South Korea's Economic Reality After the Financial Crisis and Its Impact on South-North Relations

Yukiko Fukagawa

Introduction

The final year of the 20th century witnessed the historic summit between Kim Dae Jung, the president of the Republic of Korea (ROK) and Kim Jong Il, the paramount leader of the Democratic People's Republic of Korea (DPRK). Since then, positive expectations have emerged for a possible breakthrough in the Korean peninsula's Cold War structure. Many others, however, remain suspicious and uncertain about the prospects of reconciliation. Indeed, as North Korea started to succeed in establishing ties with major Western countries beginning in 2000, basic questions have been raised even in Seoul: What strategy lies behind the DPRK's decision to accept and respond rather positively to the "Sunshine Policy" initiated by the South? How serious is the DRPK about opening and reform? How long can the DPRK manage the external shock of opening its regime? Despite an emotional and nationalistic optimism in the

South, many seem perplexed by the sudden, dramatic reaction from the North. Conservatives in the ROK are even more suspicious and cautious. Others fear a backlash against the "Sunshine Policy" in the latter half of the Kim Dae Jung presidency, when political struggles traditionally increase.

Then, if North Korea changes its strategy unexpectedly, or if the North disappoints the South, or if there is political chaos in the North, can the South abandon the "Sunshine Policy" to go back to a more traditional, conservative policy? The answer seems to be "no," at least from the economic point of view. After the IMF negotiated reforms, the South Korean economy has become based on a structure substantially different from the past and characterized by three features: thoroughly opened capital market, enhanced market discipline, and more dependence on Chinese market. Hence, the South may have passed the Rubicon in terms of developing a new policy towards the North.

The economic reform after the financial crisis

Capital market opening and direct financing. The most important change in the South Korean economy after the IMF reforms lies in the intensive capital market opening and the rapid shift to direct financing for firms. Traditionally, unlike Thailand or Indonesia, the ROK had preferred strict controls for foreign exchange and had been conservative about capital market opening. It was only in 1993 that comprehensive deregulation and a gradual capital market opening started. Even in negotiating with the OECD for membership, the Korean capital market remained more closed than Mexico and major East European countries.[1] The rational for the slow capital market opening was that the Korean economy would not be able to sustain itself if massive capital flight or speculation occurs as a result of serious conflict with the North. The government was especially careful about short-term capital movements and property market trends. Indeed, this cautious exchange policy and capital market opening helped South Korea avoid

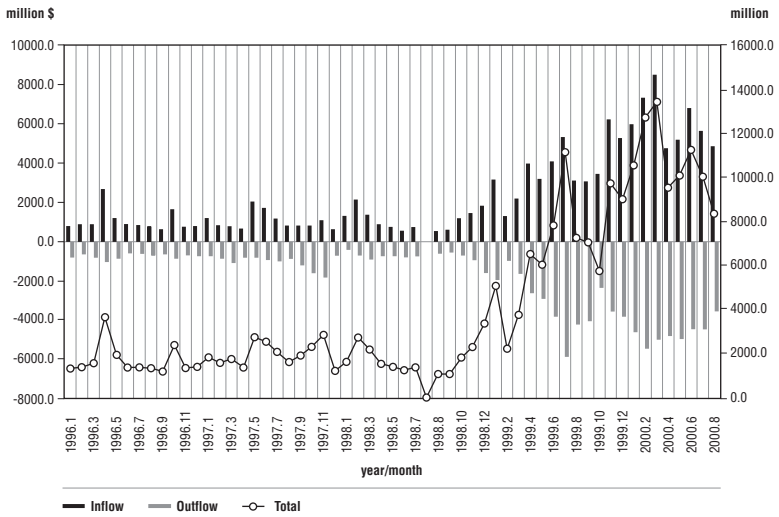
1 For the financial liberalization program in 1990s, see Bank of Korea (2000), or KIEP (1998).

Thailand's bubble economy or Malaysia's problems of speculation by foreigners.

However, to tackle the intensive liquidity crisis, the IMF included rather radical capital market opening as part of the conditionality for the bailout loans.[2] South Korea agreed to open the stock market fully to foreign investors, including hostile mergers and acquisitions, all the bond markets including the short-term one, and all the property market. Controls on foreign exchange were to be lifted fully in just three years, including Korean residents' portfolio investment and foreign savings, to the level of Hong Kong or Singapore. South Korea has faithfully followed this conditionality and the liberalization program was almost completed in June 2000.

As the capital market was opened, and the vigorous recovery of the Korean economy started to impress investors from late 1999, foreign capital poured into the new market. Table 1 indicates capital inflow and

Table 1 Capital Inflow and Outflow in Stock Exchange



2 It is well known that the conditionality reflected a very detailed demand from Wall Street, leading to the criticism of the so-called "U.S. Treasury-IMF complex."

Outflow and Inflow in Stock Exchange

	Inflow	Outflow	Total	Balance	KOSPI
1996.1	739.7	-610.8	1350.5	128.9	866.1
1996.2	855.9	-552.1	1408.0	303.8	874.8
1996.3	825.1	-741.5	1566.6	83.6	857.4
1996.4	2659.2	-972.3	3631.5	1686.9	920.1
1996.5	1160.9	-798.6	1959.5	362.3	942.5
1996.6	879	-516	1395.0	363.0	867.6
1996.7	822.4	-538.8	1361.2	283.6	832.2
1996.8	735.5	-624.9	1360.4	110.6	805.4
1996.9	607.4	-587.9	1195.3	19.5	783.4
1996.10	1610.4	-807.4	2417.8	803.0	806.7
1996.11	718.8	-633.5	1352.3	85.3	740.9
1996.12	754.1	-665.6	1419.7	88.5	690.6
1997.1	1170.3	-653.5	1823.8	516.8	669.6
1997.2	795.4	-801.5	1596.9	-6.1	698.1
1997.3	736	-1021.2	1757.2	-285.2	656.7
1997.4	615.1	-738.8	1353.9	-123.7	694.3
1997.5	2008.4	-747.3	2755.7	1261.1	713.2
1997.6	1683.7	-872.6	2556.3	811.1	765.2
1997.7	1147.7	-932.5	2080.2	215.2	752.3
1997.8	803.2	-831.7	1634.9	-28.5	740.5
1997.9	780.8	-1146.7	1927.5	-365.9	676.5
1997.10	749.5	-1565.5	2315.0	-816.0	584.1
1997.11	1057.8	-1782.3	2840.1	-724.5	494.1
1997.12	577.8	-654.7	1232.5	-76.9	390.3
1998.1	1275.9	-351.8	1627.7	924.1	475.2
1998.2	2101.4	-631.6	2733.0	1469.8	525.2
1998.3	1345.3	-863.5	2208.8	481.8	523
1998.4	843.1	-695.3	1538.4	147.8	444.2
1998.5	699.8	-698.6	1398.4	1.2	356.3
1998.6	513.7	-723	1236.7	-209.3	313.3
1998.7	695.9	-673.6	1369.5	22.3	327.8
1998.8	496.5	-554.4	1050.9	-57.9	312.8
1998.9	544.3	-494.3	1038.6	50.0	312.2
1998.10	1140	-659.8	1799.8	480.2	358.8
1998.11	1382.1	-902.2	2284.3	479.9	429.2
1998.12	1772.3	-1574.1	3346.4	198.2	524.7

KOSDAQ	Inflow	Outflow	KOSPI
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1996.7	822.4	-538.8	832.2
1996.8	735.5	-624.9	805.4
1996.9	607.4	-587.9	783.4
1996.10	1610.4	-807.4	806.7
1996.11	718.8	-633.5	740.9
1996.12	754.1	-665.6	690.6
1997.1	1170.3	-653.5	669.6
1997.2	795.4	-801.5	698.1
1997.3	736	-1021.2	656.7
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1998.8	496.5	-554.4	312.8
1998.9	544.3	-494.3	312.2
1998.10	1140	-659.8	358.8
1998.11	1382.1	-902.2	429.2
1998.12	1772.3	-1574.1	524.7

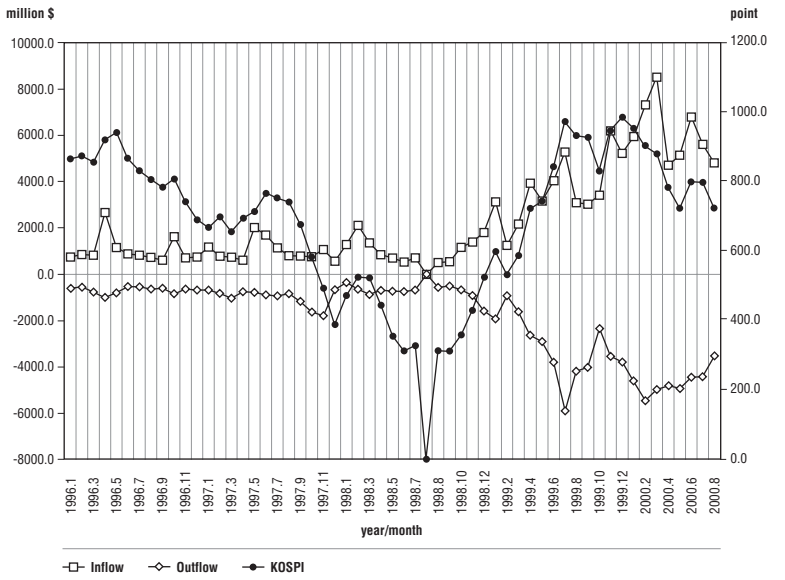
	Inflow	Outflow	Total	Balance	KOSPI	KOSDAQ		Inflow	Outflow	KOSPI
1999.1	3110.6	-1932.4	5043.0	1178.2	597.6	78.18	1999.1	3110.6	-1932.4	597.6
1999.2	1239.9	-944.3	2184.2	295.6	533		1999.2	1239.9	-944.3	533
1999.3	2130.3	-1611.3	3741.6	519.0	586.2		1999.3	2130.3	-1611.3	586.2
1999.4	3916.3	-2617.3	6533.6	1299.0	721.1		1999.4	3916.3	-2617.3	721.1
1999.5	3135.5	-2899.7	6035.2	235.8	745.4		1999.5	3135.5	-2899.7	745.4
1999.6	4023.4	-3815.3	7838.7	208.1	841.4		1999.6	4023.4	-3815.3	841.4
1999.7	5271.9	-5889.5	11161.4	-617.6	971.4		1999.7	5271.9	-5889.5	971.4
1999.8	3058.4	-4219.2	7277.6	-1160.8	933.1		1999.8	3058.4	-4219.2	933.1
1999.9	2995.2	-4049.2	7044.4	-1054.0	926.9		1999.9	2995.2	-4049.2	926.9
1999.10	3383.8	-2354.9	5738.7	1028.9	828.6		1999.10	3383.8	-2354.9	828.6
1999.11	6181.9	-3546.7	9728.6	2635.2	950.1		1999.11	6181.9	-3546.7	950.1
1999.12	5204.7	-3817.5	9022.2	1387.2	984.5		1999.12	5204.7	-3817.5	984.5
2000.1	5921.8	-4617.2	10539.0	1304.6	952.5		2000.1	5921.8	-4617.2	952.5
2000.2	7290.8	-5466.2	12757.0	1824.6	902.7		2000.2	7290.8	-5466.2	902.7
2000.3	8467.6	-5005.4	13473.0	3462.2	878.4		2000.3	8467.6	-5005.4	878.4
2000.4	4683.3	-4836.5	9519.8	-153.2	779.8		2000.4	4683.3	-4836.5	779.8
2000.5	5108.4	-4966	10074.4	142.4	720.8		2000.5	5108.4	-4966	720.8
2000.6	6769.9	-4481.8	11251.7	2288.1	795.1		2000.6	6769.9	-4481.8	795.1
2000.7	5565.4	-4470.2	10035.6	1095.2	794.1		2000.7	5565.4	-4470.2	794.1
2000.8	4789.3	-3569.6	8358.9	1219.7	720.4		2000.8	4789.3	-3569.6	720.4
GNP										
1996	520	12422	12.422	2.388846	154	5998	1.538462			
1997	476.6	12525	12.525	2.62799	11748					
1998	317.7	12810	12.81	4.032106	8822					
1999	406.7	43370	43.37	10.66388	37754	5998	43752	10.76961		

outflow into the stock exchange on a balance of payment basis. After capital market was totally opened, capital inflow grew rapidly to $14 billion at the beginning of 2000, almost seven times more than the level of the third quarter in 1998. As the volume becomes bigger, both the inflow and outflow of the capital have become more volatile since 2000, synchronizing with the intensive adjustment of the NASDAQ market.

Responding to the rising capital flow, the Korean stock market has started to be influenced heavily by foreign investors. Table 2, which shows the Korea Stock Price Index (KOSPI) and the trends of capital flows,

makes clear that until the third quarter of 1998, the inflow and index did not correlate with each other: Until then there had been controls over the foreign investors' ownership, and the gap was bigger between the inflow and the index. However, since then, the index has moved more closely with the inflow of foreign capital. Importantly, there was a shock in the bond market in the summer of 1998 due to the collapse of the Daewoo group, the second largest chaebol in terms of assets. Since then the portfolio market as a whole has become much more volatile, while the panicky behavior of mutual funds paralyzed the bond market. As the psychological uncertainty dominated, the portfolio market started to be more influenced by short-term transactions both by foreign investors as well as domestic personal speculators. Being a typical emerging market, the Korean market is crucially lacking in long-term oriented, well-functioning institutional investors,[3] as well as basic market infrastructure

Table 2 Stock Price Index and Capital Flow



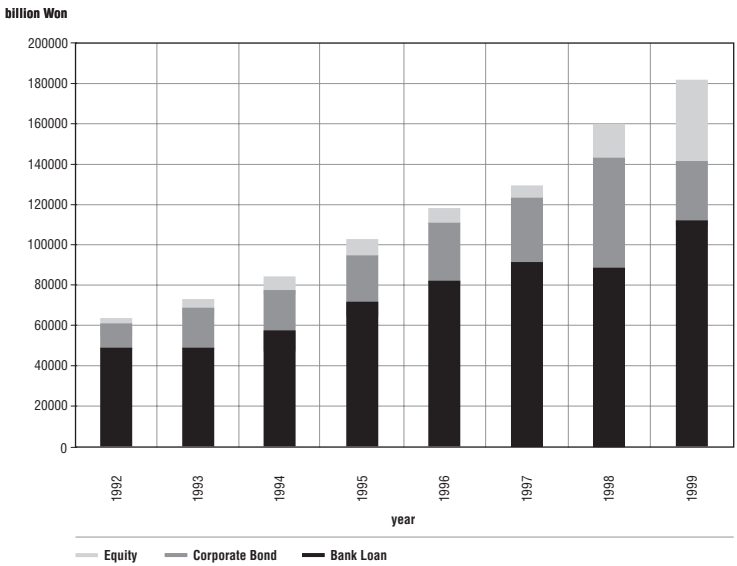
3 For the role of institutional investors, see Choi (1997), or Fukagawa (2000).

	FDI	PFI	Asset	Debit
1996.1	191.2	-5.1	-193.5	188.4
1996.2	93.5	642.0	-377.5	1019.5
1996.3	120.7	1502.7	-337.5	1840.2
1996.4	144.2	2313.5	-317.9	2631.4
1996.5	175.6	1539.1	-356.8	1895.9
1996.6	360.1	1906.2	-140.1	2046.3
1996.7	45.0	1371.8	-396.3	1768.1
1996.8	98.7	999.0	-881.7	1880.7
1996.9	111.9	881.5	-632.9	1514.4
1996.10	177.0	987.1	-870.0	1857.1
1996.11	223.4	1705.9	-923.6	2629.5
1996.12	584.1	1340.9	-570.6	1911.5
1997.1	24.1	518.3	-271.6	789.9
1997.2	401.6	340.4	-473.0	813.4
1997.3	198.3	1735.9	436.3	1299.6
1997.4	348.9	767.1	-207.5	974.6
1997.5	190.9	2045.0	-23.7	2068.7
1997.6	250.7	3016.5	-46.8	3063.3
1997.7	312.3	2695.4	-173.8	2869.2
1997.8	255.7	799.0	55.9	743.1
1997.9	42.8	1949.5	198.3	1751.2
1997.10	145.6	413.7	-301.1	714.8
1997.11	286.3	-815.1	747.2	-1562.3
1997.12	387.0	829.6	2067.9	-1238.3
1998.1	113.7	370.6	335.3	35.3
1998.2	207.5	2169.8	316.2	1853.6
1998.3	184.0	1265.5	562.9	702.6
1998.4	194.3	3667.7	52.4	3615.3
1998.5	508.2	-1200.0	-692.8	-507.2
1998.6	463.6	-1900.0	-525.7	-1374.3
1998.7	1007.2	-668.2	200.8	-869.0
1998.8	654.4	-1384.0	144.3	-1528.3
1998.9	500.1	-1825.3	-429.7	-1395.6
1998.10	732.6	-690.2	-336.2	-354.0
1998.11	409.6	-357.9	-566.6	208.7
1998.12	437.1	-1326.2	-647.6	-678.6
1999.1	560.2	1082.8	-224.0	1306.8
1999.2	364.0	198.2	-216.7	414.9
1999.3	502.2	-396.1	127.3	-523.4
1999.4	684.5	2428.9	-55.7	2484.6
1999.5	415.9	2015.6	125.8	1889.8
1999.6	709.8	-395.5	165.4	-560.9
1999.7	521.9	-1.6	96.5	-98.1
1999.8	1900.9	-1736.9	229.9	-1966.8
1999.9	307.7	565.4	771.7	-206.3
1999.10	357.9	980.4	184.6	795.8
1999.11	1219.3	2159.3	325.4	1833.9
1999.12	1789.1	1775.9	153.1	1622.8
2000.1	658.0	1030.3	101.6	928.7
2000.2	310.9	2110.5	-159.1	2269.6
2000.3	357.5	3608.7	-1467.0	5075.7
2000.4	736.8	2189.2	1243.0	946.2
2000.5	1505.4	-1052.2	-48.7	-1003.5
2000.6	516.0	480.8	-1259.1	1739.9
2000.7	1512.0	2171.8	1184.7	987.1
2000.8	-125.1	1454.1	346.8	1107.3
2000.9	—	—	—	—
2000.10	—	—	—	—
2000.11	—	—	—	—
2000.12	—	—	—	—

including transparent accounting and fair investor relations. As a result, the market has been characterized by speculative transactions by those who shared the fear that they might be less informed than chaebol-related firms or other investors. The market has shown extremely nervous responses to the North-South dialogue development since 2000.

Changed corporate finance and KOSDAQ-lead growth. Even though the equity/bond markets have turned out to be less mature, rapid restructuring in the financial sector has caused intensive financial shrinkage, starting from the money-centered banks. As the banks underwent restructuring, pressed strongly by the government, and bank interest rates were withdrawn in consultation with the IMF since the latter half of 1998, domestic capital moved from the banking sector into the equity/bond market, expecting improved performance by firms. Therefore, the five largest chaebols, later four largest after the bankruptcy of Daewoo, could allocate the capital in the market. Table 3 indicates the bond boom in 1998 taken over by equity finance in 1999. As was confirmed in Table 2, a market hike encouraged more capital to flow into the market pushing up the index again for the expansionary cycle. The market enjoyed a boom from 1999 until the first half of 2000.

Table 3 Structure of Corporate Finance



Corporate Finance in change

	Bank Loan	Corporate Bond	Equity	Total
1992	54527	11154	2349	68030
1993	55060	15599	3258	73917
1994	61832	20049	6247	88128
1995	74871	23598	6266	104735
1996	85141	29903	5285	120329
1997	94296	34321	3389	132006
1998	92851	55998	14158	163007
1999	112869	30670	41113	184652

ROK's Trade with China

	Import from C	Import from J	Import from USA	Others	Total
1991	3440.5	21120.9	18894.4	38069.1	81524.9
1992	3724.9	19457.7	18287.3	40305.4	81775.3
1993	3982.7	20015.5	17928.2	41873.7	83800.1
1994	5462.8	25390	21578.8	49916.6	102348.2
1995	7401.2	32606.4	30403.5	64707.8	135118.9
1996	8538.6	31448.6	33305.5	77046.4	150339.1
1997	10116.9	27907.1	29981.2	76611.2	144616.4
1998	6484	16840.4	20403.2	49554.2	93281.8
1999	8866.7	24142	24922.3	61821.3	119752.3

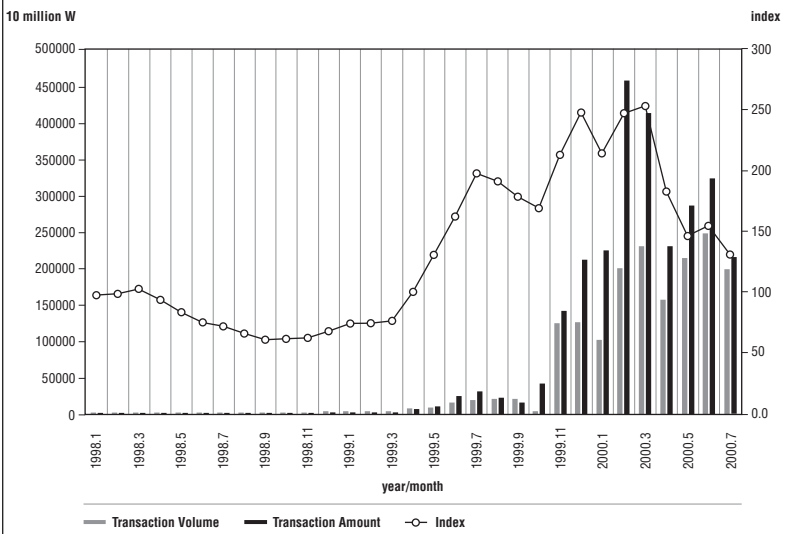
	Import from C	Export to C
1991	3440.5	1002.5
1992	3724.9	2653.6
1993	3982.7	5151
1994	5462.8	6203
1995	7401.2	9143.6
1996	8538.6	11377.1
1997	10116.9	13572.5
1998	6484	11944
1999	8866.7	13684.6

	Export to C	Export to J	Export to USA	Others	Total
1991	1002.5	12355.8	18559.3	39952.5	71870.1
1992	2653.6	11599.5	18090	44288.1	76631.2
1993	5151	11564.4	18137.6	47382.6	82235.6
1994	6203	13522.9	20552.8	55734.5	96013.2
1995	9143.6	17048.9	24131.5	74734	125058.0
1996	11377.1	15766.8	21670.5	80900.7	129715.1
1997	13572.5	14771.2	21625.4	86195.1	136164.2
1998	11944	12237.6	22805.1	85326.4	132313.1
1999	13684.6	15862.5	29474.7	84663.3	143685.1

FDI to China	Others	Total	FDI
1990	55	903	958	39
1991	85	1030	1115	112
1992	221	998	1219	269
1993	622	639	1261	629
1994	821	1479	2300	1066
1995	1240	1831	3071	878
1996	1627	2657	4284	911
1997	895	2335	3230	732
1998	805	3088	3893	290

Another stimulating factor came from the KOSDAQ market being pushed by booming venture firms. As Table 4 shows the venture business boom reached its peak at the beginning of 2000 until the market was seriously affected by the NASDAQ adjustment in April. Before the collapse, the capital, which could not be absorbed fully by the corporate bonds of large chaebols, spilled over into venture capital. It was notable that unlike Japan, where potential entrepreneurs are still contained in the big, established firms, Korean venture firms could find fresh human capital through the intensive restructuring of chaebol-related firms. Thanks to the excellent Internet infrastructure in broadband, Korea's venture capital flourished in IT-related businesses. It was fortunate for Korea to find a way to go back to the growth track through the IT boom backed by KOSDAQ capital. Since the summer of 2000, however, the boom became a bust, but the boom experience has encouraged small firms to seek equity financing. While the market itself remains volatile, corporate finance has had to shift from indirect finance to direct capital allocation, sensitively assessing the

Table 4 Growth of KOSDAQ Market



KOSDAQ development

	10 million W		million W		
	Transaction Volume	Transaction Amount	Index	Transaction Amount	
1998.1	345	586.4	98.4	5,864	586.4
1998.2	413	722.1	99.3	7,221	722.1
1998.3	336	970.1	103.8	9,701	970.1
1998.4	159	269.6	95.1	2,696	269.6
1998.5	186	207.4	84.6	2,074	207.4
1998.6	581	807	76.5	8,070	807
1998.7	467	246.7	72.7	2,467	246.7
1998.8	480	175.1	66.7	1,751	175.1
1998.9	456	328.9	61.4	3,289	328.9
1998.10	828	424.6	62.2	4,246	424.6
1998.11	1,787	674	63.2	6,742	674.2
1998.12	2,793	1,386	68.7	13,862	1386.2
1999.1	3,215	1,648	75	16,477	1647.7
1999.2	3,774	1,690	75.1	16,895	1689.5
1999.3	3,507	1,615	76.9	16,154	1615.4
1999.4	7,726	6,425	101	64,247	6424.7
1999.5	8,179	10,203	131.3	102,026	10202.6
1999.6	14,976	23,217	162.9	232,168	23216.8
1999.7	18,411	30,270	198.6	302,700	30270
1999.8	20,795	21,708	192.3	217,080	21708
1999.9	19,421	15,306	179.3	153,058	15305.8
1999.10	3,070	40,952	169.5	409,523	40952.3
1999.11	124,500	140,947	213.3	1,409,474	140947.4
1999.12	125,150	211,113	247.8	2,111,125	211112.5
2000.1	101,100	223,950	214.6	2,239,500	223950
2000.2	199,700	457,560	247.1	4,575,600	457560
2000.3	229,454	411,191	252.8	4,111,909	411190.9
2000.4	155,777	229,500	182.8	2,295,000	229500
2000.5	213,000	285,350	146.2	2,853,500	285350
2000.6	247,000	322,473	154.6	3,224,730	322473
2000.7	197,300	214,200	130.7	2,142,000	214200

North Korean business of some companies such as Hyundai. The political influence from the North affects not only the capital movement, but will directly influence the South Korean real sector through market discipline.

Implications for the South-North relations. Drastically increased capital inflows and outflows are expected to grow further after the portfolio investment by Korean residents is completely liberalized in 2000. Unlike the times when corporate finance was heavily dependent on implicitly long-term bank lending instead of direct financing, the increasing scale of capital transactions will have a greater impact on the Korean economy. For instance, the capital inflow into the equity market was only 2.4 percent of Korean GDP in 1996, but it grew to 10.7 percent in 1999. At the same time, the outflow was also only 1.4 percent in 1996, but it reached 9.3 percent in 1999.

If there were to be some serious political tensions with the North and Korean residents' capital left based on the 1996 scale, it would reach 10.8 percent of Korean GDP. Since 1996 was a year when the economy was in a normal state but the capital transactions were still under strict controls, this figure can be considered as the modest scenario. Now, after the crisis, Korean non-performing debt is estimated at almost 40 percent of its GDP. 10.8 percent of sudden capital outflow with no inflow would create an extreme shock to the economy, and an absolute condition for the stable performance of the Korean economy is to prevent massive capital flight resulting from political tensions. This may imply that the North can threaten the South effectively enough by creating political, especially security, pressure without developing any costly weapons.

Even if capital flight did not occur, or emergency controls could prevent capital flight, a critical security threat will be able to cause fatal damage to the South Korean economy through a crash in the equity market. Without any threat from the North, the equity market will remain vulnerable, partly because financial restructuring is still going on, and partly because of the structural weakness mentioned. In addition, recently intensive electronic transactions have contributed to the short-term transactions. Now, in South Korea, 50-80 percent of market transactions is estimated to be through the Internet or even hand phones. This is probably the highest ratio in the world. In a financial panic, ironically, advanced IT has contributed to encouraging short-term transactions. During the

transition period when the banks cannot provide enough loans to firms, direct finance is expected to play a complementary role, while providing an engine for the new economy in South Korea. However, this also means that any kind of financial panic in the market will be fatal to the economy. Therefore, the first reality is that peace with the North has turned out to be essential following the implementation of structural adjustment policies for the South.

Growing-Out-the-Debt and Survival Strategy

Soaring budgetary deficit. Even in the midterm, there is another reason why South Korea needs the North; the soaring pressure on the government budget. Traditionally, South Korea had maintained a conservative budgetary policy, and the deficit used to be almost negligible. However, after the intensive injection of public capital into the restructured banks and other financial institutions, the budgetary deficit grew to W18.8 trillion in 1998 and 13.1 trillion in 1999 by consolidated basis, or 3.2 percent of GDP, compared to a W1.1 trillion surplus in 1996. Thanks to the robust recovery, the deficit turned to surplus of W5.6 trillion again in 2000. However, as more capital is needed to restructure the Daewoo group, some of the Hyundai subsidiaries and many other non-viable firms as well as banks, the government has decided to commit another W49 trillion already in 2000, which consists of W149 trillion of public money as the accumulated basis. The outstanding of national bond issuance has almost tripled from 1996 to W71.2 trillion in 2000, and with the sharp downturn of the economy in 2001, downside risk has increased again to focus on the budget. Unless the non-performing loans are miraculously liquidated while capital inflow continues, there can be an interest hike by the crowding-out effect of national bonds steadily. The Korean economy will have to struggle with this soaring budgetary deficit at least for the midterm, and obviously there will less and less room for integration if the North collapses.

Growing-out-the-debt and survival strategy. Therefore, besides restructuring, Korea will have to find a strategy to grow out of debt, while surviving in the competition with both Japan and China in the mid to long-term. A positive aspect is that North Korean labor if successfully mobilized is anticipated to mitigate a South Korean labor shortage, especially in "old economy" sectors. The average wage dropped by 9.3 percent in 1998 in the South, but in 1999 it went up by 11.1 percent and there were even some large-scale labor disputes.[4] On the other hand, there already have been OEM-based transactions with the North, and the South has been impressed with the disciplined, cheap labor. Demographically, the South Korean structure is still much younger than Japan, enjoying more than 70 percent of the working population. However, already, a recent sharp decline in birth rate and very strong demand for higher education has made it difficult to find enough labor in manufacturing and construction. If international division of labor can be established smoothly with the North, the South Korean old economy will be able to enjoy substantial cost reduction in construction, heavy industries, marine transportation, and other sectors, which in fact, the North has accumulated certain experience.

In addition to the division of labor, another positive aspect for the Korean economy is to make it the center or to enhance its hub function in the Northeast Asian region. This is symbolized by the railroad connection between the North and the South. The so-called Euro Land Bridge from China to Europe was completed in 1990; specifically, it connects the ports of Renun, Shanghai, Qingdao, and Tianjin with the Netherlands via Moscow. The idea in South Korea is to connect the railroad from Pusan and other ports with this bridge so that South Korea will be able to improve its economic structure by enhancing its hub function as in Singapore. Korea has also shown a strong interest in regional energy development, as well as being an IT hub by developing B2B and B2C sites. In fact, since the big earthquake in Kobe, Pusan port has turned to make itself a major substitute in the region. And a sign of Korean ambitions.

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4 For instance, Daewoo Motors had to declare default due to the labor union, which rejected the restructuring plan of reducing the number of employees in 2000.

Implications for South-North relations. The reality of South Korean hub strategy depends on the economic linkages in the region. So far, among the world's hundred largest economies, only Japan, China, Taiwan, Hong Kong, and South and North Korea have not joined any regional cooperation framework.[5] The political wall has been traditionally high, being reinforced by deeply rooted mutual distrust in Northeast Asia. Even in the early 1990s, when the boom of regional economic integration started in Asia, including Southern China-Hong Kong/Taiwan, Thailand-Vietnam/Laos, and the China-Russian border, economic exchange in this region has been marginal, partly due to the existence of the most closed economy of the DPRK. For instance, despite its potential, intensively studied by the UNDP, a project to develop the area around the Tumen River has not seen any crucial progress in the last decade.

However, once a change in the DPRK starts, even slowly, and the momentum for regional cooperation emerges, the South Korean economy will potentially reap much benefit for various reasons. First, having integration in mind, the ROK has been constantly positive about cooperation since the 1990s. But now it has even more incentive and need for cooperation given its severe budgetary constraints in the midterm. In the South Korean point of view, a sudden collapse of the North has to be deterred by any means, because if it happens at present, the ROK's support can only be very limited, and this may allow other regional powers to play a more important role as in history. On the other hand, if this economic constraint in the South reduces North Korean fears that they would be absorbed immediately, it may provide the North with a rational motive for cooperation.

Secondly, to find a breakthrough to go back to the economic growth track, the South desperately needs a clear and strategic blueprint. Until the crisis, South Korea followed the changes of Japanese industrial structure and this strategy has been safe in securing a position in the world market by exporting goods slightly cheaper than Japan. This strategy had been

5 Japan started negotiations with Singapore, while the ROK has sought ties with Chile.

preconditioned on the assumption that Japan would keep growing and advancing its industrial structure constantly, providing more room for Korean export growth. This strategy had to end when Japan stopped growing, and indeed South Korea went into a crisis with Japan's fall in 1997.

If cooperation with the North is realized, South Korea's "old economy" will be able to depend on less costly Northern labor, while also helping the North. Also, once the North opts to enter international society and succeeds in getting support from international organizations as well as Japan, the North Korean market could be a frontier for the South's business, such as construction and engineering, heavy and chemical industries, and probably some consumer goods.[6]

Finally, if North Korea agrees to share the advantage, the strategic location of the Korean Peninsula could be projected. It has access to the Euro Land Bridge as well as a connection with Russia to establish a business center for various industries in the region, such as transportation and distribution, energy, business supports, tourism, R&D activities, and probably even IT. Needless to say, the "business center strategy" cannot be developed or sustained with political tension in the region. If South Korea seeks this strategy, the success will be highly dependent on the stability in the North. However, on the other hand, the very structure itself may bring better stability, not only because the South and the North would share a common interest, but also because mutual dependence might change the bilateral balance, and alleviate North Korea's contained feelings and hence any desperate behavior. The users and customers of a Korean business center will oppose political friction in the peninsula. The second economic reality is that the South needs the regional integration in the mid to long-term, which can enhance political stabilization.

6 Before the summit in 2000, President Kim Dae Jung repeatedly referred to the possible frontier market after economic exchange with the North.

Greater presence of China

Expanding economic exchange between China and the ROK. A final factor in the wake of the East Asian financial crisis is the growing presence of China. Fortunately, China was not affected directly, partly due to its closed capital market and strong foreign exchange control. While most of its competitors have suffered from a financial shrinkage, even when the depreciated exchange rate brought better export potential, China could recover faster, because of its huge domestic demand. With its entrance into the World Trade Organization (WTO) regime, China's economic presence will become even more prominent.

China's growing presence, in contrast with Japan's sunset, has started to change the balance in the region. After the financial crisis, South Korea has actually paid more business attention to China than to the United States or Japan, her old allies.[7] Although under the Kim Dae Jung regime, Japan-South Korea relations have improved dramatically, there remains the memory in South Korea that the financial panic started with Japan.[8] Moreover, with the lifting of import controls against Japanese products, imports have started to increase rapidly enough since 1999 to raise traditional fears that the economy will be dominated and affected by Japan again. On the other hand, the restructuring process lead by market capitalism has encountered emotional resistance in the domestic market, especially from labor unions. Even before the crisis, South Korea had trade frictions with the United States on automobiles, steel, and other major export items, which interpreted the financial crisis as sanctions for the friction.

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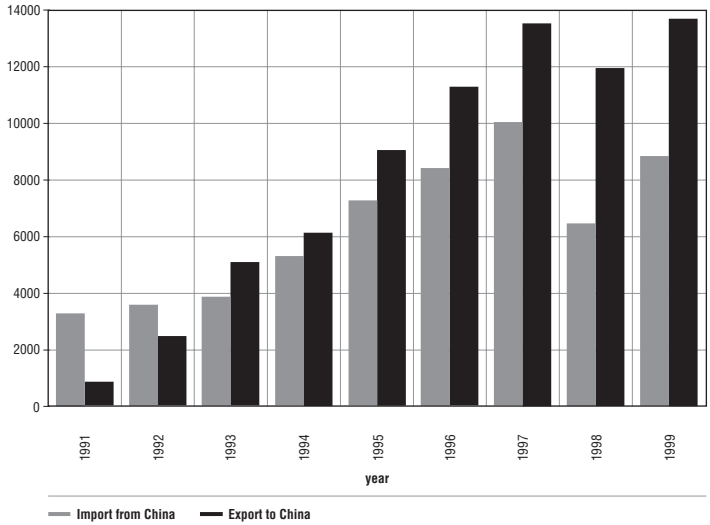
7 Many opinion polls after the crisis supported the greater presence by China in the 21st century in South Korea.

8 In South Korea, many believe that the financial crisis was triggered by intensive capital withdrawal by Japanese financial institutions.

Table 5 ROK's Trade with China



Unlike the United States or Japan, South Korea's economic ties with China have been growing impressively fast, and with less friction so far.[9] As noted in Table 5, South Korean trade with China has been accelerated in only eight years since the diplomatic ties were established. It is notable that exports dropped only a little in 1998 when the economy was undergoing severe restructuring, while imports are lagging due to shrinkage in Korean demand. As result shown in Table 6-A to 6-B, the Chinese market share for South Korean exports has grown, substituting for the stagnant Japanese, as well as the stable American market. Presence in imports is much more limited among Japan and the United States, implying that South Korea's stable trade surplus with China is in contrast with those matured markets.

9 In 2000, China stopped import of petrochemical products and hand phones from the ROK in revenge for South Korean measures to restrict garlic imports from China. This was virtually the first severe friction with China, but it settled down in a relatively short period.

Table 6-A ROK's Export Structure

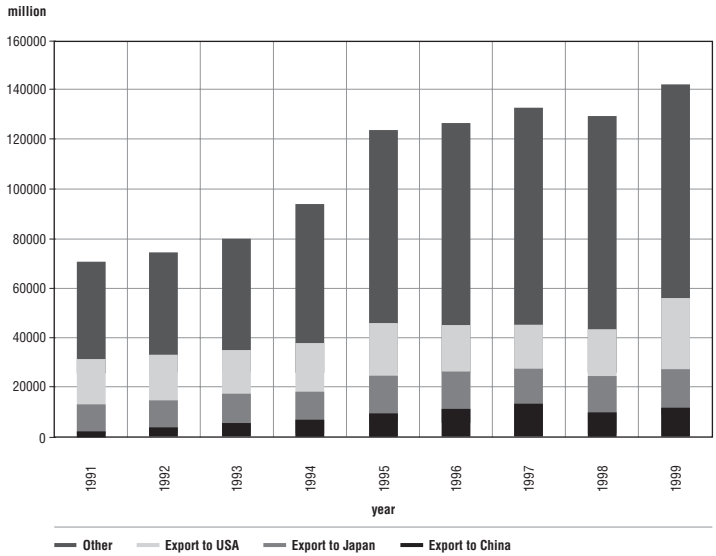


Table 6-B ROK's Import Structure

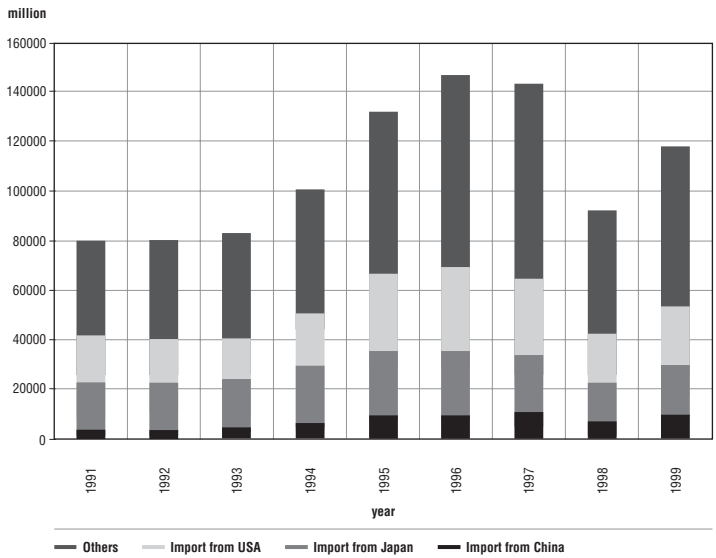
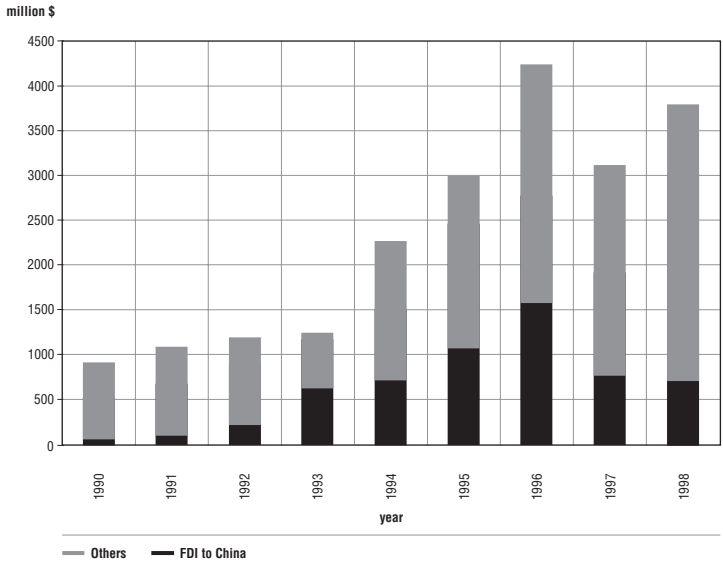


Table 7 ROK's FDI to China



More importantly, South Korean foreign direct investment (FDI) to China, following trade, has grown very rapidly as in Table 7. In total amount, nearly 20-30 percent of Korean investment has gone to China, but in a number of cases in accumulated FDI by South Korea, as much as 45 percent is concentrated in China by small companies mostly in labor-intensive industries. Recently, in discussions about a Free Trade Agreement with Japan, South Korea has insisted on inviting China into the arrangement, perplexing Tokyo.

Echoing models. China has traditionally shared an interest in the stability of the peninsula. It especially pays close attention to the ethnic Korean Chinese at the border. It will be natural for the DPRK, which has maintained a connection with China, to seek practical advice when it really starts to reform and open, even in any kind of limited form. China will be happy to share its own experience by increasing its intellectual influence in the DPRK. The existence of the DPRK as a buffer between

the ROK will be appreciated by China, so that it can share its experience of gradual economic reform without democratization.

However, with the start of dialogue between the South and the North, there will be another experience that China will share: The increase of mutual economic dependence between Taiwan and China, which has been a tacit deterrent for the security problem. Taiwanese FDI and the resulting industrial concentration have strongly supported China's industrial capacity especially in electronic devices and IT-related manufacturing. Taiwanese high-tech industries have also enjoyed a positive productivity and cost reduction effect in the mainland given its own labor shortage. Not only is North Korea trying to learn from China, but South Korea may also try to learn from this experience. And if the South does so, the influence of China will be greater. Based on this precedent model, North Korea can maintain special relations with the South, while expanding normal official ties with Western countries, and the South will gain more time for restructuring. There is an open question of whether the two Koreas can be independent from the complicated politics, and can be practical like the Chinese. But the echoing between China-Taiwan relations and South-North relations may at least contribute to bringing the peninsula closer to China.

Implications for South-North relations. Even if the economic presence of China is positive to both South Korea and North Korea, there will be a constraint for the DPRK to copy the Chinese-type of gradual reform, given the minor scale of the domestic market. As a resource-poor country, the DPRK desperately needs to expand exports, while China could benefit by agricultural reform leading to a larger domestic market. In fact, China will be able to provide its huge market to the DPRK, especially after China becomes a WTO member. In the early stages, there are many things for the DPRK to learn to be competitive in the external market, and China, with its various consumption levels unlike the ROK and Japan, may serve as a better market in which the DPRK can practice. When South Korean FDI serves as the engine for the North Korean exports, the potential of the Chinese market will be even more attractive. For instance, in textile industries China already has upgraded its supporting industries, and the

North will be highly dependent on material and parts imports from China in the early stages. In the past, the North has been supported by China mainly through food and energy inputs, but after the "reform" and opening starts, intellectual dependence on China will be greater, which has accumulated practical experience and information.

The absorptive power of the Chinese market will be more direct for South Korea. Although China is catching up very rapidly, there will be complementarity in areas such as telecom devices, automobiles, and other heavy and chemical products. Above all, in choosing a technological standard, China will have a greater impact on the ROK with it's bargaining. In IMT-2000, the next generation mobile phone, South Korea focused on the cdma-one standard, but only when China decided to adopt W-cdma with Japan and Europe also, the ROK had to switch to the same decision because of the market dependence on China. Even as the ROK tries to make itself the business hub of Northeast Asia, its function and success will be highly dependent on consumers, mostly Chinese and Japanese. Not only in trade and FDI, but also in technology standards, in infrastructure building, or in tourism and other services trade, China will be critical for the South too.

China, holding the cards for both the North and the South in terms of economic cooperation and intellectual support, will be more influential in the South-North dialogue. China will be able to keep the influence on both, in accordance with its national interests. The third reality then, is that although the Chinese have been relatively modest about their role in the dialogue, in addition to the geographical grounds for being involved in the issue, China has successfully acquired these economic cards.

Conclusion

Although some people expect possible dramatic changes of policy by the North as well as by the South, the options for South Korea seem to be limited, at least from an economic point of view. After the IMF reform, the

capital market was totally opened with the potential risk of capital flight. At the same time, the shift of corporate finance from indirect to direct financing has created a more vulnerable structure on the economy through the possible excessive response by the market from an unpredictable political threat. On the other hand, since huge public spending has been committed to restructuring the financial as well as corporate sector, the growing-out strategy is very much needed, including a center/hub function in the Northeast region by the South. In this context, the Chinese presence will inevitably grow by offering its markets for both the South and the North. In addition, since China has the experience of reform to offer the North, and the experience of economic interdependence with Taiwan for the South, its role will not be limited to being a market provider, but will expand and deepen into being the intellectual supporter for the North-South dialogue.

When President Kim Dae Jung came back from the DPRK after his historical visit, he proudly declared that the time had come when the destiny of the peninsula would not be manipulated by the conflicts of surrounding superpowers. However, intensive market opening and globalization has started to pressure the South to follow the market response as well as closer relations with China, the largest geographical neighbor. Neither of these factors will be manipulated by South Korean domestic politics, and, in this sense, the situation is ironically similar to North Korea, which has taken the risk of uncontrollable interface with international society. President Kim's visit might have kicked off the time when two hermit kingdoms challenge globalization sharing their goal of integration.