



South Korea in the mid-1990s

The miracle continues

Credit ratings for long-term debt:

Moody's: A1

Standard & Poor's: AA-
(recently upgraded)

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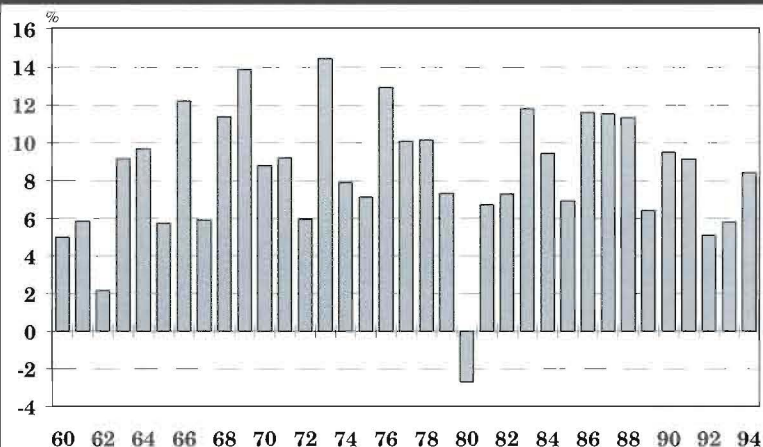
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BTAR 37/2

- South Korea's average annual GNP growth rate has exceeded 8% for the last three decades.
- The country appears to have reconciled sound economic management and democratic political pressures to an extent that is rare in the third world.
- The ongoing economic restructuring has increased the international competitiveness of many capital-intensive and technology-intensive industries.
- Despite strained intra-Korean relations due to the nuclear inspection issue, military confrontation between the two sides is unlikely.
- Sudden collapse of North Korea is a risk, but South Korea intends to alleviate this risk by propping up the North economically if necessary.

Real GDP South Korea Growth:



Source: Datastream

South Korea: Economic and Stock Market Statistics

ECONOMIC INDICATORS	1989	1990	1991	1992	1993	1994e	1995f
GDP (current prices, US\$ billion)	212.97	244.04	283.88	296.84	318.67	345.44	372.00
Per Capita GDP (current price, US\$)	5,025	5,693	6,561	6,799	7,500	8,470	9,122
Real GDP Growth Rate %	6.4	9.5	9.1	5.1	5.6	8.4	7.7
Growth of Total Consumption %	10.4	10.1	9.3	6.8	5.3	7.0	8.2
Growth of Fixed Capital Investment %	15.9	25.9	12.6	(0.8)	3.6	9.9	9.5
Growth of Exports %	(4.1)	4.2	11.8	11.0	11.2	13.4	12.3
Growth of Imports %	16.3	14.3	19.2	5.1	6.7	20.1	11.0
Balance of Payments (US\$, million):							
Trade Balance	4,598	(2,004)	(6,980)	(2,146)	1860	(3,100)	(4,100)
Merchandise Exports (fob)	61,409	63,124	69,582	75,169	80,810	93,700	109,100
Merchandise Imports (fob)	(56,811)	(65,127)	(76,561)	(77,315)	(78,950)	(96,800)	(113,200)
Current Account Balance	5,056	(2,179)	(8,726)	(4,528)	384	(4,800)	(5,400)
Overall Balance	2,453	(274)	(3,741)	4,898	6,542	8,000	8,200
CPI Inflation Rate %	5.1	9.5	9.6	4.5	5.8	6.3	5.9
Unemployment Rate %	2.6	2.4	2.3	2.4	2.8	2.4	2.2
Interest Rates:							
Yields on Corporate Bond % (3 years)	15.2	18.5	18.9	14.0	12.2	14.3	14.9
Lending Rate % (up to one year)	11.3	10.0	10.0	10.0	8.6	8.5	8.5
Money Growth Rate (M2) %	18.4	21.2	18.6	13.0	14.2	17.3	16.0
Exchange Rate (end of period, W/\$)	680	716	759	788	808	787	750
Foreign Exchange Reserves (US\$, million)	15,214	14,793	13,701	17,121	20,228	21,680	21,880
Months of Total Imports	2.6	2.2	1.8	2.1	2.5	2.4	2.4
Total External Debt as % of GDP	15.9	15.8	16.3	17.4	16.9	15.9	15.5
Total Debt Service as % of Exports	11.7	11.4	7.8	7.9	8.5	6.7	6.0
Central Government Budget Deficit (-) or Surplus as % GDP	0.3	0.4	(0.8)	0.3	0.3	(0.6)	(0.3)
KOREA STOCK MARKET							
Korea Composite Stock Index (year end)	909.7	696.1	610.9	678.4	866.2	1,027.4 ¹	891.9 ²
Market Cap (US\$, billion)	140	110	96	107	139	190	177
Market Cap as % of GNP	66.8	46.5	32.1	35.6	44.2	50.3	46.9
No. of Listed Companies	626	669	686	688	693	695	695
P/E Ratio (x) (Year End)	13.9	12.8	11.2	10.9	12.7	17.9	11.9
Weighted Dividend Yields	1.2%	1.5%	1.8%	1.9%	1.4%	1.4%	1.6%

Source: The Bank of Korea, International Financial Statistics, EIU, Bankers Trust Research

¹ Figure as of Year-end 1994

² Figure as of May 9, 1995

Overview

South Korea has a population of 44 million and a territory of 38,345 square miles. Ethnically and culturally, it is one of the most homogenous societies in the world. It was almost entirely an agrarian economy before the Japanese invasion in 1910. The liberation from Japanese colonial rule in 1945 was marred by the partition of Korea into two parts, North and South, because the United States and the Soviet Union could not agree on the procedures for unification and the structure of a unified Korea.

Development in Perspective

1945: Partition

From 1945 to 1950 Korea struggled with the reality of partition. North Korea was increasingly armed by the Soviet Union, South Korea disarmed by the United States. As recent findings from Soviet archives have now demonstrated, North Korea invaded South Korea in 1950 at Stalin's behest.

1950-'53: War

The Korean War from 1950 to 1953 destroyed almost two-thirds of the nation's productive capacity, and killed almost 1 million civilians. The war ended by maintaining the partition of the Republic of Korea (south) and the Democratic People's Republic of Korea (north).

1950s: Priority for the Military

The 1950s, including the period after the war, were marked by a desperate struggle for military survival. The North seemed better organized and better armed than the South and also appeared to have better economic prospects. The South's policy was to focus budget priorities on the army, political priorities on repressive stability, and economics on inward-looking development. During this period the country failed to compete successfully with the North, and the prospects looked extremely bleak.

1960-'61: Premature Democratization

In 1960 a revolt against the repressive, unsuccessful regime of Syngman Rhee brought to power a democratic government. The democratic regime, however, was marked by demonstrations, economic populism, and continued vulnerability to the North. After nine short months of unstable democracy, most of the population welcomed a military coup by Park Chung-Hee.

1961-79: Growth at any cost

General Park radically revised the country's priorities to focus on economic growth at all costs. Despite his military background and the severe threat from the North, he kept military expenditures under tight control in order to focus national priorities on economic development. He created a more competitive economy, moved toward a more open, export-driven economic policy, fostered the development of roughly a dozen

hyper-competitive conglomerates that came to constitute half of the economy, and guided those conglomerates in considerable detail using the authority of the presidential office and government ownership of the banking system to channel economic activity in the desired direction. This period lasted until Park's death in October 1979.

In the mid-1970s North Korea began to default on its foreign debt, and although this was little noted at the time it now appears clearly as a symbol of the changing balance of power created by South Korea's economic success and the North's failure to match it.

1980s: Drive for Diplomatic Supremacy

After a tumultuous period from the death of Park Chung-Hee through the consolidation of power by Chun Doo-Hwan, South Korea shifted to using its now-powerful economy as the base for a drive for diplomatic supremacy over North Korea. Chun quickly seized the initiative in the early 1980s with an IMF meeting in Seoul, an Inter-Parliamentary Union meeting, the Asian Games, and above all a dramatic proposal for a meeting with North Korea's leader Kim Il-Sung. These steps gave South Korea the initiative over North Korea. Gradually the South's superior economic performance led more and more countries to recognize South Korea and fewer to recognize North Korea. The triumph of this phase was the staging of the Olympic Games in Seoul in 1988.

In 1990 and 1991 South Korea's rise and the former Soviet Union's collapse led to recognition of South Korea by most eastern European countries and Mongolia. 1990 also saw the initiation of formal diplomatic relations with the Soviet Union and of trade relations with China. 1991 brought entry into the United Nations with China's approval. More importantly, 1990 also brought an exchange of visits with North Korea and the assumption by South Korean generals of command over the U.N. forces in Korea which were previously commanded by Americans. Thus by 1990, South Korea stood on its own feet, was a major force in the world economy, and towered over the formerly superior North.

1988-'92: Democratic Revival

The turn of the decade also brought a turn to democracy. In 1961 democracy had failed because populist political demands, demagogic ideology, and weak government institutions had combined into a dangerous mix of social disorder, inflation, and political division. By the late 1980s, South Korean society was dominated by a solid middle class. In fact, South Korea drew stability not just from a middle class center of gravity but also from an exceptionally egalitarian distribution of income. Extraordinary economic success had created a centrist economic and political consensus (see the chart on "National Consensus")

and discredited both the militarists on the right and the socialists on the left. By this time South Korea was an educated society that could confront the complex issues of modern democracy. The institutions of government, from the army to the finance ministry and the economic planning system, had become highly professional and able to hold their own against populist pressures. In short, through a period of dictatorial forced-development South Korea had created the prerequisites of democracy.

**ELEMENTS OF
NATIONAL CONSENSUS**

**MIXED, GRADUALLY LIBERALIZING ECONOMY
RELATIVELY OPEN ECONOMY
PRIORITY FOR HIGH GROWTH
ANTI-COMMUNISM
DEMOCRACY
ALLIANCE WITH U.S.
AUTONOMY FROM JAPAN
GOAL OF NATIONAL UNIFICATION**

Civilianization

The transition to democracy was quick but smooth. In 1987, amid widespread public backing of opposition figure Kim Dae Jung's demands for a presidential system, conservative former general Roh Tae Woo split with his mentor, Chun Doo Hwan, and advocated the presidential system. Kim Dae Jung split the opposition, and Roh Tae Woo was elected. His conservative background reassured those who feared a return to the disorders of 1961. He then consolidated the two major conservative parties with the more moderate of the old opposition parties (under Kim Young Sam) into a unified party, which was intended to emulate Japan's long-governing Liberal Democratic Party. Kim Dae Jung responded by merging with another minor party, but very quickly the opposition split once again. In the subsequent election, Kim Young Sam, a civilian who had led much of the democratic opposition during the years of dictatorship, brought victory to the conservative coalition and thereby completed the transition away from military leadership and across the goal line of full democratic legitimacy.

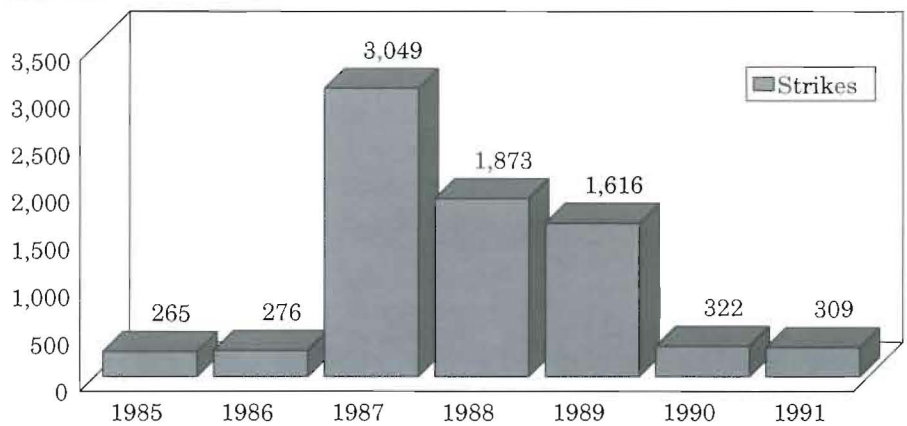
**1992-'94:
Reconciliation of
Democracy and
Growth**

The transition to democracy was achieved without the disorder of 1960's premature democratization, but it brought a surge of populist demands, especially from labor unions who needed to vent their anger at the political abuses and wage suppression of the dictatorial era. The result was a huge increase in wages, a

surge of inflation, and a huge negative swing in the country's current account balance. These were the kinds of trends that time after time had destabilized young third world democracies. (Note the recent history of Brazil or of Peru before Fujimori.) But in South Korea the prerequisites of stable democracy were in place and after several years the economy equilibrated into a pattern of rapid growth, moderate inflation, and a solid current account.

The chart on "Korean Labor Disputes" is the best indicator of the rapid digestion of the pressures of a newly democratic society. The current account has been more volatile but has not spiraled out of control. Inflation has settled down to mid-single digits. These are the signs that Korean democracy and rapid growth have reached an accommodation.

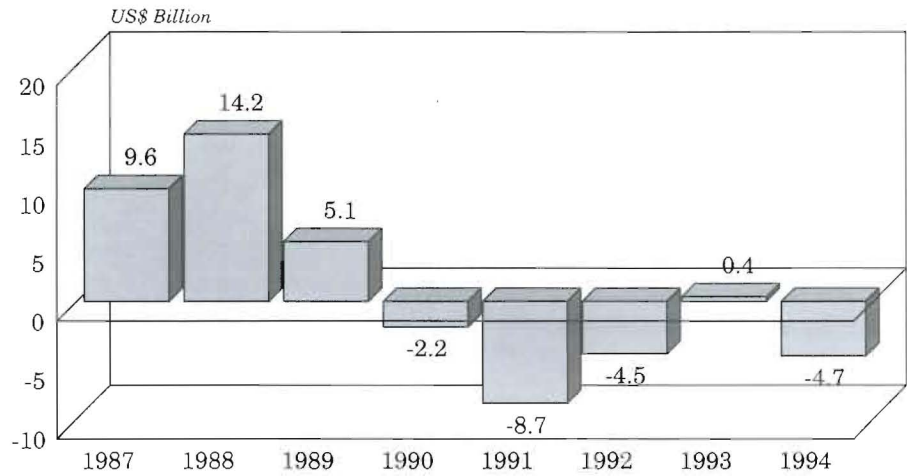
Figure 1: Korean Labor Disputes



Source: Korea Labor Institute

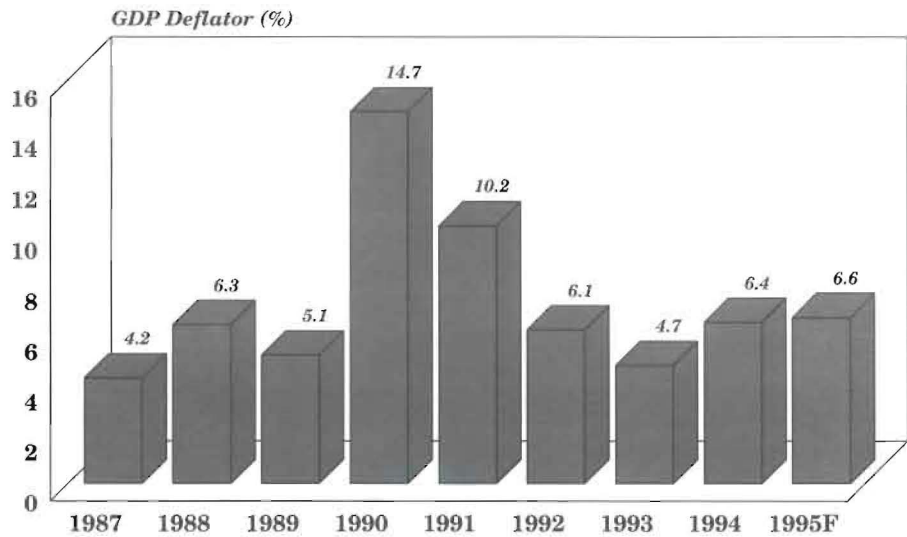
1991 Jan-Aug figures annualized

Figure 2: Current Account Balance



Source: Ministry of Finance

Figure 3: Inflation



Source: International Financial Statistics

South Korean society's maturity made possible a combination of democracy and vibrant economic growth. It has a stability that is not characteristic of most young democracies in Africa and Latin America.

South Korea's Economy

One of the Asian miracle economies

South Korea is the largest of the “four dragons” in Asia that have achieved miraculous economic growth for over three decades. In the early 1950s, South Korea was one of the poorest agrarian countries in Asia. Since the launching of the First Five-Year Economic Plan in 1962, Korea's economy has grown at an average GNP growth rate exceeding 8% over the last 32 years. Now, a major industrialized economy in Asia, South Korea recorded an estimated 1994 per capita GNP of US\$8,280 and a total GNP of US\$345 billion, ranking it the twelfth largest economy in the world.

Driven by export-led strategy

The main driving force behind such strong performance is the successful adoption of an outward-looking development strategy making exports the engine of growth – a strategy well suited to Korea's conditions: insufficient natural resources, limited domestic market, and abundant, well-educated, industrious manpower

Large-scale economy

That strategy has been characteristic of all the great Asian takeoffs, but the South Korean economy has very distinctive characteristics. First, with 44 million people it is by far the largest of the dragon economies. This large population has been able to sustain an economy far more diverse than the other dragons. In addition to agriculture, South Korea has the full range of light industry, heavy industry, and services. Moreover, a relatively egalitarian distribution of income has created a larger market for middle-class products than would be characteristic of many other economies with the same size population. South Korea is now the world's 15th largest economy, larger than the majority of OECD countries.

World-class scale

Second, its biggest firms have world-class scale. Firms like Samsung, Hyundai, and Daewoo are large even by U.S. standards. (For instance, Daewoo had 1993 sales of US\$31 billion and was number 33 in Fortune magazine's list of the world's largest corporations.) As a result they have the capacity to undertake huge projects – for instance building ports in the Middle East. Unlike virtually all their counterparts in Hong Kong, Taiwan and Singapore, they have the scale to establish global brand names. Many have also used their scale to extend their technological reach, for instance by purchasing Silicon Valley computer firms.

Hyper-competition

The South Korean conglomerates, called *chaebol*, are hypercompetitive. Unlike the large government-sponsored monopolies in, for instance the Philippines under Marcos, the government-fostered Korean *chaebol* were pushed into the same

industries – for instance, textiles – and forced by the presence of so many big firms in such a small market to compete frenetically in order to survive. Those which succeeded in Korea became so competitive that succeeding in the rest of the world became comparatively easy.

Global competitiveness

Korea's consumer electronics, semiconductor, automobile, steel and shipbuilding industries thus are globally competitive. The consumer electronic industry's world market share reached 15% in 1993, claiming the second largest producer in the world. In 1993, Korea's share in the world-wide semiconductor market was 17.8%, and in DRAM chips it was responsible for 23.5% of world market production. Its automobile and shipbuilding industries are major players in world trade. The Korean automobile industry produced 2/3 million units in 1994, making Korea the world's 5th largest automobile producing nation. In 1993, Korea became the largest shipbuilder in the world for the first time, surpassing Japan in new orders. It is the sixth largest steel maker and the eighth largest chemical producer.

Resilience

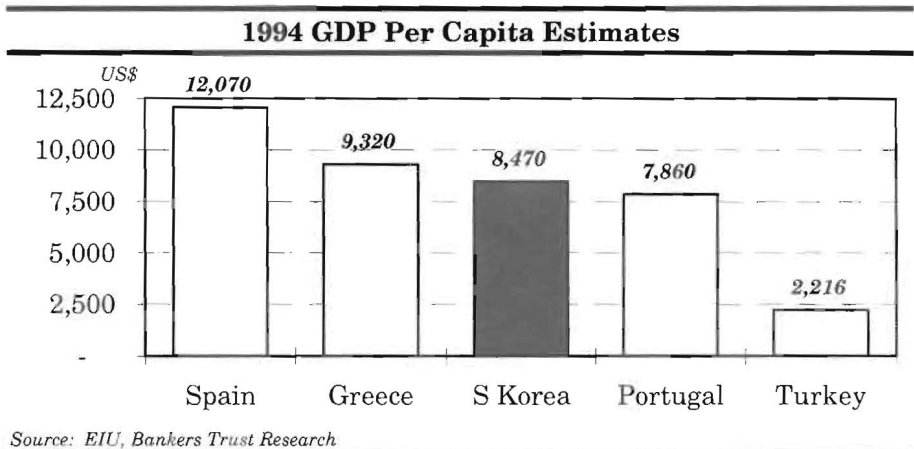
Like the other Asian miracle economies, South Korea's economy has proven to be extraordinarily resilient in the face of adverse developments in the world economy. A glance at the growth chart on the cover of this report demonstrates the point. During the 1973-'74 oil shock and the 1975 global recession, the country maintained very high growth by the standards of the rest of the world. Likewise after the 1978 oil shock and during the 1982 and 1991 recessions. (The bad year of 1980 was due to a combination of rapid disinflation and political turmoil. That combination is extremely unlikely to repeat itself.)

This exceptional resilience results from a policy of forcing rapid adjustment to new market developments rather than resisting them. This policy approach is a legacy of the 1961-'79 strategy of betting the future of the nation on exceptional economic performance. It is made possible by the unusual competence of the country's economic management institutions (for instance, the Finance Ministry and the Bank of Korea) and by the public consensus built upon three decades of rapidly improving standards of living.

Prosperity

South Korea is also prosperous. It has just reached the per capita income of such southern European countries as Greece and Portugal and will soon be well ahead of them. Actually, the comparison with Greece and Portugal underestimates South Korea's strengths. South Korea is a far more homogeneous and egalitarian society than any southern European counterpart; this makes for greater social stability over the long run, and economically it creates a broader middle class market. South

Korea's superior economic dynamism gives its society a more enthusiastic, positive tone. And, unlike Greece and Portugal, South Korea is an economic dynamo with global reach.



Economic Restructuring

During the last decade, South Korea has been in the process of economic restructuring. In the 1960s and 70s, Korea's economic growth was built on labor-intensive, low value-added industries such as textiles and footwear. Since the mid-1980s, facing increasing competition from other emerging Asian economies such as China and Southeast Asian countries, South Korea has been under pressure to upgrade its economic structure by fostering high technology industries such as electronics, automobile, steel and shipbuilding. During this period, the manufacturing and service industries have continued to experience balanced development. In 1993, heavy and chemical industries made up 71.5% of the total manufacturing sector and light industries 28.5%.

Currently, Korea's economy faces the following main challenges:

Raising R&D

Improving the technological level of its industries. In the 1960s and 70s, during its rush to industrialization, South Korea's emphasis was entirely on growth in production, which created a "quick-fix" mentality and an imbalance between quantitative growth and qualitative improvement. In the early 1990s, many Korean products had an international image of poor quality and high price. Investment growth in R&D lagged far behind economic growth. For example, the ratio of R&D investment to total sales in Korea's shipbuilding industry is less than 1%, while Japan's ratio exceeds 2%. In fact, Korea's total R&D expenditure is less than that of General Motors or Mitsubishi.

In the past, Korea's industries obtained advanced technology by borrowing from advanced countries, via technology licensing and transferring. As its economy becomes increasingly a direct competitor of other advanced countries, it will have greater difficulty obtaining technology from these countries. Further economic growth will increasingly depend on Korea's own technological developments.

Deregulation

Creating a new government-business relationship. The salient feature of the Korean government-business relationship has been the government's dominance of business. Before the 1980s, the government micro-managed every aspect of the Korean economy. The private sector followed the government's instructions. Since then, the Korean economy has grown too large and too complex for the government to micro-manage. The government has tried to foster private initiative and creativity at all levels of business and to free the economy from the constricting government planning and intervention. But old habits die hard. The government bureaucrats are so accustomed to intervention that it is very hard for them to give up their grips on the economy. Many government bureaucrats are not sure as to what kind of economic role they should play in the future. On the other hand, the private sector is still very timid in dealing with the government. It will take a long time for healthier government-business relations to emerge.

Financial liberalization inevitable

Financial reform. The development of the Korean financial sector was heavily repressed throughout the rapid growth era. Government-led development in Korea was implemented primarily through governmental control of the financial sector. Korean banks were forced to make large volumes of policy loans. The government still routinely appoints many bank presidents, even for banks that are privately owned, and dictates what products individual banks are allowed to offer. As a result, among the rapidly developing countries of Asia only the banks of China and India make lower returns on their assets than do South Korea's backward banks. In recent years, the government has realized the importance of financial liberalization, but the pace of actual liberalization has been painstakingly slow.

Since President Kim Young Sam came to power, reforms have gained momentum. In June 1993, the Korean government presented a comprehensive Blueprint for Financial Sector Liberalization, with a detailed time table for phased implementation in three steps during the period of 1993-1997. Among other reforms, interest rates are being gradually deregulated, government-directed subsidized credit schemes are being reduced, and there is some relaxation of controls on foreign exchange remittances and Korean investments abroad. One

reason for the government's resolve to liberalize the financial sector is the external pressures it faces. One source of pressure is the US and European countries. The other is competition for foreign capital by other Asian countries. Korea's desire to become a member country of the OECD by 1997 also acts as a disciplinary device. Currently, it is apparent that, although the Korean government is determined to overhaul its financial sector in a comprehensive manner, the pace of reform will continue to be slow because of the government's aversion to subjecting the domestic financial institutions to "excessive" foreign competition.

**Over concentration
of economic power**

Creating a competitive domestic market. The Korean economy is dominated by a small number of large conglomerates, called *chaebols* in Korean. The chaebols are so dominant in many of the main industries that they cause economic inefficiencies. They have privileged access to bank loans, which were and still are the most important source of corporate funds, crowding out financially weak small and medium-sized companies. Furthermore, most big chaebols have higher debt-to-equity ratios than their smaller competitors. The high degree of leverage for large firms becomes a reason for getting the government's support in times of difficulty, because they are "too big to fail." New rules on issues like anti-trust and bailing out distressed firms need to be created to foster a more competitive and efficient domestic market.

Protected economy

Internationalization. South Korea was one of the first third world countries to internationalize in the sense of choosing an economic growth strategy designed based on encouragement of exports. The result was an economy where trade came to constitute a huge share of GNP. But South Korea also protected its domestic markets for finished goods, adopted tight controls on foreign investors, severely limited foreign portfolio investment, and froze foreign banks out of much of the domestic market. As in Japan, many of these controls were informal rather than matters of law. For instance, purchasers of foreign luxury cars were frequently investigated by the tax authorities. "Frugality campaigns" put a stigma on the purchase of imported luxury goods. Foreign firms were severely limited in their right to advertise their products. Foreign banks found themselves unable to access local funds because of market practices that have much more restrictive consequences for them than for local banks. Even today, contrary to the trend elsewhere, the share of foreign banks in South Korea is declining. Foreign high-tech companies frequently decline to invest in South Korea because their ability to compete there is more restricted than elsewhere in Asia. As a result, foreign direct investment is a smaller share of total investment in Korea than in any other rapidly growing Asian

country.³ But there is increasingly wide recognition among Korean elites that this will have to change in order to secure membership in the OECD, to comply with World Trade Organization rules, to ensure access to high technology from abroad, and above all to maintain the international competitiveness of South Korean manufacturing and service industries. Belief in the necessity of really opening the market is more widespread in South Korea than in Japan, and President Kim Young Sam has been an eloquent advocate of internationalization.

³ U.S. Assistant Secretary of State Daniel K. Tarullo, speech to the Korea-United States 21st Century Council, February 9, 1995.

Economic Outlook

Revival of high growth...

Economic Growth. After two consecutive years of low GNP growth (5.1 percent in 1992 and 5.6 percent in 1993), the economy turned around in the fourth quarter of 1993. It grew 8.4 percent in 1994 and is expected to grow over 9.0 percent in 1995 and around 7 percent in 1996.

...driven by investment...

The current economic expansion is driven by capital investment and strong exports. According to a 1994 government survey, fixed asset investment by 200 large manufacturing and marketing firms grew at an annual rate of 53% from a year earlier. This increase in investment not only fuels the current economic growth, but also raises production capacity and competitiveness in the future by increasing and upgrading the capital stock.

...and exports

Aided by a strong yen and revival of the country's principal export markets, 1994 exports increased by 22% over 1993. An even stronger yen and continued strong demand in overseas markets should lead to continued rapid export growth.

Higher than targeted inflation rate

Inflation and Money Supply. Consumer price inflation in 1994 was 6.3%, slightly over the government's target of 6%, mainly caused by a rise in the price of agricultural products due to bad weather. The CPI inflation rate, excluding food items, is actually not higher in 1994 than in 1993, so the economy was not overheating. Money supply growth is gradually declining (17.3% for M2 in 1994, an expected 16.0% in 1995) and so are interest rates (15.4% on a 90-day CD at the end of 1994, an expected 14.9% at the end of 1995). Consumer price inflation should very gradually decline over the next two years, helped along by relatively tight money and gradual appreciation of the currency.

Exchange rate. The Won/US\$ exchange rate appreciated from 813 in January 1994 to 760 in early May 1995. This appreciation is mainly due to expected capital inflows that respond to the government's financial liberalization measures and is likely to continue.

Trade balance deteriorating

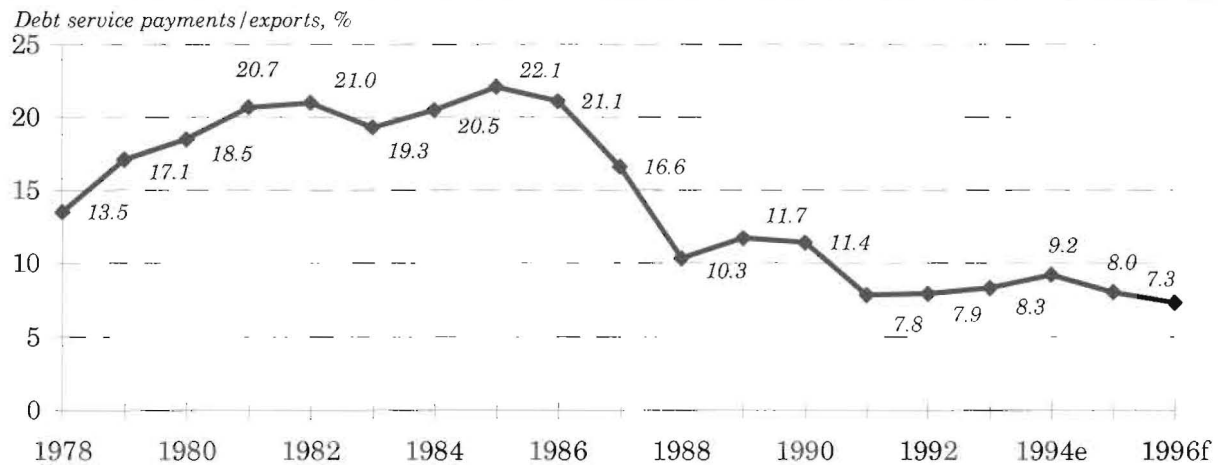
External balance. One of the costs of rapid growth has been very strong demand for imports, especially for investment purposes, which has more than offset rising exports. The numbers, however remain quite manageable, and the high proportion of capital goods in the import figures means that investments are being made which will increase future exports and decrease future imports.

The overall pattern is one of rapid, sustainable, diversified growth with moderate inflation and moderate current account deficits. Prospects for future growth and technological progress are being enhanced by determined, although not rapid, liberalization, and by large capital investments.

Creditworthiness

South Korea has managed its foreign debt with exceptional skill. Even in the years of breakneck growth, it kept its debt service ratio, the best measure of creditworthiness, within ranges acceptable to conservative bankers. The normal banker's requirement for creditworthiness is a debt service ratio under 20 percent. As indicated in the accompanying graph, South Korea has remained well within that limit since the late 1970s. Recently it has been under half the limit. Even at the time of the great third world debt crisis of 1982, South Korea's financial position remained solid and conservative.

Figure 4: Debt Service Ratio (1978-1996)



Source: IIF

South Korea's other creditworthiness numbers also demonstrate a solid, conservatively financed economy. Its net debt to exports ratio, which needs to remain below 100 percent for a creditworthy country, is only 13 percent. Its ratio of total debt to GNP, which also should remain below 100 percent, is only 18 percent. The one ratio that initially appears less than satisfactory is the number of months of imports covered by foreign exchange reserves. Normally, we expect this to be 3 months or more, where as South Korea only has 2.5 months. This does not in fact reveal a weak credit situation. The country's reserves of foreign exchange and gold, at a combined US\$26.9 billion, are in fact large enough to provide an adequate cushion. The low ratio reflects the fact that South Korean trade involves a huge level of imports, which are processed into exports. If something happened to exports, import requirements would also drop. On balance, these numbers reveal one of the third world's most creditworthy countries.

1950-1980: Maximum danger

For many years after the Korean War, relations between North and South were so volatile that war appeared possible at any moment. The concentration of military force along the Korean Demilitarized Zone is one of the greatest such concentrations in the world today – indeed in world history – and the proximity of these great forces leads to a palpable, frightening tension at the points of contact. Through the 1970s there were frequent, sudden fatal incidents. North Korean forces were postured for surprise attack – huge concentrations deployed forward, with communications security and an alert status reached only a handful of times since World War II by U.S. forces and never by Soviet forces. North Korean equipment was not designed to sustain a long war, only to provide a sudden strike capability designed to overwhelm the South quickly. This immensely expensive configuration demonstrated an intent to invade upon any opportunity.

Several times the two sides came to the brink of war. On many occasions the confrontation turned violent. For decades the North launched commando raids in the south and provoked confrontations along the demilitarized zone and over islands off the coast. On one occasion North Korean commandos penetrated near the presidential mansion, Blue House, and nearly achieved the assassination of President Park. In 1975, after the U.S. defeat in Vietnam, North Korean invasion of South Korea was averted only by Chinese pressure on the North to desist.⁴ As late as 1983, North Korean agents planted bombs during the South Korean president's visit to Burma and succeeded in killing a number of the South Korean government's most important officials. In 1987 North Korean agents blew up a South Korean passenger airliner.

South Korea's posture, on the other hand, was defensive, premised on the necessity to survive an attack and prevail in the long run.

Southern economic superiority

While the South has experienced rapid economic growth and rising international stature, the North's economy has lagged far behind, under a rigid Soviet-style regime. In 1992, South Korea's per capita GNP reached US\$6,799, while North Korea's was US\$943. Evidence shows that North Korea's economy has been declining for the last five years, while the South's was growing rapidly.

⁴ The writer of this paper was a consultant to Korea's National Defense College and author in 1985 of a study of the North-South military balance used at that school. Some of the information in the above narrative comes from that study.

1980s: Strategic stabilization

As the defensive South gained on the offensive North, the military situation gradually stabilized. Sudden, violent incidents declined. Major provocations almost vanished.⁵ The situation gradually evolved from explosive and confrontational to tough but restrained. Although North Korea still maintains a 1.1 million-strong military force, which is much more numerous than the corresponding South Korean force, today the South Koreans, supported by 37,000 American troops in the South and an American nuclear capability, enjoy substantial superiority.

Contacts gradually increased

Since the early 1970s, the two sides have gradually increased contacts on issues ranging from family reunification and intra-Korean reconciliation, to denuclearization of the Korean Peninsula. On September 4, 1990, the first South-North Prime Ministers' meeting was held in Seoul, which led to the signing of three important accords between the two sides on reconciliation, nonaggression, and denuclearization. Since 1992, the two sides have started preliminary meetings for a possible South-North Summit meeting.

Economic contacts between the two Koreas already exist. Since 1988, Seoul has allowed indirect trade with the North. Each year South Korean firms buy up a little under \$200 million-worth of gold, zinc, fish and rice liquor from the North, shipping it via China or Hong Kong. In November 1994, South Korea announced that it would gradually lift the ban on economic exchanges with North Korea.

Military invasion by North unlikely

Although the possibility of a military invasion from North Korea can never be ignored, it has now become extremely unlikely. For several decades, the big powers have all feared instability on the Korean peninsula. The United States was determined to defend South Korea. Japan supported that policy since it believed that an aggressive, unified communist Korea would be "a dagger pointed at the heart of Japan." The Soviet Union found Korea a usefully sensitive pressure point, but its strategic focus was Europe and the last thing it needed was a war in the Asian backyard. China was preoccupied with internal development and, as noted above, was already willing in 1975 to assert its power in order to preserve the peace. Thus all the great powers oppose warfare on the peninsula, and each in its own way acts to restrain North Korea.

⁵ The downing of a U.S. helicopter which strayed into North Korea on December 17, 1994, and the temporary sequestration of its pilot by the North Koreans, was a relatively minor unpleasantness which was resolved by the end of the month despite crude North Korean diplomacy and abusive treatment of the pilot, rather than a deliberate provocation like the incidents mentioned earlier.

**1990s: Southern
strategic superiority**

South Korean economic predominance, followed with a lag by military superiority, increased the stability of the peninsula. The end of the Cold War simply strengthened trends that had already been operating for decades. North Korea first lost the support of the Soviet Union. Then South Korea established economic and diplomatic relations with China in the early 1990s, and China gradually distanced itself from the North. While China went through the motions of supporting North Korea, its enthusiastic embrace of South Korea was profoundly embarrassing to the North. That is perhaps the ultimate symbol of North Korean diplomatic defeat.

Nuclear Korea?

The South tried first

Given the scale of the military confrontation in Korea, inevitably the question of nuclear weapons has arisen. It arose first in South Korea, which, in the early 1970s, developed a massive and nearly successful program not just to build nuclear weapons but to build one of the most sophisticated forms of nuclear weapons, namely tactical nuclear weapons that could be deployed by ground forces. A secret but powerful confrontation led by U.S. President Richard Nixon first halted the program and then gradually persuaded South Korean civilian and military leaders that nuclear weapons presented more dangers to their national security than advantages.⁶ The Korean peninsula is compact, and the population is highly concentrated around certain cities. A nuclear exchange in this confined space could easily extinguish the Korean nation permanently. The South Koreans could look at such arguments with considerable equanimity because they were protected by U.S. forces and because their own military was gaining on the North month by month.

**The North: A nuclear
gambit from
weakness**

North Korea, however, was losing its allies and losing its race with the South and becoming more insecure at home. In the desperate search for an equalizer, they developed ballistic missiles capable of hitting Japan and acquired nuclear power plants capable of producing weapons-grade material in sufficient quantity to build several bombs. In 1989 "North Korea unloaded an unknown amount of spent fuel that may have been processed

⁶ This writer participated in research programs designed to halt the trends toward Asian nuclear proliferation in the 1970s and edited the first book on the subject. See William H. Overholt, *Asia's Nuclear Future* (Boulder, Colorado: Westview Press, 1977) and a more forthcoming Japanese edition published in 1983 by Simul Press.

into plutonium.”⁷ In March 1993 North Korea, under pressure from the International Atomic Energy Agency over discrepancies in North Korean accounting for its plutonium stocks, announced that it would withdraw from the nuclear Non-Proliferation Treaty (NPT). Washington became convinced that North Korea, nominally an adherent to the Non-Proliferation Treaty, was hiding a nuclear weapon program. Beijing believed, on the contrary, that North Korea was bluffing a nuclear weapon program to obtain economic and diplomatic concessions.

North Korea's failure to allow monitoring required by the Non-Proliferation Treaty led to a confrontation with Washington and pressure by all the big powers. While there were disagreements among the big powers over tactics, they all brought pressure on North Korea. For instance, the U.S. demanded sanctions and China opposed them, but U.S. diplomats described Chinese policy as extremely helpful throughout the crisis. Chinese officials even maintain privately that former North Korean President Kim Il-Sung died in a frenzy of work triggered by three demands from Chinese leader Deng Xiaoping, one of which was for cessation of the nuclear program. The confrontation ended temporarily after President Clinton gave North Korea the primary diplomatic concessions it had sought unsuccessfully since 1954 (mainly direct diplomatic contacts and agreements with the United States), promised the building of new reactors worth billions of dollars, and dropped the threat of sanctions. In return North Korea promised to freeze construction of new nuclear reactors, to refrain from operating an existing 5-megawatt reactor, to seal its reprocessing plant, to remain a party to the NPT, and to permit IAEA inspections. Currently the agreement has foundered over U.S. and South Korean insistence that the promised nuclear reactors come from South Korea and North Korean insistence that they should not.

Great danger to the world

How important is this? It is very important to the world that North Korea not become a nuclear power. If North Korea acquires nuclear weapons, South Korea will quickly do so. Faced with a nuclear Korea, Japan would feel both threatened and humiliated and would almost certainly join the nuclear club. Japan will never accept a position of military inferiority to Korea. This would trigger a reaction from China, and a big Asian nuclear arms race would ensue. In the process, Taiwan, which also almost built nuclear weapons in the early 1970s, would probably also go nuclear. All this would create a much more dangerous Asia just at a time when America's ability to mediate and prevent

⁷ Secretary of State Warren Christopher, Statement to Foreign Relations Committee, United States Senate, January 24, 1995. In what follows, I have drawn heavily on Secretary Christopher's testimony.

conflict from getting out of hand will diminish because American economic growth is not keeping up with Asia's.

Less danger to South Korea

On the other hand, the immediate danger to Korea itself, and to investors in Korea, is rather limited. Nuclear weapons are mainly useful for deterring nuclear or non-nuclear attack by someone else. They are remarkably useless, particularly when some of your enemies also have them, for gaining concrete objectives. Suppose North Korea builds a few nuclear weapons. If it then threatens to use them, but does not actually fire them, it will precipitate a total economic blockade, particularly by its most important trading partner, Japan. To state the obvious point, the Japanese have very powerful feelings about nuclear weapons, and very powerful feelings about Korea; putting the two together will elicit a powerful reaction from Japan. All the big powers, and particularly China, which has most to fear from nuclear-armed crazies in a neighboring territory, would unite to defeat a Pyongyang which was making nuclear threats. In today's world, all big powers want peace in Korea so that they can concentrate on domestic political unity and economic development. They would unite to isolate North Korea, and the probable result would be North Korean economic collapse.

On the other hand, if North Korea actually used a nuclear weapon against the South, the United States would likely respond with a volley that would char much of North Korea and eliminate the regime overnight.

More complex gambits, such as attempting to seize Seoul by surprise attack and then explode a demonstration weapon to deter countermeasures, appear equally doomed in the face of the overwhelming conventional and nuclear dominance of a U.S.-South Korean alliance supported by all the other big powers. The only way this writer can imagine to get real value from the nuclear weapons would be to hold Tokyo hostage in return for financial concessions. Such a strategy would only be productive in the very short run.

Thus, paradoxically, North Korean nuclear weapons present a danger to the world but not much of a threat to the viability of South Korea. A major confrontation could temporarily roil South Korean financial markets – although the last confrontation, which was severe, did not even do that.

Unification?

Koreans, northern and southern alike, are obsessed with reunification. Koreans have a far longer history of national unity than Germany, are much more homogeneous than Germans, and

far more patriotic than Germans. Pyongyang's most potent political weapons against the South have always been calls for quick reunification. South Korean students demonstrate violently for unification and occasionally take horrible risks in unification's name.

North Korea has long called for instant political unification, through a national convocation that would effectively allow the North to control the process of unification and the structure of the unified nation. South Korea, on the other hand, has called for gradually increasing contacts, beginning with such things as reuniting of separated families and economic intercourse. The latter scenario would allow South Korea's superior standard of living and superior freedoms to subvert the North. As long as the two regimes were both strong, there was a standoff on reunification as on everything else. But on this dimension, as on all others, South Korean economic and political superiority have yielded a potentially decisive advantage.

North Korea's internal stability and legitimacy have rested on its leaders' claims that it was a workers' state which provided a superior society, and that it was the only true representative of Korean nationalism as against a South Korea that was effectively colonized by the United States. In the face of South Korea's vastly superior standard of living and rising international stature, these claims were sustainable only by cutting North Koreans off from all knowledge of the rest of the world – an exaggerated version of the old Hermit Kingdom policy.

Breaking the seal

The first real breaches of the hermetic seals came with Red Cross talks in the early 1970s. Only a few members of the North Korean political/intelligence elite were allowed to venture into South Korea, but they were surprised by what they saw. At a 1980 South Korean conference on strategies of reunification, Lee Hong-Koo, currently prime minister of South Korea, described to some of us participants the early North Korean reactions: It must have been a lot of trouble, said one North Korean delegate looking at Seoul's traffic jams, to import all those cars to impress us. Yes, replied a South Korean delegate, and it took a lot more effort to import all the tall buildings.

Throughout the 1980s, many North Korean students studied in Beijing and were amazed by the relative prosperity and freedom of China's people. Since China during the late Mao Zedong era had been so similar to North Korea in totalitarian politics and socialist economic failure, the awareness of China's reformist success was particularly damaging to North Korean morale.

Later a further breach occurred as South Korean scholars began to meet their Northern counterparts at conferences in Beijing. By the early 1990s, the South Koreans reported that the Northern professors were tabling papers that professed the official line but making speeches that said quite different, politically incorrect things. Pyongyang's loss of control over some of its most respected intellectuals illuminated ideological decline in the North.

Later still, North Korea, desirous of earning desperately needed foreign exchange, began to allow some visits by South Koreans to Pyongyang in order to make contact with long-lost relatives. Initially the relatives had to leave their villages and journey to Pyongyang, but later some South Koreans were allowed, in return for more cash, to visit relatives outside Pyongyang. More contacts occurred through Northern-oriented Koreans in Japan and through the opening of minor trade. The ideological vacuum seal was broken. Knowledge of the horrible conditions in the North consolidated political opinion in the South. And the glimmerings that South Koreans had such a superior life began to shake confidence in key parts of North Korean society.

Now South Korean economic, military, diplomatic and social superiority, together with Northern economic and ideological decline, present the possibility that unification will occur on South Korean terms.

Fear of spasmodic unification

But what are those terms? The South Korean government fears and opposes a sudden, German-style reunification. That would mean a sudden flood of refugees from the North, together with a Southern responsibility to subsidize the welfare of a huge subsistence-level Northern population. They believe this would cause greater economic and social dislocation in Korea than occurred in Germany after reunification.

Favored scenario: political gradualism, economic boom

South Korea would prefer a gradual opening, in which trade and investment by the South maintained the stability of a declining North Korean regime. Rather than imposing a huge welfare burden on the South, this scenario would present southern firms with a huge population of some of the world's cheapest labor and cheapest land. The result could be a boom even greater than that which has occurred between Hong Kong and neighboring Shenzhen. (Shenzhen, a Chinese special economic zone just north of Hong Kong and about three times the size of Hong Kong, has experienced what may be history's most rapid economic takeoff and in the process helped lift the British colony rapidly to income levels higher than those of Britain itself.)

Can gradualism be ensured?

What are the chances of such an optimistic scenario? South Korea does possess some leverage – and some help. Unlike Germany, where East Germans were able to escape by the side door into Hungary and thence to West Germany, Korea has no side door. There are oceans on both sides, and the coasts can be effectively patrolled. Penetration across the demilitarized zone is virtually impossible except for a few individuals per year. South Korea has considerable wherewithal for propping up the Northern regime economically. Moreover, China does not want the embarrassment of a communist collapse on its frontier, and it must fear the rise of a unified Korea which would be one of the world's most powerful countries both economically and militarily. Likewise, Japan and Korea have long despised one another, and Japan does not want to see the rise of an immensely powerful, potentially hostile Korea. Both China and Japan would therefore be willing to use trade, investment and quite possibly aid to prop up the doddering North Korean regime. If it were successfully propped up, and if it were increasingly open to trade with a more successful South Korea, a wealthy Japan, and an avariciously reformist China, North Korean society would undoubtedly turn to very profitable putty in the hands of South Korean chaebols.

Other scenarios

There is a good chance for such a scenario but no absolute assurance. It is not difficult to write a scenario for the outbreak of internal strife in North Korea, followed by disintegration of the regime and eventual South Korean intervention at the invitation of some side – perhaps to ensure that nuclear capabilities stay out of the wrong hands.

While one cannot rule out such spasmodic scenarios, from an investment perspective one must add up the substantial probability that the favored gradualism scenario would work, the probability that a relatively sudden but peaceful unification could be accomplished without vastly more dislocation than occurred in Germany, and the probability that a more risky scenario would occur eventually but not for many years. Against this sum is the risk that some relatively exotic scenarios would occur in the short run. The balance of such probabilities is not unfavorable.

It is in fact imaginable that a sudden North Korean collapse could be handled without unbearable economic burdens on South Korea. The economic strain of German unification derived heavily from the West German government's political decision to vastly overvalue the East German currency and treat one Ostmark as if it were equal to one Deutschmark. This decision deprived the East of its natural cost advantage and forced the West to undertake vast subsidies of people, regions, and industries which were uncompetitive because they were artificially overpriced. While there would be no sudden

unification without strain, South Korea would not be under German-style pressure to overvalue the North Korean currency; the natural fit between southern technology, capital, and organization on one hand, and North Korean cheap land, labor and natural resources on the other, could rapidly create one of the world's great economic takeoffs.

Investment Perspective

South Korea's strategic situation has mirrored the Cold War. During the Cold War, investors in West Germany, and even investors in the United States, had to look over their shoulders at the awesome military standoff between NATO and the Warsaw Pact. These risks were real but manageable.

Ever since 1961, South Korea has presented the world with enormous investment opportunities in the shadow of a rather awesome military confrontation. Investors have always had to glance at the standoff on the demilitarized zone, but despite the huge forces there have been increasingly important elements of stability, strong trends favoring the South, and a powerful big power consensus in favor of peace. These structural features persist. Now they are supplemented on the positive side by trends toward economic unification and the emergence of some clear elements of reform in North Korea, and on the negative side by the risk of instability in North Korea and big power jockeying over the North Korean nuclear program. On balance, as in Germany a few years ago, the forces are still awesome but the risks still appear limited in relation to the opportunities.

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