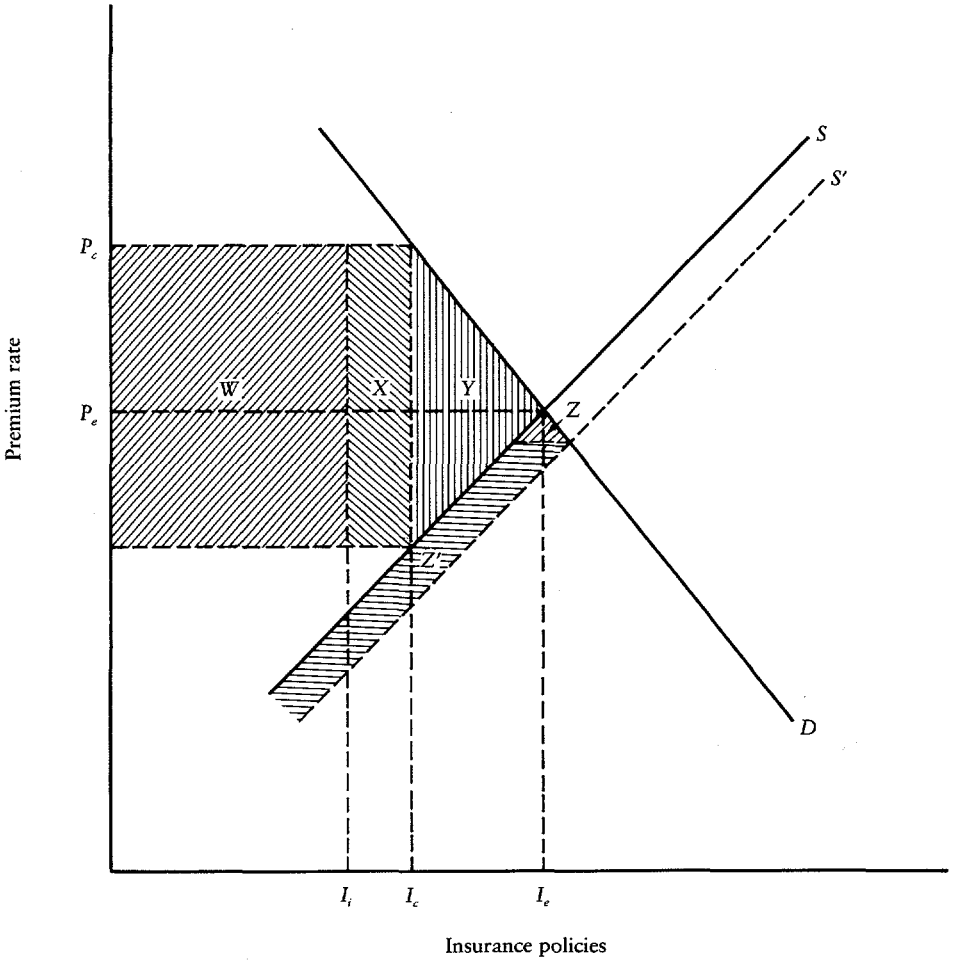
13. Figure 1 illustrates the effects of different policy options on national welfare. It should be noted, however, that the figure abstracts from various complicated insurance market issues such as adverse selection and the moral hazard effect. In the insurance market, we cannot draw a simple upward sloping supply curve and a downward sloping demand curve, because under conditions of asymmetric information they may be subject to adverse selection and the moral hazard effect. In some cases, the market may even fail to achieve a stable equilibrium point (see Rothschild and Stiglitz 1976).

14. The profit going to foreign firms may be even larger than B because their supply curve may lie below curve S because of their efficiency. But the part larger than B would not be a net cost to the host country in terms of the opportunity cost concept.

15. The welfare gain will be only some part of D' with the remainder being increased profit for foreign firms.

16. This argument is based on partial equilibrium analysis. The welfare gain may be greater in the general equilibrium context.

Figure 1. *The Welfare Effects of Various Policy Options for the Korean Insurance Market*



Note: P_e is the equilibrium premium rate; I_e is the equilibrium number of insurance policies.

This analysis suggests that if a country takes the policy option of allowing foreign entry while maintaining regulation, the result may be in a net loss (X) to the economy, whereas if it takes the policy option of allowing foreign entry while deregulating the market, the result would be an increase in the welfare of the economy ($Y + Z +$ part of Z') beyond what could be achieved without foreign transactions (Y.

Despite the teachings of simple economic theory, many developing-country governments intervene to protect cartelized market structures. Advocates of such policies often justify them in terms of externalities of one kind or another

or second best arguments (for example, the need to take into account market imperfections or the instability of price equilibrium when markets are thin). It is also true, however, that underlying these arguments is the desire of governments to maintain their political power to distribute rents—or to retain their leverage over the private industrial sector through their power to distribute rents.

For this reason and others, the financial services industry in developing countries is often heavily controlled by the government.[17] It is not the purpose of this article to take a position on the merits of this approach, although it is worth noting that many empirical studies suggest that government intervention only increases distortions and inefficiency.[18]

Rather, the purpose of this article is to suggest, through the example of the United States–Korea trade dispute and the simple market analysis presented above, that developing countries facing strong pressure to open their financial services markets to foreign firms can increase their national welfare by liberalizing the domestic market when (or preferably before) opening it to foreign firms. In other words, *the case for deregulation of domestic financial services markets in developing countries becomes stronger in the current international trade environment.* For a developing country government that insists on maintaining a regulatory and protective regime that generates rents for service suppliers, the current trade environment will increase the cost of this policy. For a developing country that initiates deregulation and develops a competitive domestic market environment, however, the current trade environment offers an opportunity to enhance national welfare.

V. Conclusion

Financial services markets (including banking and insurance) are heavily regulated and protected by the government in many developing countries. Market structures are oligopolistic, and prices are often set by cartels. This heavy government intervention and lack of competition have led to inefficiencies in the financial services industries in these countries.

Restrictive government policies are often justified in terms of externalities and market imperfections. But many developing countries have regulated their financial services industries as an element of industrial policy, in order to promote strategic industries by providing them with preferential access to credit at low cost. In the process, the profitability of financial institutions has been

17. Governments in many developing countries control or own the financial services industry as a tool of their industrial policy. Governments set prices which may not reflect market conditions, and then direct asset management in support of strategic industrial sectors.

18. For example, a recent liberalization of banks and nonbank financial intermediaries in Korea has substantially increased the efficiency of credit allocation (see Cho and Cole 1986).

supported by government-determined interest rates, service fees, or premium rates that often do not reflect market conditions.

The international trade environment has recently changed and is less favorable for developing countries. Increasingly, industrial countries are retaliating against the various financial and fiscal subsidies that developing countries provide for their exports by establishing countervailing duties and other protective measures. At the same time, industrial countries (especially the United States) are exerting stronger pressure on developing countries to open their financial services markets to foreign firms.

Economists have made a strong case for financial services market liberalization in developing countries on the grounds of economic efficiency and growth. This argument has not been well received by many developing countries for various reasons, including its variance from their own economic philosophies. This article has argued, however, that the case for liberalization of domestic financial services is *stronger* under the current international trade negotiation environment, notwithstanding the various arguments used by developing countries to justify maintaining their regulatory and protective regimes.

It can also be argued that industrial countries should encourage developing countries to move toward liberalization of their financial services sector. But "liberalization" of financial services may not be beneficial to developing countries if opening the financial services market is considered by both sides to mean sharing the rents generated by regulation of the market—as in the United States–Korea case—rather than opening the domestic market to competition. If this approach becomes widespread, developing countries may become increasingly reluctant to open their markets, while continued government regulation and the inefficiencies resulting from lack of competition will restrict the development of financial services markets. By limiting the markets or the size of the markets that firms from industrial countries can enter, this approach may lead to economic losses in the long term for industrial countries as well. Liberalization of transactions in financial services will be beneficial to both developing and industrial countries in the long run only if market expansion is discussed in the context of overall liberalization of domestic financial services in developing countries.

Appendix: Section 301 of the U.S. Trade Act

Section 301 of the U.S. Trade Act authorizes the president of the United States to take action against foreign trade practices that violate international trade agreements or burden or restrict U.S. commerce in an unjustifiable, unreasonable, or discriminatory fashion. Action may be initiated by the U.S. Trade Representative (USTR) directly or at the direction of the president, or following a petition from any interested persons, including business or labor. If a petition is filed, the USTR has forty-five days to determine if an investigation is warranted.

Section 301 directs the USTR to seek advice from public and private groups and to consult with the foreign country involved in the dispute as part of its investigation. Most cases are resolved through negotiations with the country whose practices are being questioned. If the USTR finds that unfair trade practices exist and the dispute cannot be resolved through negotiations or through the General Agreement on Tariffs and Trade dispute-settlement procedures, the USTR makes a recommendation to the president of the United States on what action, if any, he should take.

Under Section 301, the president has the authority to take all appropriate and feasible actions within his power to obtain the elimination of unfair trade practices. Specifically, he may impose duties, fees, or restrictions on products and services of the offending country; these goods do not necessarily have to be related to the goods and services which are the subject of the complaint. The president may also deny licenses issued by U.S. federal regulatory agencies to foreign service suppliers. The degree and duration of these actions is determined by the president. (Adapted from a U.S. presidential press release, September 7, 1985.)

References

Bhagwati, Jagdish N. 1987. "Trade in Services and the Multilateral Trade Negotiations." *World Bank Economic Review* 1, no. 4 (September): 539–47.

Caves, Richard E. 1974. "Multinational Firms, Competition, and Productivity in Host-Country Markets." *Economica* 41 (May): 176–93.

Cho, Yoon Je. 1986. "Status of Korea's Financial Liberalization." Draft, International Economic Research Division, World Bank Development Research Department. February.

———. 1987a. "Developing Country Strategy for International Trade in Financial Service—Lessons from the Opening of the Korean Insurance Market." Paper presented at the World Bank Conference on Developing Countries' Interests and International Transactions in Services, Washington, D.C., July.

———. 1987b. "How the United States Broke into Korea's Insurance Market." *World Economy* 10 (December): 483–96.

Cho, Yoon Je, and David Cole. 1986. "The Role of the Financial Sector in Korea's Structural Adjustment." World Bank Development Research Department. Processed. Washington, D.C.

Kim, Kiwhan. 1986. "Trade Negotiations and the Developing Countries of Asia: Possible Benefits and Costs." Occasional Paper 86-02. Seoul, Korea: Ilhae Institute.

Korea Insurance Corporation. 1986. *Insurance Statistics Yearbook*. Seoul.

Lall, Sanjaya. 1978. "Transactionals, Domestic Enterprises, and Industrial Structure in Host LDCs: A Survey." *Oxford Economic Papers* 30 (July):217–48.

Lee, Young Ki, Myung K. Kim, and Jin W. Park. 1986. "An Analysis of the Comparative Advantage and Competitiveness of the Life Insurance Industry." *Hanguk Gaebal Yungu* (Korean Development Institute) 8, no. 2 (June): 104–126.

Republic of Korea. 1986. *Korean Economic Indicators*. Seoul, Korea: Economic Planning Board.

Rothschild, Robert, and J. E. Stiglitz. 1976. "Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Inperfect Information." *Quarterly Journal of Economics* 90 (November): 629–50.

Swiss Reinsurance. *Sigma*. Swiss, 1985.